

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 28, 2009

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

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.

YES NO

Indicate by a check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES 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 definitions of "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer (Do not check if a smaller reporting company)

Smaller Reporting Company

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

YES 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 – 31,636,000 shares outstanding as of December 30, 2009.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

| PART I. | <u>FINANCIAL STATEMENTS</u> | <u>PAGE NO.</u> |
|-----------------|---|------------------------|
| Item 1. | Condensed Consolidated Financial Statements (unaudited): | |
| | Condensed Consolidated Balance Sheets as of November 28, 2009 and August 29, 2009 | 3 |
| | Condensed Consolidated Statements of Operations for the quarters ended November 28, 2009 and November 29, 2008 | 5 |
| | Condensed Consolidated Statements of Cash Flows for the quarters ended November 28, 2009 and November 29, 2008 | 6 |
| | Notes to the Condensed Consolidated Financial Statements | 7 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 16 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 24 |
| Item 4. | Controls and Procedures | 24 |
| PART II. | <u>OTHER INFORMATION</u> | |
| Item 1. | Legal Proceedings | 25 |
| Item 1.A. | Risk Factors | 25 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 25 |
| Item 3. | Defaults upon Senior Securities | 25 |
| Item 4. | Submission of Matters to a Vote of Security Holders | 25 |
| Item 5. | Other Information | 25 |
| Item 6. | Exhibits | 26 |
| | <u>SIGNATURE</u> | 27 |

PART I. ITEM 1. FINANCIAL STATEMENTS

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED BALANCE SHEETS
 NOVEMBER 28, 2009 AND AUGUST 29, 2009
 (unaudited)
 (in thousands)

ASSETS

| | <u>November 28, 2009</u> | <u>August 29, 2009</u> |
|---|------------------------------|----------------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 4,877 | \$ 6,760 |
| Restricted cash | 444 | 818 |
| Trade accounts receivable, net of allowance for doubtful accounts of \$112 and \$125, respectively | 12,049 | 8,697 |
| Inventories | 22,064 | 21,171 |
| Other receivables | 2,836 | 2,624 |
| Prepaid expenses and other current assets | <u>1,715</u> | <u>1,710</u> |
| Total current assets | <u>43,985</u> | <u>41,780</u> |
| Property, plant and equipment, at cost | 73,492 | 74,657 |
| Less accumulated depreciation and amortization | <u>(58,683)</u> | <u>(59,510)</u> |
| Property, plant and equipment, net | 14,809 | 15,147 |
| Long-term securities | 4,458 | 4,458 |
| Investment | 460 | 460 |
| Other assets | <u>1,674</u> | <u>1,840</u> |
| Total assets | <u><u>\$ 65,386</u></u> | <u><u>\$ 63,685</u></u> |

(continued)

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
NOVEMBER 28, 2009 AND AUGUST 29, 2009
(continued)
(unaudited)
(in thousands)

LIABILITIES AND STOCKHOLDERS' EQUITY

| | November 28, 2009 | August 29, 2009 |
|---|----------------------|--------------------|
| Current liabilities: | | |
| Trade accounts payable | \$ 5,129 | \$ 3,170 |
| Accrued expenses | 6,679 | 6,972 |
| Customer deposits | — | 12 |
| Deferred profit | 2,458 | 2,362 |
| Total current liabilities | 14,266 | 12,516 |
| Long-term accrued expenses | 555 | 512 |
| 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; 31,636 shares issued and outstanding | 226,562 | 226,562 |
| Accumulated deficit | (177,646) | (177,591) |
| Accumulated other comprehensive loss | (1,136) | (1,027) |
| Other stockholders' equity | 2,785 | 2,713 |
| Total stockholders' equity | 50,565 | 50,657 |
| Total liabilities and stockholders' equity | \$ 65,386 | \$ 63,685 |

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS ENDED NOVEMBER 28, 2009 AND NOVEMBER 29, 2008
(unaudited)
(in thousands, except per share amounts)

| | November 28, 2009 | November 29, 2008 |
|--|----------------------|----------------------|
| Sales | \$ 14,617 | \$ 12,244 |
| Cost of goods sold | 8,050 | 7,617 |
| Gross margin | 6,567 | 4,627 |
| Selling, general and administrative expenses | 3,795 | 5,657 |
| Research and development expenses | 2,756 | 4,393 |
| Operating income (loss) | 16 | (5,423) |
| Interest expense | — | (17) |
| Interest income | 28 | 132 |
| Other (loss, net) | (83) | (20) |
| Loss before income taxes | (39) | (5,328) |
| Income taxes expense (benefit) | 16 | (11) |
| Net loss | \$ (55) | \$ (5,317) |
| Net loss per common share: | | |
| Basic | \$ 0.00 | (\$ 0.17) |
| Diluted | \$ 0.00 | (\$ 0.17) |
| Weighted average common shares – basic | 31,636 | 30,839 |
| Weighted average common shares – diluted | 31,636 | 30,839 |

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE QUARTERS ENDED NOVEMBER 28, 2009 AND NOVEMBER 29, 2008
(unaudited)
(in thousands)

| | November 28, 2009 | November 29, 2008 |
|--|----------------------|----------------------|
| OPERATING ACTIVITIES: | | |
| Net loss | \$ (55) | (\$ 5,317) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Stock compensation expense | 270 | 109 |
| Depreciation | 691 | 937 |
| Amortization | — | 61 |
| Gain on sales of fixed assets | (57) | |
| Changes in operating assets and liabilities: | | |
| Restricted cash | — | 113 |
| Accounts receivable | (3,352) | 3,505 |
| Inventories | (893) | (1,187) |
| Prepaid expenses and other assets | (51) | 10 |
| Trade accounts payable | 1,959 | 305 |
| Accrued expenses | (448) | (1,605) |
| Customer deposits | (12) | 3 |
| Deferred profit | 96 | (1,510) |
| Net cash used in operating activities | (1,852) | (4,576) |
| INVESTING ACTIVITIES: | | |
| Capital expenditures | (353) | (5) |
| Proceeds from sales of fixed assets | 57 | — |
| Decrease in restricted cash | 374 | — |
| Sale of marketable securities | — | 975 |
| Net cash provided by investing activities | 78 | 970 |
| FINANCING ACTIVITIES: | | |
| Principal payments on capital lease | — | (223) |
| Net cash used in financing activities | — | (223) |
| Effect of exchange rates on cash | (109) | 87 |
| Decrease in cash and cash equivalents | (1,883) | (3,742) |
| Cash and cash equivalents at beginning of period | 6,760 | 14,788 |
| Cash and cash equivalents at end of period | \$ 4,877 | \$ 11,046 |

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.

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 condensed consolidated financial 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 financial 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 29, 2009, 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 June 2009, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2009-01, *Generally Accepted Accounting Principles* (ASC Topic 105), which established the FASB Accounting Standards Codification (the Codification or ASC) as the official single source of authoritative U.S. generally accepted accounting principles (“GAAP”). All existing accounting standards are superseded. All other accounting guidance not included in the Codification is considered non-authoritative. The Codification also includes all relevant SEC guidance organized using the same topical structure in separate sections within the Codification.

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

Following the Codification, the Board will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

The Codification is not intended to change GAAP, however it changes the way GAAP is organized and presented. The Codification is effective for the Company's condensed consolidated financial statements as of and for the period ended November 28, 2009 and the principal impact on the financial statements is limited to disclosures as all future references to authoritative accounting literature will be referenced in accordance with the Codification. In order to ease the transition to the Codification, the Company is providing the Codification cross-reference alongside the references to the standards issued and adopted prior to the adoption of the Codification.

In December 2007, the FASB issued SFAS 141 (revised 2007) ("SFAS 141R"), "Business Combinations" (ASC Topic 805), and SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements" (ASC Topic 810), to improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements, respectively. The provisions of this guidance were effective for us beginning in the first quarter of fiscal 2010. The adoption did not have an impact on our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events" (ASC Topic 855). This guidance is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. The disclosure requirement under this guidance was effective for our annual reporting for our fiscal year ending August 29, 2009. We evaluated subsequent events through the date and time the financial statements were issued on January 8, 2010.

In October 2009, the FASB issued ASU No. 2009-13, "Revenue Recognition (ASC Topic 605) – Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force." This guidance modifies the fair value requirements of ASC subtopic 605-25, "Revenue Recognition – Multiple Element Arrangements" by allowing the use of the "best estimate of selling price" for determining the selling price of a deliverable. Using this guidance, a vendor is required to use its best estimate of the selling price when vendor specific objective evidence or third-party evidence of the selling price cannot be determined. In addition, the residual method of allocating arrangement consideration is no longer permitted. This guidance is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted and we adopted this guidance in the first quarter of fiscal 2010. The adoption did not have a material impact on our consolidated financial statements for the first quarter of fiscal 2010. The adoption may have a material impact in future fiscal quarters.

(2) Inventories

Inventories are summarized as follows (in thousands):

| | November 28, 2009 | August 29, 2009 |
|-----------------------------------|-----------------------------|-----------------------------|
| | <u> </u> | <u> </u> |
| Finished products | \$ 1,960 | \$ 3,013 |
| Work-in-process | 6,716 | 4,797 |
| Raw materials and purchased parts | 13,388 | 13,361 |
| | <u>\$ 22,064</u> | <u>\$ 21,171</u> |

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

(3) Accrued Expenses

Accrued expenses are summarized as follows (in thousands):

| | November 28, 2009 | August 29, 2009 |
|-----------------------|----------------------|--------------------|
| Salaries and benefits | \$ 2,073 | \$ 1,507 |
| Vacation | 1,193 | 1,157 |
| Realignment | 453 | 986 |
| Product warranty | 1,412 | 1,702 |
| Other | 1,548 | 1,620 |
| | <u>\$ 6,679</u> | <u>\$ 6,972</u> |

(4) Supplementary Cash Flow Information

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

| | Quarters Ended | |
|-----------------------|----------------------|----------------------|
| | November 28, 2009 | November 29, 2008 |
| Income taxes received | — | (\$ 17) |

(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. For the quarters ended November 28, 2009 and November 29, 2008, other comprehensive loss consisted of the foreign currency translation adjustment. The components of comprehensive loss are summarized as follows (in thousands):

| | Quarters Ended | |
|---|----------------------|----------------------|
| | November 28, 2009 | November 29, 2008 |
| Net loss | \$ (55) | (\$ 5,317) |
| Items of other comprehensive (loss) income: | | |
| Foreign currency translation | (110) | 87 |
| Comprehensive loss | <u>(\$ 165)</u> | <u>(\$ 5,230)</u> |

(6) Stock-Based Compensation

Stock-based compensation expense for new stock options granted or vested under the Company's stock incentive plans and employee stock purchase plan was reflected in the condensed consolidated statements of operations for the first quarter of each of fiscal 2010 and 2009 as follows (in thousands):

| | Quarters Ended | |
|-------------------------------------|----------------------|----------------------|
| | November 28, 2009 | November 29, 2008 |
| Cost of goods sold | \$ 26 | \$ 10 |
| Selling, general and administrative | 132 | 79 |
| Research and development | 112 | 20 |
| | <u>\$ 270</u> | <u>\$ 109</u> |

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

The fair value of each option grant 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. There were no options granted during the first quarter of fiscal 2010 and 5,000 options were granted in the first quarter of fiscal 2009.

The following assumptions were used to estimate the fair value of options granted during the first quarter of fiscal 2009 using the Black-Scholes option-pricing model:

| | <u>Quarter Ended November 29, 2008</u> |
|-------------------------|--|
| Stock options: | |
| Volatility | 71.0% |
| Risk-free interest rate | 2.2% |
| Expected option life | 5.4 |
| Stock dividend yield | — |

There were no options granted during the first quarter of fiscal 2010.

A summary of our option activity for the first quarter of fiscal 2010 is as follows (in thousands, except price per share and contractual term):

| | <u>Number of Shares</u> | <u>Weighted- average Exercise Price Per Share</u> | <u>Weighted- average Remaining Contractual Term</u> | <u>Aggregate Intrinsic Value</u> |
|-------------------------------------|-----------------------------|---|---|--|
| Outstanding as of August 29, 2009 | 3,399 | \$ 6.05 | | |
| Options granted | — | — | | |
| Options forfeited | (1) | 2.24 | | |
| Options expired | (53) | 6.38 | | |
| Options exercised | — | — | | |
| Outstanding as of November 28, 2009 | <u>3,345</u> | \$ 6.05 | 4.2 | \$ 277 |
| Exercisable as of November 28, 2009 | <u>2,934</u> | \$ 6.78 | 3.6 | \$ 47 |

A summary of the status of our unvested option shares as of November 28, 2009 is as follows (in thousands except fair value amounts):

| | <u>Number of Shares</u> | <u>Weighted-average Grant-Date Fair Value</u> |
|-------------------------------|-----------------------------|---|
| Unvested at August 29, 2009 | 471 | \$ 0.60 |
| Options granted | — | — |
| Options forfeited | (1) | 1.40 |
| Options vested | (59) | 1.05 |
| Unvested at November 28, 2009 | <u>411</u> | \$ 0.54 |

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

As of November 28, 2009, there was \$238,000 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 0.7 years. The total fair value of option shares vested during the first quarters of fiscal 2010 and fiscal 2009 was \$270,000 and \$109,000, respectively.

(7) Product Warranty

Warranty provisions and claims for the quarters ended November 28, 2009 and November 29, 2008 were as follows (in thousands):

| | <u>November 28, 2009</u> | <u>November 29, 2008</u> |
|--------------------------------------|------------------------------|------------------------------|
| Beginning balance – warranty accrual | \$1,702 | \$2,757 |
| Warranty provisions | (196) | 101 |
| Warranty claims | (94) | (416) |
| Ending balance – warranty accrual | <u>\$1,412</u> | <u>\$2,442</u> |

During the first quarter of fiscal 2010, the Company reversed \$345,000 of unused prior period warranty accruals associated with improved claims experience.

(8) Cost Reductions and Realignment

In the second quarter of fiscal 2009, the Company committed to a plan of additional cost reduction actions, including the reduction of headcount, salary reductions and scheduled plant shutdowns. The cost reduction actions were due to the Company continuing to be impacted by the global economic slowdown and in particular the reduced demand for the Company's products. A total of 111 positions were eliminated of which 37 were manufacturing positions, 37 were sales, service and marketing positions, 8 were administrative positions and 29 were engineering positions. Severance and outplacement costs, net of change in estimate, recorded in fiscal 2009 were allocated as follows: \$1,133,000 to selling, general and administrative expense, \$875,000 to research and development expense and \$604,000 to cost of goods sold.

The fiscal 2009 severance and outplacement costs are summarized as follows (in thousands):

| | <u>Amount Charged Fiscal 2009</u> | <u>Amount Paid through November 28, 2009</u> | <u>Accrual at November 28, 2009</u> |
|--|---|--|---|
| Selling, general and administrative expenses | \$ 1,133 | \$ 995 | \$ 138 |
| Research and development expenses | 875 | 706 | 169 |
| Cost of goods sold | 604 | 458 | 146 |
| Total | <u>\$ 2,612</u> | <u>\$ 2,159</u> | <u>\$ 453</u> |

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

(9) Long-term Securities

As of November 28, 2009, the Company had investments in ARS reported at a fair value of \$4.5 million after reflecting a \$0.2 million other than temporary impairment against \$4.7 million par value. The other than temporary impairment was recorded in fiscal 2008. The Company valued the majority of ARS 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 every 28 days through an auction process and at the end of each reset period, investors can sell or continue to hold the securities at par. There were no redemptions of the Company's ARS in the first quarter of fiscal 2010.

The \$4.7 million par value ARS held by the Company are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education and are classified as long-term. All of the ARS held by the Company continue to carry investment grade ratings and have not experienced any payment defaults. 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's ARS are classified as long-term assets. 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.

The Company categorizes its assets and liabilities into one of three levels based on the assumptions (inputs) used in valuing the asset or liability. Level 1 provides the most reliable measure of fair value, while Level 3 generally requires significant management judgment. The three levels are defined as follows:

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company valued its ARS based on level 3 inputs in which values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These level 3 inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the ARS.

(10) 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

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

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.

In October 2009, the Company entered into a settlement agreement with the Office of Export Enforcement for \$450,000. The Company began paying \$5,000 per month for ten months in November 2009. The remaining \$400,000 included in the settlement will be suspended for 12 months. If the Company does not commit any export violations during the 12-month period, it will be released from further payment, including the suspended \$400,000. As of November 28, 2009, the Company has accrued \$45,000 for payments to be made under the settlement agreement, which is reflected in other accrued expenses.

(11) Share Repurchase Plan

In October 2008, the Company authorized the repurchase of up to \$3 million of the Company's common stock to be effected from time to time in transactions in the public markets or in private purchases. The timing and extent of any repurchases will depend upon market conditions, the trading price of the Company's shares and other factors, subject to the restrictions relating to volume, price and timing of share repurchases under applicable law. The repurchase program may be modified, suspended or terminated at any time by the Company without notice. The Company did not repurchase any of its common stock during fiscal 2009 or the first quarter of fiscal 2010.

(12) Liquidity

As of November 28, 2009, the Company had \$9.8 million of cash, cash equivalents, restricted cash and marketable securities, of which \$4.5 million are classified as long-term due to the lack of liquidity of the ARS as discussed in Note 8. During the first quarter of fiscal 2010, the Company used approximately \$1.9 million for operations. During fiscal 2009, the Company used approximately \$10.1 million for operations, which included the liquidation of approximately \$2.4 million of life insurance investments. The cash usage in fiscal 2009 and the first quarter of fiscal 2010 was primarily related to funding operations.

In light of its financial condition, the Company recognized the need to reduce its use of cash and implemented a number of cost reduction steps in fiscal 2009. The Company's actions in fiscal 2009 are expected to lower the Company's annual operating expenses.

The Company currently does not have any revolving line of credit or other form of debt financing. If the economic environment does not improve in fiscal 2010, and, notwithstanding the Company's cash management initiatives, if more cash is needed to fund the Company than expected, the Company may need to take additional actions. These actions could include entering into a sale-leaseback arrangement for its facility in Chaska, Minnesota, entering into an asset-based lending arrangement, borrowing up to \$3.5 million against or liquidating its remaining life insurance investments of \$3.6 million and/or borrowing up to 50% against or selling some or all of its currently illiquid ARS, possibly at a loss, selling additional

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

equity or other cash generating actions. If the Company must engage in any of the foregoing cash generating actions, there is no assurance that any such actions will be available to the Company, particularly those relating to third-party financing arrangements. Further, there is no assurance on the amount of cash that may be generated as a result of these actions, or whether the amount of cash received will be sufficient to cover the Company's operating expenses at such time. The sale of additional equity would likely result in additional dilution to the Company's shareholders.

(13) Income Taxes

As of November 28, 2009 and August 29, 2009, the Company had \$0.6 million and \$0.5 million, respectively, of liabilities recorded related to unrecognized tax benefits. Included in the liability balance as of November 28, 2009 and August 29, 2009 are approximately \$0.5 million and \$0.4 million, respectively, of unrecognized tax benefits that, if recognized, will affect the Company's effective tax rate. Accrued interest and penalties on these unrecognized tax benefits were \$0.1 million as of both November 28, 2009 and August 29, 2009. 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. 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 2003. Income tax examinations that the Company may be subject to for the various state and foreign taxing authorities vary by jurisdiction.

The Company recorded income tax expense of \$16,000 in the first quarter of fiscal 2010 related primarily to foreign taxes. The Company recorded an income tax benefit of \$11,000 in the first quarter of fiscal 2009. The income tax benefit in fiscal 2009 related primarily to foreign taxes.

(14) Revenue Recognition Change

As discussed in Note 1, the Company elected early adoption of ASU No. 2009-13. The ASU was adopted on a prospective basis in the first quarter of fiscal 2010. Revenue arrangements entered into prior to the first quarter of fiscal 2010 continue to be accounted for under the Company's previous revenue recognition policy. As of the first quarter of fiscal 2010, revenue from multiple element arrangements is allocated among the separate accounting units based on the relative selling price of each deliverable. The Company recognizes the equipment revenue upon shipment and transfer of title. The equipment revenue is determined based on the estimated selling price which is determined by management's judgment. The other multiple elements include installation, service contracts and training. Equipment installation revenue is determined based on estimated service person hours to complete installation and 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 determined 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 determined 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.

The impact of the new revenue recognition policy was not material to the Company's consolidated financial statements.

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

(15) Other Sales Information

Geographic Information

International sales were approximately 54% of total sales in the first quarter of fiscal 2010 and approximately 76% of total sales in the first quarter of fiscal 2009. The basis for determining sales by geographic region is the location that the product is shipped to. Included in these percentages and the table below are sales to related parties. Sales by geographic area are summarized as follows (in thousands):

| | Quarters Ended | |
|---------------------|------------------------------|------------------------------|
| | November 28, 2009 | November 29, 2008 |
| Asia | \$ 5,688 | \$ 6,643 |
| Europe | 2,162 | 2,663 |
| Other | — | 2 |
| Total International | 7,850 | 9,308 |
| Domestic | 6,767 | 2,936 |
| | <u>\$ 14,617</u> | <u>\$ 12,244</u> |

South Korea accounted for 33% of total sales in the first quarter of fiscal 2010 and in the first quarter of fiscal 2009. In the first quarter of fiscal 2009, China accounted for 16% of total sales and Germany accounted for 11% of total sales.

Customer Information

The following summarizes significant customers comprising 10% or more of the Company's trade accounts receivable as of November 28, 2009 and August 29, 2009 and 10% or more of sales for the first quarters of fiscal 2010 and 2009, which includes sales through affiliates to end-users:

| | % of Trade Accounts Receivable as of | | % of Sales for the Fiscal Quarter Ended | |
|------------|---|----------------------------|--|------------------------------|
| | November 28, 2009 | August 29, 2009 | November 28, 2009 | November 29, 2008 |
| Customer A | 41% | 27% | 57% | 17% |
| Customer B | 16% | 22% | * | 15% |
| Customer C | * | 10% | * | * |
| Customer D | * | * | * | 16% |

* Trade accounts receivable from or sales to respective customer were less than 10% as of the end of or during the fiscal period.

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,” “believes,” “seeks,” “estimates,” “could,” “would,” or the negative of such terms or other comparable terminology. These forward-looking statements include, but are not limited to, expected annual cost savings; expected breakeven revenue level; expected cash flow revenue level; expected orders, expected revenues, expected financial results, expected cash usage and other expected financial performance for the second quarter of fiscal 2010. 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 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 investments 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 29, 2009. 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

Gartner, Inc. (“Gartner”), a leading equipment industry research group, in December 2009 revised its revenue forecasts for the semiconductor industry from that made in September 2009; Gartner now expects calendar 2009 worldwide semiconductor revenue to decrease 11.4 percent and semiconductor capital equipment spending to decrease 46.8 percent from the calendar 2008 levels. The September 2009 Gartner forecast projected calendar 2009 worldwide semiconductor revenue to decrease 17.0 percent and equipment spending to decrease 47.9 percent from the calendar 2008 levels.

Many semiconductor manufacturers are experiencing improved factory utilization rates. As a result, they are increasing their production capacity through equipment upgrades and technology conversions. The capacity expansions have primarily occurred at foundries that provide outsourcing services for logic device producers and microprocessor suppliers. Memory device manufacturer spending on equipment that enables technology advancement and increased productivity started to accelerate in the second half of calendar 2009 with a sustainable spending increase expected by industry analysts to continue in calendar 2010.*

As a result of the improving industry conditions Gartner recently forecasted that semiconductor revenues will grow 13.0 percent, to \$255 billion, in calendar 2010, from the expected \$225 billion level in 2009. Certain industry analysts expect demand for smart cell phones, personal computers and LED’s , along with higher chip unit prices to be key drivers for year-over-year growth. Gartner recently forecasted the equipment revenues will increase 56.3 percent in calendar 2010, to \$25.5 billion, from the expected \$16.3 billion level in calendar 2009. Certain industry analysts expect both logic and memory capacity additions to contribute to the year-over-year revenue increase.

Application of Critical Accounting Policies and Estimates

In accordance with 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 relative selling price of each deliverable. We recognize the equipment revenue upon shipment and transfer of title. The equipment revenue is determined based on the estimated selling price which is determined by management's judgment. The other multiple elements include installation, service contracts and training. Equipment installation revenue is determined based on estimated service person hours to complete installation and 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 determined 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 determined 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 trade 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.

Impairment 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. 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 may not be recoverable, we measure any impairment based on the fair value of the long-lived assets. Net long-lived assets amounted to \$14.8 million as of November 28, 2009.

In the first quarter of fiscal 2010, we did not generate positive cash flows from operations. If our long-term future plans do not yield positive cash flows in excess of the carrying amount of our long-lived assets, we would anticipate possible future impairments of those assets.*

Considerable management judgment is necessary in estimating future cash flows and other factors affecting the valuation of long-lived 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.

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 six months 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 quarter of fiscal 2010, we reversed \$345,000 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. The amounts of these provisions are based upon historical loss trends, inventory levels, physical inventory and cycle count adjustments, 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. In the first quarter of fiscal 2010, we recorded approximately \$400,000 of additional inventory provisions associated primarily with engineering design changes.

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 and analyzes 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 determined to be past due based on payment terms and are written off after management determines that they are uncollectible.

As of November 28, 2009, our accounts receivable included \$2.0 million attributable to a past due receivable with a customer in Asia. The customer has delayed payment due to their cash flow issues and lower than expected capacity utilization. Management is working on obtaining a letter of credit for the outstanding amount with expected payment in the second quarter of fiscal 2010.* Management still believes that this receivable is collectible and will continue to monitor the situation closely.*

Stock-Based Compensation

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 future awards or 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 for all 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 of such estimates may differ. The valuation allowance can also be impacted by changes in the tax regulations.

Significant judgment is required in determining unrecognized tax benefits. We have established accruals for unrecognized tax benefits using management's best judgment and adjust these accruals as warranted by changing facts and circumstances. A change in our accruals in any given period could have a significant impact on our results of operations for that period. The accrual for unrecognized benefits increased by \$43,000 for the first quarter of fiscal 2010 and decreased by \$93,000 for the first quarter of fiscal 2009.

FIRST QUARTER OF FISCAL 2010 COMPARED WITH FIRST QUARTER OF FISCAL 2009

The Company

The following table sets forth for the fiscal quarter indicated, certain income and expense items as a percent of our total sales.

| | Percent of Sales | |
|-------------------------------------|----------------------|----------------------|
| | November 28, 2009 | November 29, 2008 |
| First quarter ended: | | |
| Sales | 100.0 % | 100.0% |
| Cost of goods sold | 55.1 | 62.2 |
| Gross profit | 44.9 | 37.8 |
| Selling, general and administrative | 25.9 | 46.2 |
| Research and development | 18.9 | 35.9 |
| Operating income (loss) | 0.1 | (44.3) |
| Other (expense) income, net | (0.4) | 0.8 |
| Loss before income taxes | (0.3) | (43.5) |
| Income taxes expense (benefit) | 0.1 | (0.1) |
| Net loss | (0.4%) | (43.4%) |

Sales Revenues and Shipments

Sales revenues increased to \$14.6 million for the first quarter of fiscal 2010 as compared to \$12.2 million for the first quarter of fiscal 2009. The increase related primarily to improved industry conditions. International sales were \$7.8 million, representing 54% of total sales during the first quarter of fiscal 2010 and \$9.3 million, representing 76% of total sales, during the first quarter of fiscal 2009.

Shipments were \$14.6 million in the first quarter of fiscal 2010 as compared to \$9.6 million in the first quarter of fiscal 2009.

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

We currently expect second quarter of fiscal 2010 revenues to be between \$18 and \$20 million.* In order to achieve this revenue level, we will need to receive several system orders that can be shipped and recognized as revenue in the second quarter.*

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; the sales of inventory previously written down to zero; and the competitive pricing environment.

Gross margin as a percentage of sales was 44.9% for the first quarter of fiscal 2010 compared to 37.8% for the first quarter of fiscal 2009. The increase in gross margin was primarily related to improved manufacturing capacity utilization associated with the increase in shipments from \$9.6 million in the first quarter of fiscal 2009 to \$14.6 million in the first quarter of fiscal 2010.

Gross profit margins are expected to be 41% to 43% of revenues for the second quarter of fiscal 2010 due to mix of products sold.* We anticipate improved capacity utilization as a result of expected higher shipments as compared to the first quarter of fiscal 2010 and continued cost control.*

Selling, General and Administrative Expenses

Selling, general and administrative expenses were \$3.8 million in the first quarter of fiscal 2010 and \$5.7 million in the first quarter of fiscal 2009. The decrease related primarily to cost reduction initiatives associated with reductions in headcount taken in fiscal 2009.

We expect selling, general and administrative expenses in the second quarter of fiscal 2010 to be in the range of \$3.8 to \$4.0 million as we continue to focus on managing costs and supporting the expected higher revenue amount.*

Research and Development Expenses

Research and development expenses were \$2.8 million for the first quarter of fiscal 2010 and \$4.4 million for the first quarter of fiscal 2009. The decrease related primarily to cost reduction initiatives associated with reductions in headcount taken in fiscal 2009. During the first quarter we continued investing in the introduction of our ORION[®] Single Wafer Wet System, applications development and cost reduction efforts.

We expect research and development expenses to range from \$2.8 to \$3.0 million for the second quarter of fiscal 2010.* This reflects the engineering resources required to support customer demonstrations, evaluation tool placements and the ORION system introduction initiative.

Income Taxes

We recorded income tax expense of \$16,000 in the first quarter of fiscal 2010 and income tax benefit of \$11,000 in the first quarter of fiscal 2009, primarily related to foreign taxes in both periods.

Our net deferred tax assets on the balance sheet as of November 28, 2009 have been fully reserved for with a valuation allowance. We do not expect to significantly reduce 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 \$188 million, which will begin to expire in fiscal 2011 through fiscal 2030 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

Our net loss was \$55,000 in the first quarter of fiscal 2010 as compared to a net loss of \$5.3 million in the first quarter of fiscal 2009.

Assuming that we can achieve the projected revenues, gross margin and operating expense levels, we expect to report net income between \$0.5 and \$1.5 million in the second quarter of fiscal 2010.*

Liquidity and Capital Resources

Our cash, restricted cash, cash equivalents and marketable securities were approximately \$9.8 million as of November 28, 2009, a decrease of \$2.3 million from the end of fiscal 2009. The decrease was primarily due to \$1.9 million of net cash used for operations and \$0.4 million of capital expenditures.

As of November 28, 2009, we had investments in ARS reported at a fair value of \$4.5 million after reflecting a \$0.2 million other than temporary impairment against \$4.7 million par value. The other than temporary impairment was recorded in fiscal 2008. The ARS we hold are marketable securities with long-term stated maturities for which the interest rates are reset every 28 days through an auction process. There were no redemptions of our ARS in the first quarter of fiscal 2010.

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 26 to 34 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.

Accounts receivable increased \$3.4 million from the end of fiscal 2009. The increase in accounts receivable related primarily to an increase in shipments to \$14.6 million in the first quarter of fiscal 2010 as compared to \$12.5 million in the fourth quarter of fiscal 2009. The balance at the end of fiscal 2009 included \$2.0 million attributed to a past due receivable with a customer in Asia. The customer has delayed payment due to their cash flow issues and lower than expected capacity utilization. We are working on obtaining a letter of credit for the balance with expected payment in the second quarter of fiscal 2010. Accounts receivable will fluctuate quarter to quarter depending on individual customers' timing of shipping dates, payment terms and cash flow conditions. In certain situations, extended payment terms may be granted to customers.

Inventory was approximately \$22.1 million at November 28, 2009 and \$21.2 million at the end of fiscal 2009. The increase in inventory related primarily to an increase in work-in-process inventory associated with increased orders and the anticipation of future shipments.

Trade accounts payable increased to \$5.1 million as of November 28, 2009 as compared to \$3.2 million at the end of fiscal 2009. The increase in trade accounts payable related primarily to the timing of inventory receipts and payments to vendors.

As of November 28, 2009, our current ratio of current assets to current liabilities was 3.1 to 1.0, and working capital was \$29.7 million.

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

| <u>Contractual Obligations:</u> | Payments due by period | | | | |
|--|-------------------------------|------------------------------------|-------------------------|-------------------------|-------------------------------------|
| | <u>Total</u> | <u>Less than 1 Year</u> | <u>1-3 years</u> | <u>3-5 years</u> | <u>More than 5 years</u> |
| Operating lease obligations | \$ 916 | \$ 557 | \$ 328 | \$ 22 | \$ 9 |
| Purchase obligations | 5,551 | 5,551 | — | — | — |
| Royalty obligations | 163 | 163 | — | — | — |
| Other long-term commitments ⁽¹⁾ | <u>1,375</u> | <u>125</u> | <u>500</u> | <u>500</u> | <u>250</u> |
| Total | <u>\$ 8,005</u> | <u>\$ 6,396</u> | <u>\$ 828</u> | <u>\$ 522</u> | <u>\$ 259</u> |

⁽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 \$0.6 million of accruals for unrecognized tax benefits, as the timing of payments or reversals is uncertain.

Capital expenditures were \$353,000 in the first quarter of fiscal 2010, as compared to \$5,000 in the first quarter of fiscal 2009. We expect capital expenditures to be less than \$100,000 in the second quarter of fiscal 2010.* Depreciation for the second quarter of fiscal 2010 is expected to be between \$0.6 and \$0.7 million.*

In light of our financial condition, we implemented a number of cost reduction steps in fiscal 2009 to reduce our use of cash. Our cost reduction actions in fiscal 2009 are expected to lower our annual operating expenses by \$11 to \$12 million, which is expected to reduce our cash flow breakeven revenue level to approximately \$12 to \$14 million per quarter, depending on the gross margins and the timing of shipments and accounts receivable collections.* In addition, we plan to manage cash flows by reducing capital expenditures to less than \$500,000 in fiscal 2010 and to aggressively improve our working capital levels in the second half of fiscal 2010.*

We do not have any revolving line of credit or other form of debt financing. If the economic environment does not improve in early fiscal 2010 and, notwithstanding our cash management initiatives, more cash is needed to fund operations than expected, we may need to take additional actions.* These actions could include additional cost reduction measures and possible cash generating activities, including exploring a sale-leaseback arrangement for our Chaska, Minnesota facility, entering into an asset-based lending arrangement, borrowing up to \$3.5 million against or liquidating our remaining life insurance investments of \$3.6 million, borrowing up to 50% against or selling some or all of our currently illiquid ARS, possibly at a loss, or selling additional equity.* We can provide no assurance that any of these cash-generating activities will be available to us when needed, or if available, on such terms that will be acceptable or in sufficient amounts to cover our operating expenses at such time. The sale of additional equity would likely result in additional dilution to our shareholders.* In addition, without substantial available capital, we may be unable to take advantage of strategic opportunities as they arise, such as investments in or acquisitions of businesses, products or technologies.*

At the expected revenue and expense run rate, we anticipate being cash flow neutral from operations in the second quarter of fiscal 2010.* We believe that with existing cash, cash receipts, cash equivalents, marketable securities and internally generated funds, there will be sufficient funds to meet our currently projected working capital requirements, and to meet other cash requirements through at least fiscal 2010.* 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. 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

See Note 1 of the Notes to Condensed Consolidated Financial Statements.

ITEM 3. QUANTATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our cash flows and earnings are subject to fluctuations in foreign exchange rates due to investments in foreign-based subsidiaries. As of November 28, 2009, our investments included 100% interests in our Europe and Asia sales and service offices and a 20% interest in Apprecia Technology, Inc. (formerly known as m•FSI LTD), which operates as a distributor for us in Japan. We denominate the majority of our sales outside of the U.S. in U.S. dollars.

We have direct sales, service and applications support and logistics responsibilities for our products in Europe and the Asia Pacific region and 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 November 28, 2009, we had not entered into any hedging activities and our foreign currency transaction gains and losses for the first quarter of fiscal 2010 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 long-term debt. As of November 28, 2009, 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 annual impact on income (loss) before income taxes of a 1% change in short-term interest rates would be approximately \$98,000 based on cash, restricted cash, cash equivalents and marketable securities balances as of November 28, 2009.

As of November 28, 2009, our investment portfolio included ARS reported at a fair value of \$4.5 million after reflecting a \$0.2 million other than temporary impairment against \$4.7 million par value. The other than temporary impairment was recorded in fiscal 2008. The interest rates of our ARS are reset every 28 days through an auction process and at the end of each reset period, investors can sell or continue to hold the securities at par.

The ARS held by us are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. All ARS held by us are rated by the major independent rating agencies and carry investment grade ratings and have not experienced any payment defaults.

All of our ARS have experienced 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 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 and recorded an other than temporary impairment of approximately \$0.4 million as of August 28, 2008. Approximately \$0.1 million of this other than temporary impairment was reversed in fiscal 2009 associated with the redemption of approximately \$3.0 million ARS at par. If the issuers of the ARS 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 SEC 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

We are not subject to any material pending legal proceedings.

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 29, 2009.

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

(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)
- 3.5 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.

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]

DATE: January 8, 2010

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

INDEX TO EXHIBITS

| <u>Exhibit</u> | <u>Description</u> | <u>Method of Filing</u> |
|----------------|--|----------------------------|
| 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. |
| 3.5 | 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.

CERTIFICATIONS

I, Donald S. Mitchell, certify that:

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

Date: January 8, 2010

/s/ DONALD S. MITCHELL
 Donald S. Mitchell
 Chairman and CEO
 (Principal Executive Officer)

CERTIFICATIONS

I, Patricia M. Hollister, certify that:

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

Date: January 8, 2010

/s/ PATRICIA M. HOLLISTER
Patricia M. Hollister
Chief Financial Officer
(Principal Financial and Accounting Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002 (18 U.S.C. SECTION 1350)

In connection with the Quarterly Report of FSI International, Inc., a Minnesota corporation (the “Company”), on Form 10-Q for the quarter ended November 28, 2009 as filed with the Securities and Exchange Commission (the “Report”), each of the undersigned hereby certifies, pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350), that to the undersigned’s knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: January 8, 2010

/s/ Donald S. Mitchell
Donald S. Mitchell
Chairman, President and
Chief Executive Officer

/s/ Patricia M. Hollister
Patricia M. Hollister
Chief Financial Officer and
Assistant Secretary