ISCO INTERNATIONAL INC
Form 10-Q
May 13, 2005
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2005.

¨ **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For the transition period from ______ to ______

Commission file number: 000-22302

ISCO INTERNATIONAL, INC.

(Name of Registrant as Specified in Its Charter)

Delaware	**36-3688459**
(State or Other Jurisdiction of	**(I.R.S. Employer**

Incorporation or Organization)	**Identification No.)**
1001 Cambridge Drive, Elk Grove Village, Illinois **(Address of Principal Executive Offices)**	**60007** **(Zip Code)**

(847) 391-9400

(Registrant s Telephone Number, Including Area Code)

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 x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

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

Class	Outstanding at April 30, 2005
Common Stock, par value $0.001 per share	162,918,703
Preferred Stock Purchase Rights	

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ISCO INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2005	December 31, 2004
	(unaudited)	
Assets:		
Current Assets:		
Cash and cash equivalents	$ 839,153	$ 402,391
Inventories	1,319,958	969,048
Accounts receivable, net	829,272	122,460
Prepaid expenses and other	153,794	594,488
Total current assets	3,142,177	2,088,387
Property and equipment:		
Property and equipment	836,108	824,238
Less: accumulated depreciation	(664,846)	(638,968)
Net property and equipment	171,262	185,270
Restricted certificates of deposit	291,027	291,027
Goodwill	13,370,000	13,370,000
Intangible assets, net	1,057,264	1,051,320
Total assets	$ 18,031,730	$ 16,986,004
Liabilities and Stockholders Equity:		
Current liabilities:		
Accounts payable	$ 312,730	$ 202,613
Employee-related accrued liabilities	189,950	112,393
Accrued professional services	398,450	431,491
Other accrued liabilities	175,086	348,964
Total current liabilities	1,076,216	1,095,461
Notes and related accrued interest with related parties	9,935,994	8,642,908
Stockholders equity:		
Preferred stock; 300,000 shares authorized; No shares issued and outstanding at March 31, 2005 and December 31, 2004		
Common stock ($.001 par value); 250,000,000 shares authorized; 161,218,703 and 161,213,703 shares issued and outstanding at March 31, 2005 and December 31, 2004, respectively	161,219	161,214
Additional paid-in capital (net of unearned compensation)	164,403,260	164,149,827

Accumulated deficit	(157,544,959)	(157,063,406)
Total stockholders equity	7,019,520	7,247,635
Total liabilities and stockholders equity	$ 18,031,730	$ 16,986,004

NOTE: The condensed consolidated balance sheet as of December 31, 2004 has been derived from the audited financial statements for that date, but does not include all of the information and accompanying notes required by accounting principles generally accepted in the United States of America for complete financial statements.

See the accompanying Notes which are an integral part of the Condensed Consolidated Financial Statements.

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ISCO INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Net sales	$ 3,293,121	$ 421,950
Costs and expenses:		
Cost of sales	1,921,279	308,595
Research and development	346,511	233,989
Selling and marketing	366,391	223,539
General and administrative	851,401	1,233,550
Total costs and expenses	3,485,582	1,999,673
Operating loss	(192,461)	(1,577,723)
Other income (expense):		
Interest income	3,994	1,807
Non-cash interest expense		(250,297)
Interest expense	(293,086)	(131,445)
Other income (expense), net	(289,092)	(379,935)
Net loss	$ (481,553)	$ (1,957,658)
Basic and diluted loss per share	$ (0.00)	$ (0.01)
Weighted average number of common shares outstanding	161,217,259	154,233,040

See the accompanying Notes which are an integral part of the Condensed Consolidated Financial Statements.

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ISCO INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004
Operating Activities:		
Net loss	$ (481,553)	$ (1,957,658)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	38,615	209,373
Non-cash interest (warrant) expense		250,297
Non-cash compensation expense	252,739	48,705
Changes in operating assets and liabilities	(343,188)	273,706
Net cash used in operating activities	(533,387)	(1,175,577)
Investing Activities:		
Payment of patent costs	(18,681)	(13,231)
Acquisition of property and equipment	(11,870)	(16,111)
Net cash used in investing activities	(30,551)	(29,341)
Financing Activities:		
Exercise of warrants		2,000,000
Proceeds from loan	1,000,000	
Exercise of stock options	700	37,967
Net cash provided by financing activities	1,000,700	2,037,967
Increase in cash and cash equivalents	436,762	833,049
Cash and cash equivalents at beginning of period	402,391	346,409
Cash and cash equivalents at end of period	$ 839,153	$ 1,179,458

See the accompanying Notes which are an integral part of the Condensed Consolidated Financial Statements.

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ISCO INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1 - Basis of Presentation

The condensed consolidated financial statements include the accounts of ISCO International, Inc. and its wholly owned subsidiaries, Spectral Solutions, Inc. and Illinois Superconductor Canada Corporation (collectively referred to as the Company). All significant intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of results for the interim periods have been included. These financial statements and notes included herein should be read in conjunction with the Company s audited financial statements and notes for the year ended December 31, 2004 included in the Company s Annual Report on Forms 10-K and 10-K/A filed with the Securities and Exchange Commission. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for any subsequent quarter of for the entire year ending December 31, 2005. For further information, refer to the financial statements, including the notes thereto, included in the Company s Annual Report on Form 10-K/A for the fiscal year ended December 31, 2004.

Recent Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4. This statement amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) and requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal. The statement also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005 (as of January 1, 2006 for the Company) and are to be applied prospectively. The Company does not expect adoption of SFAS No. 151 to have a material effect on its results of operations or financial position.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). This statement requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Compensation cost is to be measured based on the estimated fair value of the equity-based compensation awards issued as of the grant date. The related compensation expense will be based on the estimated number of awards expected to vest and will be recognized over the requisite service period (often the vesting period) for each grant. The statement requires the use of assumptions and judgments about future events and some of the inputs to the valuation models will require considerable judgment by management.

SFAS No. 123(R) replaces FASB Statement No. 123 (SFAS No. 123), Accounting for Share-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. The provisions of SFAS No. 123(R) are required to be applied by public companies that do not file as small business issuers, as of the first interim or annual reporting period that begins after June

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15, 2005, and all other public companies as of the first interim or annual reporting period that begins after December 15, 2005. On April 14, 2005, the Securities and Exchange Commission (SEC) adopted a new rule amending the effective date for Statement 123(R). The amended rule allows registrants to implement Statement 123(R) as of the first annual period beginning after June 15, 2005, which is January 1, 2006 for the Company.

The Company intends to continue applying APB Opinion No. 25 to equity-based compensation awards until the effective date of SFAS No. 123(R). At the effective date of SFAS No. 123(R), the Company expects to use the modified prospective application transition method without restatement of prior interim periods in the year of adoption. This will result in the Company recognizing compensation cost based on the requirements of SFAS No. 123(R) for all equity-based compensation awards issued after the effective date of this statement with respect to the Company. For all equity-based compensation awards that are unvested as of that date, compensation cost will be recognized for the unamortized portion of compensation cost not previously included in the SFAS No. 123 pro forma footnote disclosure. The Company is currently evaluating the impact that adoption of SFAS No. 123(R) may have on its results of operations or financial position and expects that the adoption may or may not have a material effect on the Company s results of operations depending on the level and form of future equity-based compensation awards issued.

The Company has a stock-based employee compensation plan, which is more fully described in Note 5. The Company accounts for its stock-based compensation plan under Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation,* as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure,* which allows companies to apply the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees,* and provide pro forma net income and net income per share disclosures for employee stock option grants as if the fair value method defined in SFAS No. 123 had been applied. The Company applies the intrinsic value method for accounting for stock-based compensation as outlined in APB Opinion No. 25.

Stock expense for the first quarters of 2005 and 2004, respectively, includes the result of options issued with an exercise price below the underlying stock s market price. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123, using the assumptions described in Note 5, to its stock-based employee plans:

	Quarter Ended 2005	March 31, 2004
Net loss, as reported	$ 482	$ 1,958
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	252	49
Less: Total stock-based employee compensation determined under fair value based method for awards granted, modified, or settled, net of related tax effects	397	142
Pro forma net loss	$ 627	$ 2,051
Loss per share:		
Basic as reported	$ 0.00	$ 0.01
Basic pro forma	$ 0.00	$ 0.01
Diluted as reported	$ 0.00	$ 0.01
Diluted pro forma	$ 0.00	$ 0.01

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Note 2. Realization of Assets

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company has sustained substantial losses from operations in recent years, and such losses have continued through the (unaudited) quarter ended March 31, 2005. In addition, the Company has used, rather than provided, cash in its operations.

In view of the matters described in the preceding paragraph, recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon continued operations of the Company, which in turn is dependent upon the Company s ability to meet its operational and financing requirements on a continuing basis, to maintain present financing, and to succeed in its future operations. The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

The Company has incurred, and continues to incur, losses from operations. For the years ended December 31, 2004, 2003, and 2002, the Company incurred net losses of $7 million, $7.2 million, and $13 million, respectively. Although financial performance has improved, the Company incurred an additional net loss of $482,000 during the first three months of 2005. During those years the Company implemented strategies to reduce its cash used in operating activities. The Company s strategy included the consolidation of its manufacturing and research and development facilities and a targeted reduction of the employee workforce, increasing the efficiency of the Company s processes, focusing development efforts on products with a greater probability of commercial sales, reducing professional fees and discretionary expenditures, and negotiating favorable payment arrangements with suppliers and service providers. More importantly, the Company configured itself along an outsourcing model, thus allowing for relatively large, efficient production without the associated overhead. The combination of these factors has been highly effective in bringing the Company closer to profitability (from a net loss as high as $28 million during 2001) while enabling it to deliver significant quantities of solutions.

To date, the Company has financed its operations primarily through public and private equity and debt financings. Subject to the uncommitted nature of the credit line, the Company believes that it has sufficient funds to operate its business as identified herein and to meet its obligations into the third quarter 2005, and quite possibly beyond, depending on working capital and other requirements. The Company intends to continue to review available alternatives in the marketplace as it seeks to augment and/or replace its existing capital position through other sources of capital, whether debt, equity, or hybrid.

Note 3 - Net Loss Per Share

Basic and diluted net loss per share is computed based on the weighted average number of common shares outstanding. Common shares issuable upon the exercise of options are not included in the per share calculations since the effect of their inclusion would be antidilutive.

Note 4 - Inventories

Inventories consisted of the following:

	March 31, 2005	December 31, 2004
Raw materials	$ 220,000	$ 268,000
Work in process	72,000	150,000
Finished product	1,028,000	551,000
	$ 1,320,000	$ 969,000

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Cost of product sales for the three months ending March 31, 2005, and the twelve months ending December 31, 2004 include approximately $0 and $57,000, respectively, of costs in excess of the net realizable value of inventory (including obsolete materials).

Note 5 - Stock Options and Warrants

On August 19, 1993, the Board of Directors adopted the 1993 Stock Option Plan for employees, consultants, and directors who are not also employees of the Company (outside directors). This plan reached its ten-year expiration during 2003. During the 2003 annual meeting of shareholders, the Company s shareholders approved a new 2003 Equity Incentive Plan to take the place of the expiring 1993 plan. Unissued options from the 1993 plan were used to fund the 2003 plan. The maximum number of shares issuable under these plans was 14,011,468. These Plans are collectively referred to as the Plan .

For employees and consultants, the Plan provides for granting of Incentive Stock Options (ISOs) and Nonstatutory Stock Options (NSOs). In the case of ISOs, the exercise price shall not be less than 100% (110% in certain cases) of the fair value of the Company s common stock, as determined by the Compensation Committee or full Board as appropriate (the Committee), on the date of grant. In the case of NSOs, the exercise price shall be determined by the Committee, on the date of grant. The term of options granted to employees and consultants will be for a period not to exceed 10 years (five years in certain cases). Options granted under the Plan default to vest over a four-year period (one-fourth of options granted vest after one year from the grant date and the remaining options vest ratably each month thereafter), but the vesting period is determined by the Committee and may differ from the default period. In addition, the Committee may authorize option grants with vesting provisions that are not based solely on employees rendering of additional service to the Company.

For outside directors, the Plan provides that each outside director will be automatically granted NSOs on the date of their initial election to the Board of Directors. On the date of the annual meeting of the stockholders of the Company, each outside director who is elected, reelected, or continues to serve as a director, shall be granted additional NSOs, except for those outside directors who are first elected to the Board of Directors at the meeting or three months prior. The options granted vest ratably over one or two years, based on the date of grant, and expire after ten years from the grant date.

On May 10, 1999, the Board of Directors granted to each employee of the Company (other than the executive officers of the Company) (collectively, the Non-Executive Employees) the option to (i) reduce the exercise prices of up to a maximum of 15,000 of the unexercised stock options previously granted to such Non-Executive Employee under the Plan to $.5625 per share (the closing price of the Company s Common Stock on May 10, 1999) and (ii) cause all of such stock options not otherwise scheduled to become fully vested on or before May 10, 2000 to become fully vested on such date. As a result thereof, an aggregate of 279,550 stock options previously granted under the Plan were amended as described in the preceding sentence. In addition, on May 10, 1999 the Board of Directors granted to the executive officers and certain Non-Executive Employees of the Company additional non-statutory stock options to purchase an aggregate of 343,575 shares of the Company s Common Stock under the Plan. Such stock options became fully vested on the first anniversary of the date of grant, with exercise prices of $.5625 per share and expire 10 years from the date of grant.

On July 1, 2000, Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25 (FIN

44) was adopted by the Company. FIN 44 requires that stock options that have been modified to reduce the exercise price be subject to variable accounting. The Company accounts for employee stock options under APB Opinion No. 25 and non-employee stock options under Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation (SFAS No. 123).

On May 10, 1999, as described above, the Company re-priced certain stock options granted to employees and in accordance with US GAAP, at that time, the Company accounted for the re-priced stock options as fixed . As a result of adopting FIN 44, the Company is required to apply variable accounting to these options. If the market price of the Company s common stock increases above the July 1, 2000 market price, the Company will have to recognize additional compensation expense equal to the increase in stock price multiplied by the number of re-priced options. No additional expense will be recognized if the stock does not exceed the July 1, 2000 value. However, the impact cannot be determined as it is dependent on the change in the market price of the common stock from July 1, 2000 until the stock options are exercised, forfeited, or expire unexercised. Because the stock price on March 1, 2005 was below that of July 1, 2000, no expense has been recognized during the period.

On February 5, 2001, the Company s Board of Directors authorized the re-pricing of certain out of the money stock options granted to employees during the calendar year of 2000 to the closing share price on such date, or $1.9375 per share. This re-pricing causes these options to be subject to variable accounting as described in FIN 44. Because the stock price on March 1, 2005, was lower than the re-priced strike price no gain or loss was recognized during the period.

On April 1, 2002, the Company s Board of Directors authorized the re-pricing of certain out of the money stock options granted to employees. A new strike price of $0.81 per share was established, provided the respective employees remain with the Company for at least six months following the re-pricing date. In addition, certain stock options granted to directors were repriced, with a new strike price of $1.00 per share. As the stock price on March 1, 2005, was lower than the re-priced strike price no gain or loss was recognized during the period.

On July 17, 2000, the Company granted an option to a non-Company advisor in connection with the establishment of a sales office in Japan to purchase 200,000 shares of common stock at $4.9375 per share, the price of the common stoc