

FSI INTERNATIONAL INC

Form 10-K

November 10, 2005

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**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**Form 10-K**

(Mark One)

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

**For the fiscal year ended August 27, 2005**

**or**

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

**For the transition period from        to**

**Commission File Number 0-17276**  
**FSI INTERNATIONAL, INC.**

*(Exact Name of Registrant as specified in its charter)*

**MINNESOTA**  
*(State or other jurisdiction of  
incorporation or organization)*

**41-1223238**  
*(I.R.S. Employer  
Identification No.)*

**3455 LYMAN BOULEVARD, CHASKA, MINNESOTA 55318-3052**

*(Address of principal executive offices and Zip Code)*

**Registrant's telephone number, including area code:**  
**(952) 448-5440**

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

**Securities registered pursuant to Section 12(g) of the Securities Exchange Act:**  
**Common Stock, no par value; Preferred Share Purchase Rights**

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

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

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

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.    Yes ☐        No ☒

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Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based on the closing price on February 25, 2005, the last business day of the Registrant's most recently completed second fiscal quarter, as reported on the NASDAQ National Market System, was approximately \$135,944,000. Shares of common stock held by each officer and director have been excluded from this computation in that such persons may be deemed to be affiliates. This amount is provided only for purposes of this report on Form 10-K and does not represent an admission by the Registrant or any such person as to the status of such person.

As of October 31, 2005, the Registrant had issued and outstanding 29,883,000 shares of common stock.

### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Registrant's definitive proxy statement for the Annual Meeting of Shareholders to be held on January 24, 2006 and to be filed within 120 days after the Registrant's fiscal year ended August 27, 2005, are incorporated by reference into Part III of this Form 10-K Report. (The Audit and Finance Committee Report, the Compensation Committee Report and the stock performance graph of the Registrant's proxy statement are expressly not incorporated by reference herein.)

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**PART I**

**Cautionary Information Regarding Forward-Looking Statements**

Certain statements contained in this report on Form 10-K constitute forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and are 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, plan, believes, seeks, estimates, could, would or the negative of such terms or other comparable terminology. Such forward-looking statements are based upon current expectations and beliefs and involve numerous risks and uncertainties, both known and unknown, that could cause actual events or results to differ materially from those forward-looking statements. For a discussion of factors that could cause actual results to differ materially from those described in this Form 10-K, see the discussion of risk factors set forth below in Item 7 of this report. Although we believe that the expectations reflected in the forward-looking statements are reasonable as of the date of this report, we cannot guarantee future results, levels of activity, performance or achievements. We undertake no duty to update any of the forward-looking statements after the date of this report.

**ITEM 1. BUSINESS**

**The Company**

FSI International, Inc., a Minnesota corporation organized in 1973 ( FSI ), designs, manufactures, markets and supports equipment used in the fabrication of microelectronics, such as advanced semiconductor devices. In fiscal 2005, we provided Surface Conditioning technology solutions and POLARIS® system support services to worldwide manufacturers of integrated circuits.

The Surface Conditioning ( SC ) business manufactures, markets and supports equipment that uses wet, vapor, cryogenic and other chemistry techniques to clean, strip or etch the surfaces of silicon wafers. The POLARIS Systems and Services ( PSS ) business provides key services enabling customers to achieve a reasonable life for our legacy POLARIS Microlithography systems. Microlithography uses light to transfer a circuit pattern or image onto a silicon wafer. Our PSS products are used in the microlithography process to deposit light-sensitive material onto the surface of a wafer and also to develop the image in the photosensitive material. These businesses are supported by service groups that provide finance, human resources, information services, sales and service, marketing and other administrative functions.

In fiscal 2005, our products were directly sold and serviced by us in North America, Europe, and the Asia Pacific region. In addition, our products are sold and serviced in Japan through our affiliate, m FSI, LTD. Prior to March 1, 2003, our products in Europe and Asia Pacific were distributed primarily through Metron Technology, N.V. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information regarding the termination of the Metron Technology distribution agreements.

**Industry Background**

The complex process of fabricating semiconductor devices involves several distinct phases that are repeated numerous times. Because each production phase typically requires different processing technologies and equipment, no one semiconductor equipment supplier currently produces all types of tools needed to equip an entire state-of-the-art fabrication facility. Instead, semiconductor device manufacturers typically equip their facilities by combining manufacturing equipment produced by a number of suppliers. Each set of equipment performs specific functions in the manufacturing process.

Generally, increasing demand for computer chips, new computer chip designs, new materials of fabrication and new substrate (the underlying material upon which a semiconductor device or integrated circuit is formed) types both size and composition drives demand for new microelectronics

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manufacturing equipment and processes. Industries that use microelectronics increasingly demand higher performance devices from manufacturers. Over the last decade, device manufacturers have reduced the feature size and substantially increased the functionality of individual devices through a number of technological advances. Many of these advancements are made possible using the equipment and technologies FSI provides to the semiconductor industry.

Our business depends upon the microelectronics manufacturers' capital equipment expenditures. Manufacturers' expenditures in turn depend on the current and anticipated market demand for products that use microelectronic devices. The microelectronics industry has been cyclical in nature and has experienced periodic downturns. Microelectronics manufacturers require equipment suppliers to take an increasingly active role in meeting the manufacturers' technology development and capital productivity requirements. Equipment suppliers satisfy this requirement by developing and supporting products and processes required to address the new trends in microelectronics manufacturing. These trends include development of smaller geometries, transition to new materials, migration to 300 millimeter ( mm ) wafers and wafer level packaging.

A number of semiconductor device manufacturers began the transition from 200 to 300mm diameter wafers in calendar 2000. Based upon a report published in September 2005 by the Gartner Group, a leading industry market research firm, the percentages of investment in semiconductor process equipment allocated by semiconductor manufacturers to 300mm capable products were approximately 26% in calendar 2001, 40% in calendar 2002, 52% in calendar 2003 and 57% in calendar 2004. Semiconductor manufacturers' investment in 300mm capable products is forecasted to be approximately 73% of their total equipment spending in calendar 2005 and 80% of their total equipment spending in calendar 2006.\*

The semiconductor equipment market has experienced a decline from calendar 2000 through 2004. According to the Gartner Group, purchases of semiconductor equipment by microelectronics manufacturers decreased 19% from \$47 billion in calendar 2000 to \$38 billion in calendar 2004. Based upon the most recent Gartner Group forecast, the semiconductor equipment industry is expected to further decline 12% in calendar 2005.\*

**Products**

The mix of products we sell has varied significantly from year to year. The following table sets forth, for the periods indicated, the amount of revenues and approximate percentages of our total revenues by our principal product lines:

	Fiscal Year Ended					
	August 27, 2005		August 28, 2004		August 30, 2003	
	(Dollars in thousands)					
Surface conditioning products	\$ 51,857	60.0%	\$ 56,579	49.5%	\$ 46,594	52.5%
POLARIS® Systems and Services						
products	8,764	10.2%	16,521	14.4%	20,173	22.7%
Spare parts and service	25,749	29.8%	41,304	36.1%	22,059	24.8%
	\$ 86,370	100.0%	\$ 114,404	100.0%	\$ 88,826	100.0%

**Surface Conditioning Products**

Our surface conditioning products perform etching and cleaning operations for:

front-end-of-line ( FEOL ) fabrication steps, where integrated circuits or transistors are formed in and on the substrate during the manufacturing process;

back-end-of-line ( BEOL ) fabrication steps, where metal wiring levels are formed on the surface of the wafer and are connected to the transistors; and

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wafer-level packaging surface preparation, including cleaning, etching and stripping functions necessary to fabricate solder bumps or other terminal structures needed to connect the chip to the circuit board.

In today's most advanced integrated circuit ( IC ) manufacturing, there are over 100 surface preparation steps. Many factors are considered when designing and optimizing a surface preparation process to meet a particular application need. These factors can include:

cleaning and etching goals, which are related to the removal of wafer contaminants and films;

selectivity goals, which are related to leaving desired films and structures intact; and

manufacturing goals, which are related to cost, productivity, safety and environmental concerns.

The priority of each factor in determining the final surface preparation process can vary widely across the approximately 100 different steps and depends on the contaminants that need to be removed, the materials that need to be preserved on the wafer surface, the dimensions of patterned features and overall process integration. This wide variety of requirements and priorities indicates there is no one surface preparation technology that can provide the optimal process for each surface preparation requirement. This is why FSI offers a range of technologies that allow us, with our customers, to select and optimize the best solution for each step. These technologies include batch spray, batch immersion and single wafer cryogenic aerosol.

**Spray Processing Systems.** Our spray processing systems, which include the MERCURY® and ZETA® Spray Cleaning Systems, are sophisticated surface conditioning systems that remove unwanted films and contaminations from the surface of semiconductor wafers at various stages in the microelectronic device fabrication process. Multiple cassettes that contain up to 26 wafers each are placed onto a turntable inside the system's process chamber. As the turntable rotates, dispense ports apply a chemical spray to the wafers' surfaces to dissolve and remove the undesirable films and contaminants. After chemical application, deionized water (ultrapure water that has been treated and is used to remove all possible contaminants from the surface of a silicon wafer such as ions, bacteria, silica, particles and dissolved metals) is sprayed on the wafer surfaces to rinse away the chemicals. Multiple chemical and rinse steps may be employed depending on the customer's specific application. The process sequence is completed with a dry step: a flow of nitrogen into the chamber dries the wafers and the chamber. Our sophisticated control system and chemical mixing manifold allows the user to define, control and monitor a variety of chemical mixtures, temperatures and sequences. This enables the user to rapidly develop new processes and utilize the systems for multiple applications.

Our batch spray systems achieve state-of-the-art performance and are well suited for applications that require removal of high levels of contamination. Through efficient use of chemicals and water along with small footprints, customers realize operational costs that can be lower than competing systems.

The MERCURY® System is a semi-automated batch spray processor designed for wafer sizes up to 200mm in diameter and process technologies through the 130 nanometers ( nm ) node. The system offers the benefits of low capital cost and low cost of ownership in a small footprint. The MERCURY System ranges in price from \$400,000 to \$1,100,000 depending on features.

The fully-automated ZETA® System, a batch spray processor, is currently available in configurations for both 200 and 300mm wafers. The advanced process controls, process capability and automation are ideal for leading technology nodes, particularly 130nm and below. Our ZETA products provide a reliable, automated environment to move wafers to and from the process chamber. This tool's eight-chemical flow system allows for a wide range of chemical blend ratios. The system is also available in a semi-automated configuration capable of processing 200mm or 150mm wafers. Our ZETA systems range in price from \$1,000,000 to \$2,800,000.

Subsequent generations of the ZETA System, have increased capabilities with the addition of new tool packages and processes. The FlashClean™ Advantage package, consisting of hardware, software and process advancements, enhances system productivity and performance by shortening process time and



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increasing throughput. The PlatNiStrip™ process for nickel platinum films is designed to help our customers implement salicide formation at the 65-nm technology node. The EcoBlend™ dilute acid process is a cost-effective and environmentally friendly method to remove post-ash residues for aluminum and tungsten interconnect applications.

To address our customers' desire for more environmentally benign processes, we supply an ozonated water generation module for use with our MAGELLAN, ZETA and MERCURY Systems. The use of ozone (a form of oxygen having three atoms to the molecule) in semiconductor processing is attractive because it uses only oxygen and water in the place of sulfuric acid and hydrogen peroxide mixtures and lowers costs by reducing chemical consumption, water usage and waste treatment.

**CryoKinetic Processing Systems.** Our ANTARES CryoKinetic (an energy transfer process used to remove non-chemically bonded particles from the surface of a microelectronic device) Cleaning System is a fully automated, single-wafer cleaning platform designed for 200 and 300mm wafers. These systems offer a field-proven history of removing surface particle defects and improving customer yields. The ANTARES system cleans using an all-dry non-chemically reactive method of removing defects from all surface types from the beginning to the end of the device manufacturing process. Of particular benefit to our customers is its inherent compatibility with new device materials and increasingly smaller device features.

CryoKinetic clean technology allows our customers to insert particle removal steps in the manufacturing line where previous or traditional wet cleaning and scrubber methods have been phased out due to their incompatibility with new materials and were found to cause watermark residue and surface charge defects. Implementing the CryoKinetic clean allows our customers to recover yield that would normally be lost by traditional approaches.

The ANTARES system is also available with the AspectClean™ process. The AspectClean process is a method of removing particle defects from front-end-of-line (FEOL) and back-end-of-line (BEOL) patterned structures without altering film properties or physically damaging the structures, which is becoming more critical in 65nm development programs and 90nm production ramps. Traditional methods of defect reduction have been phased out due to damage issues, where as this process is demonstrating high removal efficiency on sensitive narrow structures without causing damage.

We believe the technical capabilities of the ANTARES system are extendable well beyond current technology nodes and will result in increased customer acceptance due to the limitations of aforementioned scrubbing methods.\* ANTARES systems range in price from \$1,200,000 to \$2,200,000.

**Vapor Processing Systems.** We are discontinuing the EXCALIBUR product line at the end of calendar year 2005. Changing market needs created a situation where the specialized use of the EXCALIBUR system was no longer required. FSI will retain the extensive portfolio of intellectual property patents as it relates to this technology.

**Immersion Processing Systems.** Immersion cleaning systems are used to clean silicon wafers by immersing wafers in multiple tanks filled with process chemicals. These systems enable the implementation of high performance isopropyl alcohol ( IPA ) assisted drying to meet the critical cleaning requirements for 90, 65, and 45nm technology nodes. Our MAGELLAN Immersion Cleaning System is a fully automated immersion cleaning system designed for either 200 or 300mm wafers at advanced technology nodes and is capable of multiple mainstream cleans, including critical clean, resist strip and etch. It is differentiated from the competition through its process performance, flexibility, extendibility, and rapid cycle time in a footprint that is up to 40% smaller than the leading competition when configured for specific applications. The tool incorporates a portfolio of exclusive intellectual property, including our Surface Tension Gradient (STG®) rinse/dry technology, SymFlow™ etch technology, ozone oxide re-growth technology, and narrow-gate-compatible MegaLens™ Acoustic Diffuser megasonic cleaning technology. The MAGELLAN System is qualified for several processes including FEOL critical clean, FEOL photoresist strip (an etch-resistant material used for transferring an image to the surface of a silicon wafer) and post-ash clean, oxide etch and nitride etch.

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In 2005, we expanded the MAGELLAN's maximum process module configuration from five to seven, thereby enabling optimal configurations for integrated cleaning and multi-function cleaning opportunities. In addition, we made numerous product enhancements to enable tool transition from research and development to high volume manufacturing. The MAGELLAN System ranges in price from \$2,000,000 to \$5,000,000.

*YieldUP Rinse Dry and Immersion Systems*. An end-of-life plan for our YieldUP systems has been initiated. See Item 3 Legal Proceedings for additional information on our ability to sell YieldUP 2100 modules. All YieldUP 2100 rinsing and drying modules will be shipped by February 18, 2006. The last shipments of YieldUP 2000 and 4000 stand-alone systems will be June 1 and July 31, 2006, respectively. YieldUP modules and systems range in price from \$170,000 to \$700,000.

### **PSS Products**

Our PSS products are microlithography products used to deposit photoresist, which is light-sensitive, etch-resistant material used to transfer an image to the surface of a silicon wafer and develop the photosensitive material. Following our announcement on March 17, 2003 to exit the resist process equipment market, we discontinued our active manufacture and sale of these products and established the PSS business to provide key support services to our global POLARIS customer base. PSS offers:

software maintenance, process applications support, engineering and equipment maintenance.

customer's robot refurbishment, system level and standard upgrades, systems operations and maintenance training and spare parts.

POLARIS Refresh Program™, in which customers can purchase certified POLARIS clusters (an integrated environmentally isolated manufacturing system consisting of process, transport, and cassette modules mechanically linked together) made of both new and pre-owned, re-qualified modules. This allows customers to add capacity for a lower capital investment. The ratio of new to pre-owned modules is based on customer expectations and the availability of used modules. These systems are able to accommodate a variety of processes and can be purchased in a new configuration, or a system can be reconfigured and upgraded to match installed configurations.

### **Spare Parts and Service**

We offer system upgrade packages, spare part kits, software maintenance licenses, individual spare part components and support services that provide product and process enhancements to extend the life of previously purchased and installed surface conditioning and microlithography equipment. Our customer service and process engineers assist and train customers worldwide to perform preventive maintenance on and to service our equipment. In addition, our process engineering groups develop process applications to expand the capabilities of our equipment. These upgrade and spare part packages and support service programs enable our worldwide customers to realize a higher return on their capital investment.

We sell a variety of process, service and maintenance programs. A number of customers have purchased maintenance contracts in which our service employees work at the customer's facility to provide process service and maintenance support for our equipment.

### **Backlog and Seasonality**

Our backlog consists of orders with delivery dates within the next 12 months for which a customer's purchase order has been received. Our backlog at fiscal 2005 year-end was \$19.3 million, at fiscal 2004 year-end was \$20.1 million and at fiscal 2003 year-end was \$25.6 million. Approximately 53% of our backlog at fiscal 2005 year-end and 52% of our backlog at fiscal 2004 year-end was comprised of orders from two customers for each year. Seagate Technology and Texas Instruments were the top two customers in backlog at the end of fiscal 2005. Samsung and Intel were the top two customers in backlog at the end of fiscal 2004. The loss of any of these customers could have a material adverse effect on our operations.

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All orders are subject to cancellation by the customer and in some cases a penalty provision could apply to a cancellation.

In fiscal 2005, purchase orders aggregating approximately \$3.1 million, constituting 3.6% of sales, were canceled and not rescheduled. In fiscal 2004, purchase orders aggregating approximately \$1.1 million, constituting 0.6% of sales, were canceled and not rescheduled. Because of the timing and relative size of certain orders received by us and possible changes in delivery schedules and order cancellations, our backlog can vary from time to time so that backlog as of any particular date is not necessarily indicative of actual sales for any subsequent period. Our business is not seasonal to any significant extent. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations for additional sales and backlog information.

### **Research and Development**

We believe that our future success depends in large part on our ability to enhance and advance, in collaboration with our customers and other equipment and materials manufacturers, our existing SC product lines to meet the changing needs of microelectronics manufacturers. We believe that industry trends, such as the use of smaller circuit geometries, increased use of larger substrates and manufacturers' increased desire for integrated processing equipment, will make highly automated and integrated systems, including single substrate processing systems, more important to customers. For assistance in our development efforts, we maintain relationships with our customers and others, who help identify and analyze industry trends and our development activities to meet the industry's advanced technology needs.

Our current research and development programs are focused on creating new processes and technologies for cleaning substrates without damaging ever smaller patterned features being used for the most advanced IC devices. We are also conducting programs to increase process control and flexibility through monitoring and software management systems and process automation, robotics automation in the cleanroom, and integration of our product offerings with other suppliers' products. Each of these programs involves collaboration with customers and other equipment manufacturers to ensure proper machine configuration and process development to meet industry requirements.

We maintain an 8,000-square-foot, state-of-the-art demonstration and process development laboratory for our Surface Conditioning business in our Chaska, Minnesota facility. In addition, our Japanese affiliate, m FSI, LTD, maintains a demonstration laboratory in its Okayama, Japan facility.

Expenditures for research and development, which are expensed as incurred, during fiscal 2005 were approximately \$22.1 million, representing 25.6% of total sales. Expenditures for research and development during fiscal 2004 were approximately \$22.5 million, representing 19.6% of total sales, and expenditures for research and development during fiscal 2003 were approximately \$31.1 million, representing 35.0% of total sales. The fiscal 2003 to fiscal 2004 decline relates primarily to our decision to exit the resist processing market in March 2003.

We expect to continue to make substantial investments in research and development.\* We also recognize the importance of managing product transitions successfully, as the introduction of new products could adversely affect sales of existing products.

### **Marketing, Sales and Support**

We market our products worldwide to manufacturers of microelectronic devices. Our marketing and sales efforts are focused on building long-term collaborative relationships with our customers. These efforts are supported by marketing, sales, and service personnel, along with applications engineers. These worldwide FSI teams work collaboratively with individual IC manufacturers, in FSI process laboratories and at customer sites, to transfer FSI developed product and process innovations, integrate them into customer process flows and optimize them according to customer priorities.

On October 9, 2002, we announced the early termination of our distribution agreements with Metron Technology, effective March 1, 2003. This change occurred as a result of our customers asking us to

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strengthen our presence in these regions and to bring them the full capabilities of our organization. We worked closely with Metron Technology to ensure a successful transition of sales, applications, service and spares logistical functions.

As of the end of fiscal 2005, our sales effort was supported by approximately 125 employees and contractors engaged in customer service and support. During fiscal 2005, our products were directly sold and serviced by us in North America, Europe and the Asia Pacific region, and through our joint venture, m FSI, LTD, in Japan.

We believe as a result of our direct selling and service initiative, we are experiencing broader product adoption in Europe and the Asia Pacific regions.\* By providing a full portfolio of direct support services, we have developed stronger customer relationships and our customers are beginning to show greater interest in expanding beyond their use of FSI traditional spray cleaning technologies to include new BEOL and wafer bumping applications for spray, as well as employing our advanced immersion and CryoKinetic technologies. Our increased responsiveness on the local level has resulted in more productive collaborative efforts and joint development programs with IC makers throughout the world for 90nm production and 65 and 45nm development projects.

International sales, in Europe and Asia accounted for approximately 64% of total sales in fiscal 2005, 47% of total sales in fiscal 2004, and 38% of total sales in fiscal 2003.

On August 16, 2004, Metron Technology entered into a Stock and Asset Purchase Agreement ( Purchase Agreement ) with Applied Materials, Inc. ( Applied ). On December 14, 2004, Applied, pursuant to the Purchase Agreement, acquired the worldwide operating subsidiaries and business of Metron Technology. Applied paid approximately \$84,567,000 in cash to Metron Technology upon closing on December 14, 2004. In connection with the consummation of the asset sale to Applied, Metron Technology changed its name to Nortem N.V. ( Nortem ) and began a liquidation process. Nortem was delisted from the NASDAQ on April 15, 2005 and began trading over-the-counter. Shareholders of Nortem received two liquidating distributions. The initial distribution was made on March 14, 2005 at \$3.75 per share. We received \$5.6 million and recorded a gain of \$4.2 million in the third quarter of fiscal 2005. In June 2005, we received the final distribution from Nortem, net of certain Dutch withholding taxes. A portion of the final distribution was deemed a dividend, and that portion was subject to withholding tax. The net distribution was approximately \$1.02 per share. We received \$1.5 million and recorded a gain of approximately \$1.6 million in the fourth quarter of fiscal 2005 related to this final distribution. We also recorded a receivable for approximately \$0.1 million for a refund of a portion of the Dutch withholding taxes.

We own a 49% equity interest in m FSI, LTD, a Japanese joint venture company formed in 1991 with MBK Project Holdings LTD. (formerly Mitsui & Co., LTD.) and its wholly owned subsidiary, Chlorine Engineers Corp., LTD. (collectively, Mitsui ). Mitsui owns a 51% equity interest in m FSI. In connection with its formation, we and Mitsui granted m FSI certain product and technology licenses and product distribution rights pursuant to a license agreement and a distribution agreement. m FSI also distributes products of other manufacturers and its own internally developed products. In September 2004, m FSI granted FSI exclusive rights to distribute certain of m FSI s products outside of Japan and an exclusive license covering the patents and related technology with regard to certain products for use outside of Japan.

In fiscal year 2003, the majority of our international sales were made to Metron Technology or m FSI for resale to end users of our products. In addition to Metron Technology (prior to the termination of our distribution agreements) and m FSI having a direct presence in Europe and Asia, we augmented their support to customers with sales and service personnel located in the regions. In some cases, we also sold directly to an international customer, in which case we paid a commission to our affiliated distributor in connection with the sale. When commissions are taken into account, the international sales to our affiliates are on terms generally no less favorable to us than international sales by us directly to non-affiliates.

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### **Manufacturing, Raw Materials and Suppliers**

We maintain manufacturing facilities in Chaska, Minnesota and Allen, Texas. We typically assemble our products and systems from components and prefabricated parts manufactured and supplied by others, such as process controllers, robots, integrated circuits, power supplies, stainless steel pressure vessels, chamber bowls, valves and relays. Certain of the items manufactured by others are made to our specifications. Typically, final assembly and systems tests are performed by our manufacturing personnel. Quality control is maintained through quality assurance programs with suppliers, incoming inspection of components, in-process inspection during equipment assembly, and final inspection and operation of manufactured equipment prior to shipment. We have a company-wide quality program in place and received ISO 9001 certification in 1994 and ISO 9000:2000 certification in 2003.

Certain of the components and subassemblies included in our products are obtained from a single supplier or a limited group of suppliers to ensure overall quality and delivery timeliness. Although we seek to reduce dependence on sole and limited-source suppliers, disruption or termination of certain of these sources could have a temporary adverse effect on our operations. We believe that alternative sources could be obtained and qualified to supply these products, if necessary, but that production delays would likely occur in some cases.\* Further, a prolonged inability to obtain certain components could have an adverse effect on our operating results, delay scheduled deliveries and result in damage to customer relationships.

### **Competition**

The semiconductor equipment industry is very competitive and marked by ever advancing technology challenges. Significant competitive factors in the equipment market include system price, which encompasses total cost of ownership, quality, process performance, reliability, flexibility, extendibility, integration with other products, process or tool of record, and customer support.

Many of our established competitors have greater financial, engineering, research, development, manufacturing, marketing, service and support resources. To remain competitive, we must invest in research and development, marketing, customer service and support programs, and must manage our operating expenses. There can be no assurance that we will have sufficient resources to continue to make these investments or that our products will continue to be viewed as competitive as a result of technological advances by existing or new competitors or due to changes in semiconductor technology.

Our surface conditioning products compete with, among others, DaiNippon Screen Manufacturing Co. Ltd., Kaijo Denki, S.E.S. Co., Ltd., Semitool, Inc., The SEZ Group, AKrion and Tokyo Electron Ltd. Our PSS organization competes with various small equipment refurbishment, equipment maintenance and spare parts providers.

### **Customers**

We sell products from one or more of our product lines to most major microelectronics manufacturers. We have an extensive history of sales to several of the largest integrated circuit manufacturers and we have over 100 active customers worldwide.

Texas Instruments accounted for approximately 14% of our total sales in fiscal 2005, 16% of our total sales in fiscal 2004 and 24% of our total sales in fiscal 2003. Samsung Electronics accounted for approximately 11% of our total sales in fiscal 2005 and less than 10% of our total sales in both fiscal 2004 and fiscal 2003. IBM accounted for less than 10% of our total sales in fiscal 2005 and fiscal 2004 and approximately 14% of our total sales in fiscal 2003. The loss of any of these customers could have a material adverse effect on our operations.

We have experienced, and expect to continue to experience, fluctuations in our customer mix.\* The timing of an order for our equipment is primarily dependent upon the customer's expansion program, replacement needs, or requirements to improve productivity and yields. Consequently, a customer who places significant orders in one year will not necessarily place significant orders in subsequent years.

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Sales to m FSI LTD, our international distributor, accounted for approximately 5% of our total sales in fiscal 2005. Sales to m FSI LTD and Metron Technology, our international distributors, accounted for approximately 13% of our total sales in fiscal 2004, and 17% of our total sales in fiscal 2003. Usually these systems are purchased for resale to device manufacturers. On October 9, 2002, we announced the termination of our distribution agreements with Metron Technology effective March 1, 2003. See Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information regarding the termination of the Metron Technology distribution agreements.

Under the m FSI distribution agreement, m FSI has exclusive distribution rights with respect to certain of our products in Japan. A licensing agreement allows m FSI to manufacture certain of our products. The agreements may be terminated only upon the occurrence of certain events or conditions or as otherwise mutually agreed. There is no obligation under the distribution agreement for m FSI to purchase a specified amount or percentage of our products. In September 2004, m FSI granted FSI exclusive rights to distribute certain products outside of Japan and FSI was granted an exclusive license covering the patents and related technology with regard to certain m FSI products for use outside of Japan.

### **Patents, Trademarks and Intellectual Property**

Our success depends upon a variety of factors, including proprietary technology. It is important to protect our technology by obtaining and enforcing patents. Consequently, we have an active program to file patent applications in the United States and other countries on inventions we consider significant. We also possess other proprietary intellectual property, including trademarks, know-how, trade secrets and copyrights. We also protect our proprietary information through confidentiality agreements with our employees and with third parties.

We have a number of patents in the United States and other countries, and additional applications are pending. These patents may be challenged, invalidated or circumvented, or may not provide any competitive advantages to us. Pending applications may not result in patents and the claims allowed in future patents may not be sufficiently broad to protect our technology. The laws of some foreign countries may not permit the protection of our proprietary rights to the same extent as under the laws of the United States. Although we believe that protection afforded by our patents, patent applications, and other intellectual property rights has value, because of rapidly changing technology, our future success is dependent on our employees' skill sets.

In the normal course of business, we from time to time receive and make inquiries about possible patent infringement. In dealing with such inquiries, it may be necessary or useful for us to obtain or grant licenses or other rights. However, there can be no assurance that such license rights will be available to us on commercially reasonable terms, or at all. The inability to obtain certain license or other rights, or to obtain such licenses or rights on favorable terms, or the need to engage in litigation could have a material adverse effect on us. See also Item 3 Legal Proceedings for a discussion of litigation.

Our microlithography POLARIS Cluster was offered by us under a non-exclusive license from Texas Instruments. We have converted the license to a fully paid-up, worldwide license to sell and manufacture the POLARIS Cluster. We also have the non-exclusive right to manufacture and sell related Texas Instruments modules. The license agreement continues until terminated. It may be terminated by either party upon a breach by the other party, and the failure to cure, in accordance with the terms of the agreement.

Our Surface Conditioning ANTARES CX Cleaning System is offered by us under license agreements from IBM. The licenses require certain minimum royalties and system-based royalties. Royalties are based on the royalty portion revenues of licensed equipment that excludes amounts for freight, taxes, customers' duties, insurance, discounts, and certain equipment not manufactured by us.

We have approximately 95 U.S. patents. Expiration dates range from April 2006 to December 2023.

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**Employees**

As of August 27, 2005, we had approximately 486 full and part-time employees. Competition for highly skilled employees is intense. We believe that a great part of our future success depends upon our continued ability to retain and attract qualified employees. We are not subject to any collective bargaining agreement and have never been subject to a work stoppage. We believe we have good relations with our employees.

**Environmental Matters**

In January 2003, we received our certificate of registration from BSI, Inc. for its ISO 14001 environmental management system. ISO 14001 is an internationally recognized environmental management standard that empowers organizations to address the environmental impact of activities, services and processes. The standard then provides a framework for enterprises to take steps to identify issues significant to them and implement environmental management programs to achieve improved performance. Registration with ISO 14001 allows companies to reaffirm that environmental processes are essential components of their business strategy. We have a long history of environmentally-friendly practices and research and development programs that actively seek out ways to operate more environmentally efficient. We registered with ISO 14001 to emphasize our ongoing commitment to the preservation and protection of the environment, and to support existing environmental health and safety initiatives.

We implemented an enterprise-wide program to actively engage our employees and to emphasize the importance of protecting the environment in everyday life at FSI. Our programs include recycling, water use reductions, chemical handling processes and equipment design for the environment.

We are subject to a variety of governmental regulations related to the discharge or disposal of toxic, volatile or otherwise hazardous chemicals used in the manufacturing and product development process. We believe we are in compliance with these regulations and that we have obtained all necessary environmental permits to conduct our business. These permits generally relate to the disposal of hazardous wastes. If we fail to comply with present or future regulations, fines could be imposed, production and product development could be suspended, or operations could cease. Such regulations could require us to acquire significant equipment or take other actions to comply with environmental regulations at a potentially significant cost to us. If we fail to control the use of, or adequately restrict the discharge or disposal of, hazardous substances, we could incur future liabilities. See also Item 3 Legal Proceedings for a discussion of our environmental legal proceedings.

We believe that compliance with federal, state and local provisions that have been enacted or adopted regulating discharges of materials into the environment, or otherwise relating to the protection of the environment, will not have a material effect upon our capital expenditures, earnings and competitive position.\*

**International Sales**

Our sales for each of the last three fiscal years are disclosed in the financial statements included in Item 8 of this report.

**Available Information**

Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934 are available free of charge through our website at [www.fsi-intl.com](http://www.fsi-intl.com) as soon as reasonably practicable after such reports have been filed with or furnished to the Securities and Exchange Commission.

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### **Other Risk Factors**

We discuss certain risk factors in the Risk Factors Section in Management's Discussion and Analysis of Financial Condition and Results of Operations included in Item 7 of this report.

### **ITEM 2. *PROPERTIES***

We own a 197,000-square-foot facility in Chaska, Minnesota, which cost approximately \$34 million to construct and equip. The facility contains our Surface Conditioning business and other administrative and support functions. It includes research, laboratory and engineering facilities, 40,000 square feet of Class 1,000 and 10,000 cleanroom space, manufacturing support operations and a customer training center.

In February 2005, we sold our 162,000 square foot Allen, Texas facility. Concurrent with the sale, we entered into a sublease of approximately 40,000 square feet of space in the facility. The lease ends on August 31, 2006; however, we have an option to extend the sublease term for one additional period of 12 months, by giving not less than 90 days prior written notice.

We also maintain small leased sales and service offices throughout Europe and Asia near our customer locations. Management believes its existing facilities are well maintained and in good operating condition.

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

We generate minor amounts of liquid and solid hazardous waste and use licensed haulers and disposal facilities to ship and dispose of such waste. In the past, we have received notice from state or federal enforcement agencies that we are a potentially responsible party ( PRP ) in connection with the investigation of several hazardous waste disposal sites owned and operated by third parties. In each matter, we have elected to participate in settlement offers made to all *de minimis* parties with respect to such sites. The risk of being named a PRP is that if any of the other PRP's are unable to contribute its proportionate share of the liability, if any, associated with the site, those PRP's that are financially able could be held financially responsible for the shortfall.

There has and continues to be substantial litigation regarding patent and other intellectual property rights in the microelectronics industry. Commercialization of new products or further commercialization of our current products could provoke claims of infringement by third parties. In the future, litigation may be necessary to enforce patents issued to us, to protect trade secrets or know-how owned by us or to defend us against claimed infringement of the rights of others and to determine the scope and validity of our proprietary rights. Any such litigation could result in substantial costs and diversion of effort by us, which by itself could have a material adverse impact on our financial condition and operating results. Further, adverse determinations in such litigation could result in our loss of proprietary rights, subject us to significant liabilities to third parties, require us to seek licenses from third parties or prevent us from manufacturing or selling one or more products, any of which could have a material adverse effect on our financial condition and results of operations.

Certain of our product lines are intended for use with hazardous chemicals. As a result, we are notified by our customers from time to time of incidents involving our equipment that have resulted in a spill or release of a hazardous chemical. We maintain product liability insurance in an effort to minimize our risk. However, in some cases it may be alleged that we or our equipment are at fault. There can be no assurance that any future litigation resulting from such claims would not have a material adverse effect on our business or financial results.

#### **Hsu Litigation**

In fall 1995, pursuant to the Employee Stock Purchase and Shareholder Agreement dated November 30, 1990 between Eric C. Hsu and Semiconductor Systems, Inc. ( SSI ) (the Shareholder Agreement ) and in connection with Mr. Hsu's termination of his employment with SSI in August 1995, the former shareholders of SSI purchased the shares of SSI common stock then held by Mr. Hsu. In



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April 1996, we acquired SSI, and SSI became our wholly owned subsidiary. In October 1996, Eric C. and Angie L. Hsu (the plaintiffs) filed a lawsuit in the Superior Court of California, County of Alameda, Southern Division, against SSI and the former shareholders of SSI. The plaintiffs alleged that such purchase breached the Shareholder Agreement and violated the California Corporations Code, breached the fiduciary duty owed plaintiffs by the individual defendants and constituted fraud.

In September and October 2000, certain of Mr. Hsu's claims were tried to a jury in Alameda County Superior Court in Oakland, California. At the conclusion of the trial, the jury found that SSI breached the Shareholder Agreement between it and Mr. Hsu and that the damages that resulted were approximately \$2.4 million. In addition, each of the individual defendant shareholders was found liable for conversion, and damages of \$4.2 million were awarded. Certain individual defendants were also found to have intentionally interfered with Mr. Hsu's prospective economic advantage and damages of \$3.2 million were awarded. Finally, several individual defendants and SSI were found to have violated certain provisions of the California Corporation Code and damages of \$2.4 million were awarded.

In proceedings subsequent to the trial, the Court determined that the plaintiffs were entitled to an award against SSI of prejudgment interest on the breach of contract damages (approximately \$2.4 million) at 10 percent per annum from October 1996. In addition, the Court awarded plaintiffs approximately \$127,000 in costs and approximately \$1.8 million in attorneys' fees against SSI and the individual defendants. On November 16, 2001, the court signed its final judgment reflecting the jury's awards, interest, attorneys' fees and costs assessed against each of the defendants.

Following the entry of judgment, SSI and the other defendants filed post-trial motions seeking reduction in the jury's damage awards and/or a new trial. The court denied these post-trial motions and there was no reduction in damages against SSI. Mr. Hsu was awarded an additional \$431,000 for attorneys' fees and expenses incurred since the judgment was rendered in November 2001. Subsequently, SSI and the individual defendants filed an appeal on a variety of grounds, and we posted an appeal bond on behalf of SSI and defendants in the amount of \$8.3 million. As part of the posting of the bond, we entered into a letter of credit in the amount of \$5.2 million with a surety company. This letter of credit was collateralized with restricted cash of the same amount. The appellate court upheld the original judgment.

The total judgment against SSI together with post judgment interest and attorneys' fees as of February 26, 2005 aggregated approximately \$7.9 million. As a result, we recorded a \$0.3 million charge in the second quarter of fiscal 2005. We had previously recorded \$3.3 million of charges to operations associated with this litigation. During the third quarter of fiscal 2005, we retired the 250,000 shares of our common stock held in the escrow created at the time of our acquisition of SSI to cover such claims. As the SSI merger was a pooling of interests, we decreased our stockholder's equity by an amount equal to \$3.0 million. On March 28, 2005, we tendered funds totaling approximately \$7.9 million to the Hsus via a cashier's check which we believe was the full judgment amount plus all applicable interest. This included \$1.6 million of cash provided by the individual defendants. Subsequently, instead of depositing the cashier's check, the Hsus filed a motion with the court to enforce the judgment against the appeal bond and we and the individual defendants filed a motion to release the bond. The Hsus cashed the cashier's check in July 2005. In August 2005, the court ruled in our favor and an acknowledgement of full satisfaction of the judgment was filed with the courts by the Hsus' attorneys. The bond was released in August 2005.

### **YieldUP Patent Litigation**

In September 1995, CFM Technologies, Inc. and CFMT, Inc. (collectively CFM) filed a complaint in United States District Court for the District of Delaware against YieldUP, now known as SCD Mountain View, Inc., our wholly owned subsidiary. CFM filed an additional complaint against YieldUP in United States District Court for the District of Delaware on December 30, 1998.

On January 3, 2001, Mattson Technology, Inc. (Mattson) completed the merger of the semiconductor equipment division of Steag Electronic Systems AG and CFM and established its wet

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products division. With the merger completed, Mattson assumed responsibility for the two suits CFM filed against YieldUP. On March 17, 2003, SCP Global Technologies ( SCP ) acquired the wet product division of Mattson, including CFM and assumed responsibility for the two lawsuits.

On February 19, 2004, FSI and SCP announced that they settled the two patent infringement lawsuits pending in the United States District Court for the District of Delaware. In an effort to settle these lawsuits, we acknowledged the validity and enforceability of the patents, but disputed that any of our products infringed upon the claims of the patents.

We agreed to pay SCP \$4.0 million for a release from past infringement claims and a prospective license under all four patents asserted against us in the two lawsuits. The release applies to all purchasers of our products containing its Surface Tension Gradient ( STG® ) technology. The prospective license applies to all end-user customers of our products, subject to certain limitations. In addition, we agreed to supply SCP customers, at a pre-established price, our rinse/dry kits to implement STG® technology for certain applications.

As a result, we recorded a \$3.4 million charge to operations in the second quarter of fiscal 2004. We had previously recorded a \$0.6 million charge to operations associated with this litigation. We have made payments of \$3.2 million as of August 27, 2005 and will make the final payment of \$750,000 in the second quarter of fiscal 2006.\*

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS**

There were no matters submitted to a vote of shareholders during the fourth quarter ended August 27, 2005.

**ITEM 4A. EXECUTIVE OFFICERS OF THE COMPANY**

The executive officers are elected by the board of directors, generally for a term of one year, and serve until their successor is elected and qualified. The following table and discussion contains information regarding our current executive officers.

<b>Name</b>	<b>Age</b>	<b>Position</b>
John C. Ely(1)	46	Vice President, Global Sales and Service
Patricia M. Hollister(2)	45	Chief Financial Officer and Assistant Secretary
Donald S. Mitchell(3)	50	Chairman and Chief Executive Officer
Benno G. Sand(4)	51	Executive Vice President, Business Development and Investor Relations and Secretary

- (1) John Ely was named Vice President of Global Sales and Service in June 2003. He was Executive Vice President; President, of our Surface Conditioning Division from August 2000 to June 2003. Mr. Ely was the Surface Conditioning Division's Sales/ Marketing/ Applications Manager from 1997 to 2000; General Manager from 1995 to 1997; Product Specialist/ Product Manager from 1989 to 1995; and in direct sales from 1985 to 1989. Prior to joining FSI, Mr. Ely was in sales and was the Western Territory Manager based in California for Galtek, a subsidiary of Entegris, Inc.. Mr. Ely is a director of m FSI, LTD and SCD Mountain View, Inc, one of our subsidiaries.
- (2) Patricia Hollister has served as Chief Financial Officer since January 1998 and as Assistant Secretary since January 2000. She was our Corporate Controller from March 1995 to January 1998. Prior to joining FSI, Ms. Hollister was employed by KPMG LLP in Minneapolis, Minnesota where she served over 12 years on various audit and consulting engagements, most recently as a Senior Manager. Ms. Hollister is a director of various FSI-owned foreign subsidiaries as well as NVE Corporation.
- (3) Donald Mitchell was named Chief Executive Officer and President of FSI in December 1999 and became Chairman of the Board of Directors for FSI in January 2002. From its formation in 1998 until December 1999, he was President of Air Products Electronic Chemicals, Inc., located in Carlsbad, California, a division of



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1998, he served as President of Schumacher, a leading global chemical equipment and services supplier to the semiconductor industry. Throughout his career with Schumacher, he held various executive positions, including Vice President of Operations and Vice President of Sales and Marketing. Mr. Mitchell is a director of FSI and m FSI, LTD. Mr. Mitchell served as the 1999/2000 Chairman of the Board of Directors for Semiconductor Equipment and Materials International, a leading global industry trade association and was a member of the Board until July 2005.

- (4) Benno Sand has served as Executive Vice President, Business Development and Investor Relations since January 2000. He has served as Executive Vice President since January 1992 and Secretary since February 2002. Mr. Sand also served as Chief Administrative Officer from January 1998 to December 1999, as Chief Financial Officer from October 1990 to January 1998, and as Vice President of Finance from October 1987 to January 1992. Mr. Sand is a director of various FSI-owned United States and foreign subsidiaries as well as PPT Vision, Inc. and MathStar, Inc.

**PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

Our common stock is traded on the NASDAQ National Market System under the symbol FSII. The following table sets forth the highest and lowest sale prices each day, as reported by the NASDAQ-National Market System for the fiscal periods indicated:

	2005		2004	
	High	Low	High	Low
<b>Fiscal Quarter</b>				
First	\$ 5.56	\$ 3.86	\$ 6.67	\$ 4.35
Second	4.91	3.99	9.24	6.26
Third	4.77	3.22	8.70	4.70
Fourth	4.26	3.42	8.07	4.01

There were approximately 553 record holders of our common stock on October 25, 2005.

We have never declared or paid cash dividends on our common stock. We currently intend to retain all earnings for use in our business, and do not anticipate paying dividends in the foreseeable future.\*

**ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA**

The table that follows presents portions of our consolidated financial statements and are not complete. You should read the following selected consolidated financial data in conjunction with our Consolidated Financial Statements and the related Notes and with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report. The Consolidated Statement of Operations data for the years ended August 27, 2005, August 28, 2004 and August 30, 2003, and the Consolidated Balance Sheet data as of August 27, 2005 and August 28, 2004, are derived from our Consolidated Financial Statements that have been audited by KPMG LLP, independent registered public accounting firm, and are included elsewhere in this report. The Consolidated Statement of Operations data for the years ended August 31, 2002 and August 25, 2001 and the Consolidated Balance Sheet data as of August 30, 2003, August 31, 2002 and August 25, 2001 are derived from our audited consolidated financial statements which do not appear in this report. We changed our accounting for goodwill effective August 26, 2001 in accordance with Statement of Financial Accounting Standards SFAS No. 142, Goodwill and Other Intangible Assets. In addition, we changed our revenue recognition policy effective August 27, 2000, based upon guidance provided in SEC Staff Accounting Bulletin No. 101 (SAB 101),

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Revenue Recognition in Financial Statements. SAB 101 was amended in fiscal 2004 by SEC Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition.

The historical results presented below are not necessarily indicative of the results to be expected for any future fiscal year or fiscal period.

**Selected Historical Financial Data**

<b>Fiscal Year Ended</b>				
<b>August 27, 2005</b>	<b>August 28, 2004</b>	<b>August 30, 2003</b>	<b>August 31, 2002(3)</b>	<b>August 25, 2001(2)</b>

**(In thousands, excep**