ISCO INTERNATIONAL INC
Form 10-Q
November 19, 2008

UNITED STATES
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 September 30, 2008

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: 001-22302

ISCO INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	36-3688459 (I.R.S. Employer 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 a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act

Large accelerated filer [ ] Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if a smaller reporting company) Smaller reporting company [X]

Indicate by check mark whether the registrant is a shell company (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 November 12, 2008
Common Stock, par value $0.001 per share	228,471,174

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ISCO INTERNATIONAL, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

		September 30, 2008		December 31, 2007
Assets:				
Current Assets:				
Cash and Cash Equivalents	$	789,986	$	1,789,953
Inventory, net		2,686,143		3,043,230
Accounts Receivable, net		1,001,327		2,311,110
Prepaid Expenses and Other		228,807		149,659
Total Current Assets		4,706,263		7,293,952
Property and Equipment		1,735,964		1,437,030
Less: Accumulated Depreciation and Amortization		(1,182,546)		(940,328)
Net Property and Equipment		553,418		496,702
Restricted Certificates of Deposit		132,372		129,307
Other Assets		-		587,824
Goodwill		13,370,000		13,370,000
Intangible Assets, net		2,732,360		850,811
Total Assets	$	21,494,413	$	22,728,596
Liabilities and Stockholders' Equity:				
Current Liabilities:				
Accounts Payable	$	522,855	$	904,910
Inventory-related Material Purchase Accrual		45,952		240,126
Employee-related Accrued Liability		276,127		331,522
Accrued Professional Services		23,530		106,921
Other Accrued Liabilities and Current Deferred Revenue		1,013,858		452,581
Current-portion of Notes Payable		12,703,612		
Total Current Liabilities		14,585,934		2,036,060
Deferred Facility Reimbursement		80,000		87,500
Deferred Revenue - Non Current		115,280		104,940
Notes and Related Accrued Interest with Related Parties, Net of Current-portion		8,598,323		15,939,229
Stockholders' Equity:				

Preferred Stock; 300,000 shares authorized; No shares issued and outstanding at September 30, 2008 and December 31, 2007				
Common Stock ($.001 par value); 500,000,000 shares authorized; and 224,684,526 and 202,259,359 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively		229,685		202,260
Additional Paid-in Capital		182,516,090		175,281,340
Treasury Stock		(139,345)		(95,050)
Accumulated Deficit		(184,491,554)		(170,827,683)
Total Stockholders' Equity		(1,885,124)		4,560,867
Total Liabilities and Stockholders' Equity	$	21,494,413	$	22,728,596

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 September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net sales	$ 1,867,170	$ 1,924,401	$ 7,109,977	$ 6,300,357
Costs and Expenses:				
Cost of Sales	1,000,779	1,220,913	3,857,749	3,633,283
Research and Development	1,075,353	721,241	3,949,444	2,004,003
Selling and Marketing	795,086	554,494	2,429,186	1,808,800
General and Administrative	985,906	1,003,762	3,430,620	3,185,141
Goodwill Impairment	6,195,268	-	6,195,268	-
Total Costs and Expenses	10,052,392	3,500,410	19,862,267	10,631,227
Operating Loss	(8,185,222)	(1,576,009)	(12,752,290)	(4,330,870)
Other Income (Expense):				
Interest Income	3,899	34,182	14,097	70,387
Interest (Expense)	(343,954)	(248,712)	(926,456)	(759,501)
Other Income	210	-	778	-
Other Income (Expense), net	(339,845)	(214,530)	(911,581)	(689,114)
Net Loss	$ (8,525,067)	$ (1,790,539)	$ (13,663,871)	$ (5,019,984)
Basic and diluted loss per share	$ (0.04)	$ (0.01)	$ (0.06)	$ (0.03)
Weighted average number of common shares outstanding	222,246,000	200,154,000	215,814,000	193,433,000

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)

		Nine Months Ended September 30, 2008		Nine Months Ended September 30, 2007
OPERATING ACTIVITIES				
Net loss	$	(13,663,871)	$	(5,019,984)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization		539,799		138,488
Stock-based compensation charges		499,525		1,217,769
Goodwill Impairment		6,195,268		-
Changes in operating assets and liabilities		3,281,204		3,750,119
Net cash provided by (used in) operating activities		(3,148,075)		86,392
INVESTING ACTIVITIES				
Increase in restricted certificates of deposit		(3,065)		(8,208)
Payment of patent costs		(42,882)		(47,722)
Acquisition of property and equipment, net		(17,118)		(69,577)
Acquisition of Clarity		(2,193,432)		-
Net cash provided by (used in) investing activities		(2,256,497)		(125,507)
FINANCING ACTIVITIES				
Issuance of common stock		12,650		-
Proceeds from loan		2,200,000		-
Proceeds from note payable		3,250,000		-
Payment of loan		(1,013,750)		-
Treasury stock purchased		(44,295)		(64,600)
Net cash provided by (used in) financing activities		4,404,605		(64,600)
(Decrease)/Increase in cash and cash equivalents		(999,967)		(103,715)
Cash and cash equivalents at beginning of period		1,789,953		2,886,476
Cash and cash equivalents at end of period	$	789,986	$	2,782,761

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

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ISCO INTERNATIONAL
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(UNAUDITED)

Ended September 30, 2008

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Treasury Stock	Accumulated Deficit	Total
Balance as of December 31, 2005	183,252,036	$183,252	$170,387,752	$ -	$ (160,040,288)	$ 10,530,716
Exercise of Stock Options	2,582,826	2,583	427,330	-	-	429,913
Equity Financing	3,787,271	3,787	(3,787)	-	-	-
Section 16b recovery	-	-	3,124	-	-	3,124
Stock-Based Compensation	-	-	1,565,423	-	-	1,565,423
Net Loss	-	-	-	-	(4,364,984)	(4,364,984)
Balance as of December 31, 2006	189,622,133	$189,622	$172,379,842	$ -	$ (164,405,272)	$ 8,164,192
Vesting of Restricted Stock	4,303,893	4,304	(4,304)	-	-	-
1.5M Accrued Interest Converted to Equity	8,333,334	8,334	1,491,666	-	-	1,500,000
Stock-Based Compensation	-	-	1,414,136	-	-	1,414,136
Purchase of Treasury Shares	-	-	-	(95,050)	-	(95,050)
Net Loss	-	-	-	-	(6,422,411)	(6,422,411)
Balance as of December 31, 2007	202,259,360	$202,260	$175,281,340	$(95,050)	$(170,827,683)	$4,560,867
Vesting of Restricted Stock	2,310,168	2,310	(2,310)	-	-	-
Exercised of Stock Options	115,000	115	12,535	-	-	12,650
Stock-Based Compensation	-	-	499,525	-	-	499,525
Purchase of Treasury	-	-	-	(44,295)	-	(44,295)

Shares						
Shares issued for acquisition	20,000,000	25,000	6,725,000	-	-	6,750,000
Net Loss	-	-	-	-	(13,663,871)	(13,663,871)
Balance as of September 30, 2008	224,684,528	$229,685	$182,516,090	$(139,345)	$(184,491,554)	$(1,885,124)

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1 – Organization

ISCO International, Inc., ("ISCO" and, together with its subsidiary Clarity Communication Systems Inc. ("Clarity"), the "Company" or "we," "our," or "us") addresses RF (Radio Frequency) and radio link optimization issues, including interference issues, within wireless communications, as well as provides product and service offerings based on Push-To-Talk ("PTT") and Location-Based Services ("LBS"), including a proprietary combination of the two technologies in its Where2Talk ("W2T") solution. Two inactive subsidiaries, Spectral Solutions, Inc. and Illinois Superconductor Canada Corporation, were terminated during early 2008 as the Company's new subsidiary, Clarity, was acquired in connection with the merger that closed on January 3, 2008. The Company uses unique products, including ANF (Adaptive Interference Management, or AIM, family of solutions), RF^2 and other solutions, as well as service expertise, in improving the RF handling of a wireless system, particularly the radio link (the signal between the mobile device and the base station). A subset of this capability is mitigating the impact of interference on wireless communications systems. These solutions are designed to enhance the quality, capacity, coverage and flexibility of wireless telecommunications services. The Company has historically marketed its products to cellular, PCS and wireless telecommunications service providers and original equipment manufacturers ("OEMs") located both in the United States and in international markets.

Note 2 – Basis of Presentation

The condensed consolidated financial statements include the accounts of ISCO and its wholly-owned subsidiary, Clarity. All significant intercompany balances and transactions have been eliminated in consolidation. The two inactive subsidiaries were included in these results in a similar fashion, up until the time of their termination in January 2008. The termination of these subsidiaries had no impact upon the consolidated financial results.

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 Rule 8-03 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, 2007 included in the Company's Annual Report on Form 10-K, as amended, filed with the Securities and Exchange Commission (the "SEC"). The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for any subsequent quarter of, or for, the entire year ending December 31, 2008. For further information, refer to the financial statements, including the notes thereto, included in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2007 and filed with the SEC.

Recent Accounting Pronouncements

In June 2008, the Financial Accounting Standards Board ("FASB") issued FSP EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" ("FSP EITF 03-6-1"). FSP EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in computing earnings per share under the two-class method described in SFAS No. 128, "Earnings Per Share." The Company is currently in the process of evaluating the impact of adopting this pronouncement.

In May 2008, FASB issued Statement No. 162, “The Hierarchy of Generally Accepted Accounting Principles". The new standard is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with US GAAP for nongovernmental entities. Statement 162 is effective 60 days following the Securities and Exchanges Commission's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. The adoption of SFAS 162 will not have a material effect on the Company’s financial position or results of operations.

In May 2008, the Financial Accounting Standards Board (“FASB”) issued FASB Staff Position (“FSP”) APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled In Cash upon Conversion (Including Partial Cash Settlement). FSP APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity’s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We are currently in the process of evaluating the impact of adopting this pronouncement.

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In April 2008, the FASB issued FSP Statement of Financial Accounting Standards ("SFAS") No. 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP SFAS 142-3"). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). The intent of FSP SFAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141(R)"), and other applicable accounting literature. FSP SFAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. We are currently evaluating the provisions of FSP SFAS 142-3.
In February 2008, the FASB issued Staff Position No. FAS 157-2 ("SFAS157-2") which provides for a one-year deferral of the effective date of SFAS No. 157, "Fair Value Measurements," for non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis. We adopted FAS 157-2 upon its issuance.

In December 2007, the FASB issued SFAS 141(R), and SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements" ("SFAS 160"). SFAS 141(R) requires an acquirer to measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. SFAS 160 clarifies that a non-controlling interest in a subsidiary should be reported as equity in the consolidated financial statements. The calculation of earnings per share will continue to be based on income amounts attributable to the parent. SFAS 141(R) and SFAS 160 are effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We have not yet determined the effect on our consolidated financial statements, if any, upon adoption of SFAS 141(R) or SFAS 160.

In December 2007, the FASB issued FAS 160, "Noncontrolling Interests in Consolidated Financials, an Amendment of ARB No. 51," which is intended to improve the relevance, comparability and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing certain required accounting and reporting standards. FAS 160 is effective for fiscal years beginning on or after December 15, 2008. The Company is evaluating the options provided under FAS 160 and their potential impact on its financial condition and results of operations if implemented. The Company does not expect the adoption of FAS 160 to significantly affect its consolidated financial condition or results of operations.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 provides the option to report certain financial assets and liabilities at fair value, with the intent to mitigate volatility in financial reporting that can occur when related assets and liabilities are recorded on different bases. As of January 1, 2008, we elected not to adopt the fair value option under SFAS 159.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). This statement defines fair value as used in numerous accounting pronouncements, establishes a framework for measuring fair value in US GAAP and expands disclosure related to the use of fair value measures in financial statements. SFAS 157 does not expand the use of fair value measures in financial statements, but standardizes its definition and guidance in US GAAP. SFAS 157 is effective for fiscal years beginning after November 15, 2007. We adopted SFAS 157 as of January 1, 2008, with the exception of the application of the statement to non-recurring nonfinancial assets and nonfinancial liabilities. Non-recurring nonfinancial assets and nonfinancial liabilities for which we have not applied the provisions of SFAS 157 include those measured at fair value in goodwill impairment testing, indefinite lived intangible assets measured at fair value for impairment testing, asset retirement obligations initially measured at fair value, and those initially measured at fair value in a business combination.

SFAS 157 establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on our own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

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Note 3 - Realization of Assets

The accompanying financial statements have been prepared in conformity with US GAAP, which contemplates 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 year ended December 31, 2007 and the most recent quarter ended September 30, 2008. In addition, the Company has used, rather than provided, cash in its operations. Consistent with these facts, the Company's most recent annual report filed on Form 10-K, as amended, reflects that there is substantial doubt about the Company's ability to continue as a going concern.

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 a successful sale of Clarity and continued operations of the Company, which in turn is dependent upon the Company's ability to meet its 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, 2007, 2006, and 2005, the Company incurred net losses of $6.4 million, $4.4 million, and $3.0 million, respectively. The quarter ended September 30, 2008 showed an additional net loss from operations of $8.5 million, which results in a loss of $ 13.7 million year to date, included in this amount is a goodwill impairment charge of $6.2 million(see note 5 for additional discussion). Historically, the Company has implemented strategies to reduce its cash used in operating activities. Changes have included the consolidation of its 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 and has developed an increasing number of offshore suppliers providing lower cost components. Beginning in 2005, the Company began to invest in additional product development (engineering) and sales and marketing resources as it began to increase its volume of business. While viewed as a positive development, these expenditures have added to the funding requirements. During the second quarter of 2008, the Company launched several initiatives to refocus the entire organization to become more sales and market focused. These efforts included the addition of new sales channels focused on international customers, focused pursuit of new OEM relationships, development and implementation of marketing programs targeted as specific customers and customer applications and sales resources targeted at all major domestic carriers. While over time the Company believes that this refocus will eventually result in increased sales and an improvement in financial performance, there are no guarantees that these strategies will yield expected results.

On January 3, 2008, the Company acquired Clarity. There have been many implementation issues associated with this business that have required substantial investments of time and incremental cash resources that have added to the expense structure and cash usage of Clarity's business. On October 1, 2008, ISCO's Board of Directors directed management to actively pursue the sale of, or other strategic partnership for, the Clarity business unit.

The continuing development of our product lines and operations, ramping up additional sales channels, as well as any required defense of our intellectual property, will require an immediate commitment and/or availability of funds. The actual amount of our future funding requirements will depend on many factors, including: the amount and timing of future revenues, the economy and the impact on the wireless carriers network deployment plans, customer acceptance of our product offerings, the level of product marketing and sales efforts to support our commercialization plans, the

magnitude of our research and product development programs, our ability to improve or maintain product margins, and the costs involved in protecting our patents or other intellectual property. We continue to look into augmenting our existing capital position by evaluating potential short-term and long-term sources of capital, including from debt, equity, hybrid, or other methods. The primary covenant in our existing debt arrangement involves the right of the lenders to receive debt repayment from the proceeds of new financing activities. This covenant may restrict our ability to obtain additional financing to be used in the operations of our business.

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Note 4 - Business Combinations

On January 3, 2008, the Company completed its acquisition of Clarity by merger for a total of $8.9 million (which includes repayment of Clarity's indebtedness, transaction expenses and stock issuances).

The Clarity acquisition has been accounted for as a business combination under, SFAS No. 141, "Business Combinations". The assets acquired and liabilities assumed have been recorded at the date of acquisition at their respective fair values.

The results of operations of Clarity are included in the accompanying consolidated statements of operations for the three and nine months ended September 30, 2008. The total purchase for the acquisition subject to the finalization of the working capital adjustment as defined in the merger agreement, is $8.9million, and is broken down as follows:

Stock issuance (25 million shares)	$ 6,750,000
Payment of Clarity's indebtedness (includes closing costs)	1,593,000
Acquisition-related transaction costs	600,000
Total purchase price	$ 8,943,000

The above purchase price has been allocated to the tangible and intangible assets acquired and liabilities assumed based on management's estimates of their current fair values. Acquisition-related transaction costs include legal and accounting fees and other external costs directly related to the Clarity acquisition.

The purchase price has been allocated as follows:

Acquired cash	$ 62,000
Account receivable, net	425,000
Prepaids and other current assets	60,000
Fixed assets and other long term assets	289,000
Goodwill	6,195,000
Intangible assets	2,140,000
Account payable and accrued liabilities	(228,000)
Net assets acquired	$ 8,943,000

Goodwill was determined based on the residual difference between the purchase cost and the value assigned to tangible and intangible assets and liabilities, and is not deductible for tax purposes. Among the factors that contributed to a purchase price resulting in the recognition of goodwill were Clarity's history of profitability prior to 2007, strong sales force and overall employee base, and leadership position in the technology market.

Note 5 - Goodwill and Intangible Assets

During January 2008, ISCO acquired Clarity by issuing up to 40 million shares of ISCO's common stock, par value $0.001 per share (the "Common Stock"), in exchange for all of Clarity's stock and satisfaction of employee rights and

interests. The Company recorded $6.2 million in goodwill and $2.1 million in identifiable intangible assets. Intangible assets are included in the Company's condensed consolidated balance sheets. The Company also has goodwill resulting from the acquisitions of Spectral Solutions, Inc. and Illinois Superconductor Canada Corporation in 2000. Beginning January 1, 2002, goodwill was no longer to be amortized but rather to be tested for impairment on an annual basis and between annual tests, whenever there is an indication of potential impairment. Impairment losses would be recognized whenever the implied fair value of goodwill is determined to be less than its carrying value.

SFAS 142 prescribes a two-step impairment test to determine whether the carrying value of the Company's goodwill is impaired. The first step of the goodwill impairment test is used to identify potential impairment, while the second step measures the amount of the impairment loss. Step one requires the comparison of the fair value of each reporting unit with its carrying amount, including goodwill.

The Company conducts its annual impairment testing as of September 30th each year. Historically, the Company performed impairment testing as a single reporting unit, by determining whether the fair value of the Company, based on market value, as measured by market capitalization, exceeded stockholders' equity. In prior years, the excess of the Company's market capitalization over its reported stockholders' equity indicated the goodwill of the Company was not impaired.

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With the acquisition of Clarity in 2008, the Company is comprised of two reporting units, the hardware segment which includes historical ISCO operations and the software segment which includes Clarity operations. As a result of the significant reduction in the Company's market capitalization as well as the subsequent decision to pursue the sale of, or others partnership or strategic options for the software business, the Company determined that a potential impairment of goodwill may exist as of September 30, 2008 and decided to perform impairment testing for each reporting unit. The Company is still in the process of performing an extenstive analysis but has made a preliminary estimate of impairment as discussed below.

Software Segment: Subsequent to September 30, 2008, the Company received a non-binding Letter Of Intent (LOI) related to the purchase of all of the outstanding common stock of Clarity. The Company deemed this LOI to be the best estimate of fair value for the purpose of an impairment analysis of the software reporting unit. The consideration in this LOI consists of a cash payment at the closing of the transaction with the remainder of the purchase price based on future financial performance. There are a number of uncertainties surrounding the consummation of the transaction and if the transaction is consummated, the receipt of total consideration for this proposed transaction, including customer acceptance of the software, minimal revenues currently under contract, operational execution by the new owner and current global economic conditions. All of these considerations were included in the measurement of the goodwill associated with the software segment and a range of potential impairment was developed. The impairment range was determined between $3.0 million and $6.2 million, the upper range equaling the carrying value of the software segment goodwill as of September 30, 2008. There are several conditions precedent to the closing of the transaction and there can be no assurance that the transaction will be consummated on the proposed terms, if at all. The Company's management determined that the upper amount of the range represents the best estimate of the impairment as of September 30, 2008 given the contigent nature of the consideration expected to be received.

Hardware Segment: The Company is in process of determining fair value of its hardware reporting unit in taking consideration for both a market and income approach. The evaluation has not been completed at this time. While the potential exists that there is impairment to the carrying value of this asset, since the evaluation is in progress, management is unable to make a good faith estimate of impairment, if any. It is anticipated that the evaluation will be completed prior to year end with any impairment amount included in year end financial results.

The intangible assets are being amortized over periods ranging from two to ten years on a straight-line basis. Amortization expense on intangible assets for the three and nine months ended September 30, 2008 was $86,500 and $259,500, respectively. The Company’s other intangible assets are derived from patents and trademarks which represent costs, primarily legal fees and expenses, incurred in order to prepare and file patent applications related to various aspects of the Company’s technology and to its current and proposed products. Patents and trademarks are recorded at cost and are amortized using the straight-line method over the shorter of their estimated useful lives or 17 years. The recoverability of the carrying values of patents and trademarks is evaluated on an ongoing basis by Company management. Factors involved in this evaluation include whether the item is in force, whether it has been directly threatened or challenged in litigation or administrative process, continued usefulness of the item in current and/or expected utilization by the Company in its solution offerings, perceived value of such material or invention in the marketplace, availability and utilization of alternative or other technologies, the perceived protective value of the item, and other factors. Patent and trademarks were reported net of accumulated amortization of approximately $846,900 at September 30, 2008 and $851,000 as of December 31, 2007.

Note 6 - 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 7 - Inventories

Inventories consisted of the following:

	September 30, 2008	December 31, 2007
Raw materials	$ 1,154,220	$ 1,695,745
Work in process	946,014	655,676
Finished product	585,909	691,809
Total	$ 2,686,143	$ 3,043,230

Inventory balances are reported net of a reserve for obsolescence. This reserve is computed by taking into consideration the components of inventory, the recent usage of those components, and anticipated usage of those components in the future. This reserve was approximately $312,161 and $325,000 as of September 30, 2008 and December 31, 2007, respectively.

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Note 8 - Stock Options and Warrants

At September 30, 2008, a total of 2.7 million stock options were outstanding under the Company's equity compensation plans. No options were granted during the first nine months of 2008 or during 2007.

Restricted Share Rights

Restricted share grants offer employees the opportunity to earn shares of the Company's stock over time. For grants that occurred during the periods ended September 30, 2008 and December 31, 2007, the typical vesting period for employees was two to four years while the vesting period of non-employee directors was linked to the one-year service period. We recognize the issuance of the shares related to these stock-based compensation awards and the related compensation expense on a straight-line basis over the vesting period, or on an accelerated basis in those cases where the actual vesting is faster than the proportional straight-line value. Included within these grants are also performance-based shares, which are shares that vest based on accomplishing particular objectives, as opposed to vesting over time. No performance-based shares were vested during the first nine months of 2008.

The following table summarizes the restricted stock award activity during the first nine months of 2008.

	Shares		Weighted Average Grant Date Fair Value (per share)
Oustanding, December 31, 2007	3,557,000	$	0.29
Granted	6,998,001		0.17
Forfeited or canceled	(3,822,499)		0.23
Vested	(2,310,168)		0.20
Outstanding, September 30, 2008	4,421,583		0.18

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The total fair value of restricted shares vested during the three months ended September 30, 2008 and 2007 was $134,000 and $379,000, respectively. Total non-cash equity compensation expense recognized during the third quarter 2008 was $134,000, including $67,000 for vested restricted share grants and $67,000 for the straight-line amortization of restricted share grants that did not vest during the third quarter 2008.

Note 9 – Debt and Financial Position

As of September 30, 2008, the Company's debt position is described on the following table (includes accrued interest):

		Short-Term		Long-Term
August 2008 Loan Agreement			$	1,010,292
May 2008 Loan Agreeement				2,003,992
January 2008 Loan Agreement	$	1,580,612		
June 2007 Loan Agreement		11,123,000		
June 2006 Loan Agreement				5,584,039
Total	$	12,703,612	$	8,598,323

August 2008 Loan Agreement

On August 18, 2008, the Company entered into a new financing agreement (the "August Loan Agreement") with Manchester Securities Corporation ("Manchester") and Alexander Finance, L.P. ("Alexander" and together with Manchester, the "Lenders"), who, together with their affiliates, are our two largest stockholders. Under the terms of the August Loan Agreement, the Lenders provided to the Company a credit line in the aggregate principal amount of $3 million and reduced the amount of advances that may be made under the May 2008 Loan Agreement, dated May 29, 2008, between the Company and the Lenders, by $550,000.

The indebtedness under the August Loan Agreement is evidenced by the Company's 9½% Secured Convertible Notes (each a "2008 Convertible Note," together the "2008 Convertible Notes") due August 1, 2010. The Company issued a 2008 Convertible Note to Alexander in the principal amount not to exceed $1.65 million and a 2008 Convertible Note to Manchester in the principal amount not to exceed $1.35 million. Interest on the outstanding principal balance of the 2008 Convertible Notes accrues at 9½% per annum and the holders of the 2008 Convertible Notes have the right to convert the outstanding principal amount under the 2008 Convertible Notes, and all accrued but unpaid interest, at any time, in whole or in part, into shares of the Company's common stock at an original conversion price of $0.20 per share, subject to certain anti-dilution adjustments.

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The 2008 Convertible Notes are secured by the Seventh Amended and Restated Security Agreement, dated as of August 18, 2008, entered into by and among the Company, Manchester, Alexander and Clarity. The Company's obligations under the 2008 Convertible Notes are guaranteed by Clarity under the Amended and Restated Guaranty of Clarity.

On August 22, 2008, the Company drew down $450,000 of principal under Manchester's 2008 Convertible Note, which is convertible into 2,250,000 shares of the Company's common stock. On the same day, the Company drew down $550,000 under Alexander's 2008 Convertible Note, which is convertible into 2,750,000 shares of Company's common stock.

On August 18, 2008, in connection with the August Loan Agreement and the issuance of the 2008 Convertible Notes, the Company entered into a Registration Rights Agreement (as amended effective as of November 12, 2008, the "Registration Rights Agreement") with the Lenders. Pursuant to the Registration Rights Agreement, the Company is required to file a registration statement under the Securities Act of 1933, as amended (the "Securities Act") by June 1, 2009, covering the resale of at least 15,000,000 shares of our Common Stock (the "Registrable Securities"), representing the potential number of shares of our Common Stock issuable upon conversion of the maximum principal amount due on the 2008 Convertible Notes ($3 million) at the initial conversion price of $0.20 per share. Under the Registration Rights Agreement, the registration statement must be declared effective by the Securities and Exchange Commission (the "SEC") by September 1, 2009 if the registration statement is not reviewed by the SEC, or by November 1, 2009 if the registration statement is reviewed by the SEC, or the Company will be obligated to make certain delay payments. In addition, at any time after March 31, 2009 either Lender may demand by written notice to the Company (a "Demand Notice"), that the Company prepare and file such registration statement not later than the date that is 30 days following the date of the Demand Notice (the "Demand Date"). Thereafter, the Company shall use its best efforts to have the registration statement declared effective as soon as possible, but not later than 60 days from the Demand Date. The Company is also required to list the Registrable Securities on the NYSE Alternext US, formerly The American Stock Exchange (the "Exchange") by the same date the registration statement is required to be declared effective by the SEC.

The above agreements and their related documents are more fully described in the Company's Current Reports on Form 8-K filed with the SEC on August 18, 2008.

May 2008 Loan Agreement

On May 29, 2008, the Company entered into a financing agreement (the "May 2008 Loan Agreement") with the Lenders. Under the terms of the May 2008 Loan Agreement, the Lenders provided to the Company a credit line in the aggregate principal amount of $2.5 million. A portion of this line was immediately drawn upon by the Company in order to repay the outstanding $500,000 short-term loan between the Lenders and the Company under a receivables factoring arrangement, as well as $8,056 in accrued interest on the loan. The Company withdrew a total of $975,000 from each Lender for use as working capital under the 2008 Loan Agreement.

The indebtedness under the May 2008 Loan Agreement is evidenced by the Company's 9.5% Secured Grid Notes (each a "Grid Note," together the "Grid Notes"). The Company issued a Grid Note to each of Alexander and Manchester in the aggregate principal amount of $1,250,000.

To secure and guarantee payment of the Grid Notes, on May 29, 2008, the Company, the Lenders, and Clarity entered into a Sixth Amended and Restated Security Agreement and an Amended and Restated Guaranty of Clarity, in favor of the Lenders. The Amended and Restated Guaranty of Clarity adds the Grid Notes to the list of obligations for which Clarity is guaranteeing the full payment and performance by the Company to the Lenders.

The material terms of the May 2008 Loan Agreement and the Grid Notes include the following:

- The advances made pursuant to the 2008 Loan Agreement (the "Loans") bear interest at a rate of 9.5%. Interest is calculated on a 360 day year simple interest basis and paid for the actual number of days elapsed. All interest due on such Loans is payable on August 1, 2010, the maturity date of the May 2008 Loan Agreement. After the occurrence and during the continuance of an event of default, the interest rate on the Loans is increased to the lesser of 20% per annum, compounded annually, or the highest rate permitted by law and is payable on the demand of the Lenders.

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- The repayment of the principal amount of the Grid Notes, as well as the notes issued in connection with the previous financings (the "Prior ISCO Notes") and all accrued and unpaid interest may be accelerated in the event of (i) a failure to pay any principal amount on the Grid Notes; (ii) a failure to pay the principal amount or accrued but unpaid interest upon any of the Prior ISCO Notes as and when such notes become due and payable; (iii) a failure by the Company for ten (10) days after notice to it, to comply with any other material provision of any of the Grid Notes, the 2008 Loan Agreement, or any of the Prior ISCO Notes and related agreements; (iv) a default under the Sixth Amended and Restated Security Agreement or any of the Grid Notes or Prior ISCO Notes; (v) a breach by the Company of its representations or warranties under the 2008 Loan Agreement or under the Amended and Restated Guaranty of Clarity; (vi) defaults under any other indebtedness of the Company in excess of $500,000; (vii) a final judgment involving, in the aggregate, liability of the Company in excess of $500,000 that remains unpaid for a period of 45 days; or (viii) bankruptcy event.

- Any payments or prepayments by the Company or any guarantor permitted or required under the May 2008 Loan Agreement shall be applied to each Lender, pro rata in relation to the total amount of the Company's indebtedness to the Lenders then outstanding under the Grid Notes, in the following order: first, to the payment of any fees, costs, expenses, or charges of the Lenders with respect to the Grid Notes arising under the loan documents; second, to the payment of interest accrued on the outstanding advances represented by the Grid Notes; and third, to the principal balance. Any prepayments, whether optional or mandatory, permanently reduce the Lenders' commitments under the Grid Notes, pro rata, to the extent of such prepayments.

- Upon 30 days prior written notice to the Lenders, the Company may prepay outstanding amounts under the Loans, provided that the minimum amount of any prepayment must generally be at least $250,000. Upon receipt of net cash proceeds from (i) certain sales, leases, transfers or other dispositions of any assets of the Company, (ii) the incurrence or issuance of debt to third parties, (iii) the sale or issuance of capital stock, warrants, rights or options to acquire capital stock, or any other securities other than upon the exercise of outstanding options and warrants or the issuance of options pursuant to the Company's equity incentive plan, in excess of 5% of the outstanding shares of Common Stock: (iv) any judgment, award or settlement; or (v) a merger or share exchange pursuant to which 50% of the Company's voting power is transferred, the Company must prepay the lesser of the amount outstanding on the Grid Notes or the amount of such net cash proceeds.

- The Company is required to pay all of the reasonable fees and expenses incurred by the Lenders in connection with the transaction documents.

March 2008 Trade Receivables Factoring Agreement

On March 20, 2008, the Company entered into an agreement with the Lenders to assign, or factor, certain of its trade receivables (the "Assignment Agreement"). If the Company requests such a transaction and the Lenders agree, monies will be advanced to the Company based on the Company's trade receivables assigned to the Lenders. Under the Assignment Agreement, as the assigned accounts are collected by the Company (approximately 30 days from the date of the invoice), the Company will promptly pay the Lenders the amount of the collected account, plus interest at an implied annual rate of 10%. In connection with the Assignment Agreement, the Company and its Lenders agreed to a $500,000 advance with funding to occur on March 20, 2008. Future transactions would be subject to the desire of both the Company and Lenders. An additional $500,000 was borrowed under this arrangement on April 2, 2008. The first $500,000 borrowed was repaid, with approximately $6,000 of accrued interest, on May 1, 2008.

January 2008 Clarity Merger Financing

As a condition to the Clarity merger, ISCO was required to obtain financing (the "Financing") in an amount equal to $1.5 million to fund the initial operations of the combined entity after the merger and transaction expenses of the Company incurred in connection with the merger and (ii) to pay off the amount outstanding under Clarity's line of credit agreement (as described below). Pursuant to the Financing, on January 3, 2008, the Company issued a new Amended and Restated Note (the "Note") to Alexander in aggregate principal amount of $1.5 million. The Note matures on August 1, 2009, bears interest of 7% per annum and is convertible, together with all accrued and unpaid interest thereon, into shares (the "Additional Conversion Shares") of the Company's Common Stock at an initial conversion price of $0.20 per share. The note contains substantially similar terms and conditions as the Amended and Restated Notes (defined below) previously issued to the Lenders.