FSI INTERNATIONAL INC
Form 10-Q
January 04, 2011

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

(Mark One)

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

For the quarterly period ended November 27, 2010

or

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

For the transition period from ____________________ to ____________________

Commission File Number: 0-17276

FSI INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

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

952-448-5440

(Registrant s telephone number, including area code)

N/A

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

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

þ YES o NO

Indicate by check mark whether the registrant 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).

o YES o NO

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

Large Accelerated Filer o	**Accelerated Filer þ**	**Non-accelerated Filer o (Do not check if a smaller reporting**	**Smaller Reporting Company o**

company)

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

o YES þ NO

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

Common Stock, no par value 38,554,000 shares outstanding as of December 30, 2010.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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PART I. ITEM 1. FINANCIAL STATEMENTS
FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
NOVEMBER 27, 2010 AND AUGUST 28, 2010
(unaudited)
(in thousands)
ASSETS

	November 27, 2010	August 28, 2010
Current assets:		
Cash and cash equivalents	$ 30,481	$ 34,365
Restricted cash	322	322
Trade accounts receivable, net of allowance for doubtful accounts of $112	14,370	18,935
Inventories	36,206	26,145
Other receivables	2,525	2,489
Prepaid expenses and other current assets	1,628	1,184
Total current assets	85,532	83,440
Property, plant and equipment, at cost	71,946	71,502
Less accumulated depreciation and amortization	(58,852)	(58,298)
Property, plant and equipment, net	13,094	13,204
Long-term securities	3,612	3,612
Investment	460	460
Other assets	1,613	1,582
Total assets	$ 104,311	$ 102,298

(continued)

See accompanying notes to condensed consolidated financial statements.

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FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
NOVEMBER 27, 2010 AND AUGUST 28, 2010
(continued)
(unaudited)
(in thousands)
LIABILITIES AND STOCKHOLDERS EQUITY

	November 27, 2010	August 28, 2010
Current liabilities:		
Trade accounts payable	$ 11,201	$ 8,396
Accrued expenses	5,366	8,020
Customer deposits	2,196	
Deferred profit	4,281	2,669
Total current liabilities	23,044	19,085
Long-term accrued expenses	421	410
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; 38,544 shares issued and outstanding	244,741	244,796
Accumulated deficit	(167,072)	(164,570)
Accumulated other comprehensive loss	(1,187)	(1,649)
Other stockholders equity	4,364	4,226
Total stockholders equity	80,846	82,803
Total liabilities and stockholders equity	$ 104,311	$ 102,298

See accompanying notes to condensed consolidated financial statements.

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FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE QUARTERS ENDED NOVEMBER 27, 2010 AND NOVEMBER 28, 2009
(unaudited)
(in thousands, except per share amounts)

	November 27, 2010	November 28, 2009
Sales	$ 10,880	$ 14,617
Cost of goods sold	5,709	8,050
Gross margin	5,171	6,567
Selling, general and administrative expenses	4,671	3,795
Research and development expenses	3,000	2,756
Operating (loss) income	(2,500)	16
Interest income	30	28
Other income (expense), net	(38)	(83)
Loss before income taxes	(2,508)	(39)
Income tax (benefit) expense	(6)	16
Net loss	$ (2,502)	$ (55)
Net loss per common share:		
Basic	($0.06)	($0.00)
Diluted	($0.06)	($0.00)
Weighted average common shares basic	38,544	31,636
Weighted average common shares diluted	38,544	31,636

See accompanying notes to condensed consolidated financial statements.

FSI INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE QUARTERS ENDED NOVEMBER 27, 2010 AND NOVEMBER 28, 2009
(unaudited)
(in thousands)

	November 27, 2010	November 28, 2009
OPERATING ACTIVITIES:		
Net loss	($2,502)	($55)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock compensation expense	187	263
Depreciation	585	691
Gain on sales of fixed assets		(57)
Changes in operating assets and liabilities:		
Accounts receivable	4,565	(3,352)
Inventories	(10,061)	(886)
Prepaid expenses and other assets	(511)	(51)
Trade accounts payable	2,806	1,959
Accrued expenses	(2,692)	(448)
Customer deposits	2,196	(12)
Deferred profit	1,612	96
Net cash used in operating activities	(3,815)	(1,852)
INVESTING ACTIVITIES:		
Capital expenditures	(476)	(353)
Proceeds from sales of fixed assets		57
Decrease in restricted cash		374
Net cash (used in) provided by investing activities	(476)	78
FINANCING ACTIVITIES:		
Change in common stock	(55)	
Net cash used in financing activities	(55)	
Effect of exchange rate changes on cash and cash equivalents	462	(109)
Decrease in cash and cash equivalents	(3,884)	(1,883)
Cash and cash equivalents at beginning of period	34,365	6,760
Cash and cash equivalents at end of period	$ 30,481	$ 4,877

See accompanying notes to condensed consolidated financial statements.

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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 28, 2010, 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.

(2) Inventories

Inventories are summarized as follows (in thousands):

	November 27, 2010	August 28, 2010
Finished products, including evaluation systems	$ 7,117	$ 4,238
Work-in-process	14,436	9,453
Raw materials and purchased parts	14,653	12,454
	$ 36,206	$ 26,145

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

(3) Accrued Expenses

Accrued expenses are summarized as follows (in thousands):

	November 27, 2010	August 28, 2010
Salaries and benefits	$ 1,759	$ 1,028
Discretionary compensation and bonus	100	2,964
Vacation	1,117	1,055
Product warranty	1,121	1,127
Other	1,269	1,846
	$ 5,366	$ 8,020

(4) 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 27, 2010 and November 28, 2009, other comprehensive loss consisted of foreign currency translation adjustments. The components of comprehensive loss are summarized as follows (in thousands):

	Quarters Ended	
	November 27, 2010	November 28, 2009
Net loss	($2,502)	($55)
Items of other comprehensive income (loss):		
Foreign currency translation	462	(110)
Comprehensive loss	($2,040)	($165)

(5) 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 2011 and 2010 as follows (in thousands):

	Quarters Ended	
	November 27, 2010	November 28, 2009
Cost of goods sold	$ 22	$ 18
Selling, general and administrative	122	133
Research and development	43	112
	$ 187	$ 263

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 quarters of fiscal 2011 and 2010.

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

A summary of our option activity for the first quarter of fiscal 2011 is as follows (in thousands, except price per share and contractual term):

	Number of Shares	Weighted-average Exercise Price Per Share	Weighted-average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding as of August 28, 2010	3,146	$ 5.02		
Options granted				
Options forfeited				
Options expired	(1)	$ 8.56		
Options exercised				
Outstanding as of November 27, 2010	3,145	$ 5.02	4.7	$ 1,037
Exercisable as of November 27, 2010	2,508	$ 5.67	3.6	$ 529

A summary of the status of our unvested option shares as of November 27, 2010 is as follows (in thousands, except fair value amounts):

	Number of Shares	Weighted-average Grant-Date Fair Value
Unvested at August 28, 2010	730	$ 1.55
Options granted		
Options forfeited		
Options vested	(93)	1.25
Unvested at November 27, 2010	637	$ 1.59

As of November 27, 2010, there was $864,000 of total unrecognized compensation cost related to unvested share-based compensation granted under our plans. That cost is expected to be recognized over a weighted-average period of 1.2 years. The total fair value of option shares vested during the first quarters of fiscal 2011 and fiscal 2010 was $187,000 and $263,000, respectively.

(6) Product Warranty

Warranty provisions and claims for the quarters ended November 27, 2010 and November 28, 2009 were as follows (in thousands):

	November 27, 2010	November 28, 2009
Beginning balance warranty accrual	$ 1,127	$ 1,702
Warranty provisions	384	(196)

Warranty claims		(390)		(94)
Ending balance warranty accrual	$	1,121	$	1,412

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

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

(7) Marketable Securities and Fair Value Measurements

As of November 27, 2010, the Company had investments in auction rate securities (ARS) reported at a fair value of $3.6 million after reflecting a $0.2 million other than temporary impairment against $3.8 million par value. The other than temporary impairment was recorded in fiscal 2008. The Company valued the majority of its 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. However, the Company valued certain ARS based on the price at which the issuer offered to repurchase such ARS in a conditional tender offer received by the Company in October 2008 from the issuer.

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. Due to the liquidity issues experienced in global credit and capital markets, the ARS held by the Company have experienced multiple failed auctions, beginning on February 19, 2008, as the amount of securities submitted for sale has exceeded the amount of purchase orders. During the second quarter of fiscal 2008, the Company reclassified $8.5 million of ARS from current marketable securities to long-term marketable securities on the Consolidated Balance Sheet due to difficulties encountered at auction and the conditions in the general debt markets creating uncertainty as to when successful auctions may be reestablished.

The $3.8 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. 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 cash and cash equivalents and restricted cash based on level 1 inputs.

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.

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

The fair value measurements as of November 27, 2010 of cash and cash equivalents, restricted cash and marketable securities are summarized below (in thousands):

	Fair Value	Level 1	Level 2	Level 3
Cash and cash equivalents	$30,481	$30,481		
Restricted cash	322	322		
Marketable securities	3,612			$3,612

(8) Contingencies

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

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

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

In October 2009, the Company entered into a settlement agreement with the Office of Export Enforcement for $450,000. The Company paid $5,000 per month for ten months beginning in November 2009. The remaining $400,000 owed under the settlement was suspended for 12 months. The 12 month suspension period expired October 29, 2010. The Company believes it has maintained compliance with all export laws during the suspension period and does not anticipate any additional payments.

(9) 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 2010 or the first quarter of fiscal 2011.

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

(10) Income Taxes

As of November 27, 2010 and August 28, 2010, the Company had $421,000 and $410,000, respectively, of liabilities recorded related to unrecognized tax benefits. Included in the liability balance as of November 27, 2010 and August 28, 2010 are approximately $376,000 and $360,000, 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 $44,000 as of November 27, 2010 and $49,000 as of August 28, 2010. 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 benefit of $6,000 in the first quarter of fiscal 2011 related primarily to foreign taxes. The Company recorded an income tax expense of $16,000 in the first quarter of fiscal 2010, primarily related to foreign taxes.

(11) Stock Offering

The Company filed a shelf registration statement with the SEC on March 30, 2010 to register an indeterminate number of shares of common stock, preferred stock, warrants and units, the aggregate initial offering price of which is not to exceed $50 million. On June 14, 2010, the Company closed on a public offering of 6.2 million shares of its common stock at a public offering price of $3.05 per share. Net proceeds from the sale of the shares, after underwriter discounts and commissions and other offering expenses, were approximately $17.6 million. Following the June 2010 stock offering, the Company has registered under its shelf registration statement an indeterminate number of shares of common stock, preferred stock, warrants and units with an aggregate initial offering price not to exceed $31 million.

(12) Other Sales Information

Geographic Information

International sales were approximately 77% of total sales in the first quarter of fiscal 2011 and approximately 54% of total sales in the first quarter of fiscal 2010. 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 27, 2010	**November 28, 2009**
Asia	$ 3,034	$ 5,688
Europe	5,298	2,162
Other	6	
Total International	8,338	7,850
Domestic	2,542	6,767
	$ 10,880	$ 14,617

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

Singapore accounted for 20%, France accounted for 18%, Germany accounted for 13% and Italy accounted for 10% of total sales in the first quarter of fiscal 2011. South Korea accounted for 33% of total sales in the first quarter of fiscal 2010.

Customer Information

The following summarizes significant customers comprising 10% or more of the Company s trade accounts receivable as of November 27, 2010 and August 28, 2010 and 10% or more of sales for the first quarters of fiscal 2011 and 2010, which includes sales through affiliates to end-users:

	% of Trade Accounts Receivable as of		% of Sales for the Fiscal Quarter Ended	
	November 27, 2010	August 28, 2010	November 27, 2010	November 28, 2009
Customer A	*	*	*	57%
Customer B	11%	17%	28%	*
Customer C	*	14%	*	*
Customer D	37%	19%	*	*
Customer E	*	11%	*	*
Customer F	16%	*	17%	*
Customer G	*	*	11%	*

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

FSI INTERNATIONAL, INC. AND SUBSIDIARIES

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

The information in this report, except for the historical information, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and is subject to the safe harbor created by that statute. Typically, we identify forward-looking statements by use of an asterisk *. In some cases, you can identify forward-looking statements by terminology such as expects, anticipates, intends, may, should, plans, seeks, estimates, could, would, or the negative of such terms or other comparable terminology. These statements ar 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 28, 2010. 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.

The Gartner Reports described in this document (the Gartner Report) represent data, research opinions or viewpoints published, as part of a syndicated subscription service, by Gartner, Inc. (Gartner), and are not representations of fact. Each Gartner Report speaks as of its original publication date (and not as of the date of this document) and the opinions expressed in the Gartner Reports are subject to change without notice.

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

Industry

In December 2010, Gartner forecasted that semiconductor revenues will grow 32 percent, to $300 billion, in calendar 2010, from $228 billion in calendar 2009.*

Industry analysts, including Gartner, expect demand for smart cell phones, media tablets and LED s to be key contributors to the expected calendar 2010 and calendar 2011 year-over-year growth. In its December 2010 forecast, Gartner expects semiconductor revenue to increase 5 percent to $314 billion in calendar 2011.*

Gartner forecasted in December 2010 that capital equipment spending will increase 131 percent in calendar 2010 to $38 billion, from the $17 billion level in calendar 2009.* Gartner expects capital equipment spending to remain relatively flat at $38 billion in calendar 2011.*

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.

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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.

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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. We recorded approximately $300,000 in the first quarter of fiscal 2011 and $400,000 in the first quarter of fiscal 2010 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.

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 $11,000 for the first quarter of fiscal 2011 and $43,000 for the first quarter of fiscal 2010.

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FIRST QUARTER OF FISCAL 2011 COMPARED WITH FIRST QUARTER OF FISCAL 2010

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	
First quarter ended:	**November 27, 2010**	**November 28, 2009**
Sales	100.0%	100.0%
Cost of goods sold	52.5	55.1
Gross profit	47.5	44.9
Selling, general and administrative	42.9	25.9
Research and development	27.6	18.9
Operating income (loss)	(23.0)	0.1
Other (expense) income, net	(0.1)	(0.4)
Loss before income taxes	(23.1)	(0.3)
Income taxes expense (benefit)	(0.1)	0.1
Net loss	(23.0%)	(0.4%)

Sales Revenues and Shipments

Sales revenues decreased to $10.9 million for the first quarter of fiscal 2011 as compared to $14.6 million for the first quarter of fiscal 2010. The decrease related primarily to the timing of requested shipments by several of our major customers. International sales were $8.3 million, representing 77% of total sales during the first quarter of fiscal 2011 and $7.8 million, representing 54% of total sales, during the first quarter of fiscal 2010.

Shipments were $15.6 million in the first quarter of fiscal 2011 as compared to $14.6 million in the first quarter of fiscal 2010.

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.

Gross Margin

Our gross profit margin fluctuates due to a number of factors, including the mix of products sold; initial product placement discounts; utilization of manufacturing capacity; and the competitive pricing environment.

Gross margin as a percentage of sales was 47.5% for the first quarter of fiscal 2011 compared to 44.9% for the first quarter of fiscal 2010. The increase in gross margin was related to the mix of products sold and the improved manufacturing capacity utilization as a result of higher production levels.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $4.7 million in the first quarter of fiscal 2011 and $3.8 million in the first quarter of fiscal 2010. The increase in selling, general and administrative expenses related primarily to an increase in the number of service employees to support the increase in unit installations and support for product evaluations.

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Research and Development Expenses

Research and development expenses were $3.0 million for the first quarter of fiscal 2011 and $2.8 million for the first quarter of fiscal 2010. The increase related primarily to investments in our ORION® Single Wafer Wet System, applications development and cost reduction efforts.

Income Taxes

We recorded income tax benefit of $6,000 in the first quarter of fiscal 2011 and income tax expense of $16,000 in the first quarter of fiscal 2010, primarily related to foreign taxes in both periods.

Our net deferred tax assets on the balance sheet as of November 27, 2010 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 $171.0 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 $2.5 million in the first quarter of fiscal 2011 as compared to a net loss of $55,000 in the first quarter of fiscal 2010.

Liquidity and Capital Resources

Our cash, restricted cash, cash equivalents and marketable securities were approximately $34.4 million as of November 27, 2010, a decrease of $3.9 million from the end of fiscal 2010. The decrease was primarily due to $3.8 million of net cash used for operations and $0.5 million of capital expenditures.

As of November 27, 2010, we had investments in ARS reported at a fair value of $3.6 million after reflecting a $0.2 million other than temporary impairment against $3.8 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 2011.

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 25 to 33 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 decreased $4.6 million from the end of fiscal 2010. The decrease in accounts receivable related primarily to a decrease in shipments to $15.6 million in the first quarter of fiscal 2011 as compared to $29.1 million in the fourth 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 $36.2 million at November 27, 2010 and $26.1 million at the end of fiscal 2010. The increase in inventory related primarily to increases in all inventory categories associated with the shipment of demonstration tools and the building of product in anticipation of future shipments.

Trade accounts payable increased to $11.2 million as of November 27, 2010 as compared to $8.4 million at the end of fiscal 2010. The increase in trade accounts payable related primarily to the increase in inventory.

As of November 27, 2010, our current ratio of current assets to current liabilities was 3.7 to 1.0, and working capital was $62.5 million.

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

		Payments due by period			
Contractual Obligations:	**Total**	**Less than 1 Year**	**1-3 years**	**3-5 years**	**More than 5 years**
Operating lease obligations	$ 598	$ 413	$ 150	$ 35	$
Purchase obligations [1]	12,502	12,502			
Royalty obligations	193	193			
Other long-term commitments [2]	1,125	125	500	500	
Total	$ 14,418	$ 13,233	$ 650	$ 535	$

(1) Purchase obligations include purchase orders entered into in the ordinary course of business.

(2) 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 $0.4 million of accruals for unrecognized tax benefits, as the timing of payments or reversals is uncertain.

Capital expenditures were $476,000 in the first quarter of fiscal 2011, as compared to $353,000 in the first quarter of fiscal 2010.

We filed a shelf registration statement with the SEC on March 30, 2010 to register an indeterminate number of shares of common stock, preferred stock, warrants and units, the aggregate initial offering price of which is not to exceed $50 million. On June 14, 2010, we closed on a public offering of 6.2 million shares of our common stock at a public offering price of $3.05 per share. Net proceeds from the sale of the shares, after underwriter discounts and commissions and other offering expenses, were approximately $17.6 million. Following the June 2010 stock offering, we have registered under the shelf registration statement an indeterminate number of shares of common stock, preferred stock, warrants and units with an aggregate initial offering price not to exceed $31 million.

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 2011.* 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.*

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Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

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 27, 2010, our investments included 100% interests in our Europe and Asia sales and service offices and a 20% interest in Apprecia Technology, Inc., 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 27, 2010, we had not entered into any hedging activities and our foreign currency transaction gains and losses for the first quarter of fiscal 2011 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 27, 2010, 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 $344,000 based on cash, restricted cash, cash equivalents and marketable securities balances as of November 27, 2010.

As of November 27, 2010, our investment portfolio included ARS reported at a fair value of $3.6 million after reflecting a $0.2 million other than temporary impairment against $3.8 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 ARS, 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 2010 associated with the redemption of approximately $0.9 million ARS at par. 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.

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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 28, 2010.

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

None

ITEM 3. Defaults upon Senior Securities

None

ITEM 5. Other Information

None

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ITEM 6. Exhibits

(a) Exhibits

3.1	Restated Articles of Incorporation of the Company. (1)
3.2	Restated By-Laws. (1)
3.3	Articles of Amendment of Restated Articles of Incorporation (1)
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-3 filed with the SEC on March 30, 2010 and incorporated by reference.

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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 4, 2011

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

Exhibit	Description	Method of Filing
3.1	Restated Articles of Incorporation of the Company. (1)	Incorporated by reference.
3.2	Restated and amended By-Laws. (1)	Incorporated by reference.
3.5	Articles of Amendment of Restated Articles of Incorporation (1)	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.
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