

ISCO INTERNATIONAL INC

Form 10-Q

August 14, 2003

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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**Form 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2003.

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)

|  |  |
|--|--|
| <b>Delaware</b>  | <b>36-3688459</b>                                |
| _____<br>(State or Other Jurisdiction of<br>Incorporation or Organization) | _____<br>(I.R.S. Employer<br>Identification No.) |
| <b>451 Kingston Court Mt. Prospect, Illinois</b>                           | <b>60056</b>                                     |
| _____<br>(Address of Principal Executive Offices)                          | _____<br>(Zip Code)                              |
| Registrant's Telephone Number, Including Area Code                         | <b>(847) 391-9400</b>                            |
|  | _____  |

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

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

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

| Class                                     | Outstanding at July 1, 2003 |
|---|-----------------------------|
| Common Stock, par value \$0.001 per share | 147,974,927                 |
| Preferred Stock Purchase Rights           |                             |



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**ISCO INTERNATIONAL, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | June 30,<br>2003 | December 31,<br>2002 |
|--|------------------|----------------------|
|  | (unaudited)      |                      |
| <b>Assets:</b>   |                  |                      |
| Current Assets:  |                  |                      |
| Cash and cash equivalents  | \$ 315,218       | \$ 216,119           |
| Inventories  | 786,270          | 896,572              |
| Accounts receivable, net   | 133,739          | 1,551,912            |
| Prepaid expenses, settlement receivable, and other   | 165,465          | 471,918              |
|  | <hr/>            | <hr/>                |
| Total current assets   | 1,400,692        | 3,136,521            |
| Property and equipment:  |                  |                      |
| Property and equipment   | 8,973,589        | 8,968,732            |
| Less: accumulated depreciation   | (7,859,889)      | (7,463,289)          |
|  | <hr/>            | <hr/>                |
| Net property and equipment   | 1,113,700        | 1,505,443            |
| Restricted certificates of deposit   | 90,824           | 114,508              |
| Intangible assets, net   | 14,460,804       | 14,426,528           |
| Other assets, net  |                  |                      |
|  | <hr/>            | <hr/>                |
| Total assets   | \$ 17,066,020    | \$ 19,183,000        |
|  | <hr/>            | <hr/>                |
| <b>Liabilities and Stockholders Equity:</b>  |                  |                      |
| Current liabilities:   |                  |                      |
| Accounts payable   | \$ 47,258        | \$ 193,458           |
| Accrued liabilities  | 2,858,244        | 1,609,236            |
| Current debt   | 3,000,000        |                      |
|  | <hr/>            | <hr/>                |
| Total current liabilities  | 5,905,502        | 1,802,694            |
| Other long-term debt, less current portion   |                  | 2,000,000            |
| Stockholders equity:   |                  |                      |
| Preferred stock; 300,000 shares authorized; No shares issued and outstanding at June 30, 2003 and December 31, 2002  |                  |                      |
| Common stock (\$.001 par value); 250,000,000 shares authorized; 147,974,927 and 147,944,927 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively | 147,975          | 147,945              |
| Additional paid-in capital (net of unearned compensation)  | 159,216,854      | 158,172,391          |
| Accumulated deficit  | (148,204,311)    | (142,940,030)        |
|  | <hr/>            | <hr/>                |
| Total stockholders equity  | 11,160,518       | 15,380,306           |
|  | <hr/>            | <hr/>                |
| Total liabilities and stockholders equity  | \$ 17,066,020    | \$ 19,183,000        |
|  | <hr/>            | <hr/>                |

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NOTE: The condensed consolidated balance sheet as of December 31, 2002 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<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|--|--------------------------------|------------------|------------------------------|------------------|
|  | 2003                           | 2002             | 2003                         | 2002             |
| Net sales  | \$ 336,101                     | \$ 134,241       | \$ 1,571,452                 | \$ 1,697,360     |
| Costs and expenses:                                  |                                |                  |                              |                  |
| Cost of sales  | 332,426                        | 588,734          | 961,947                      | 2,126,885        |
| Research and development                             | 234,299                        | 920,254          | 524,012                      | 1,698,346        |
| Selling and marketing                                | 225,566                        | 637,280          | 499,299                      | 1,335,491        |
| General and administrative                           | 1,371,184                      | 2,028,937        | 4,299,843                    | 4,210,486        |
|  | <u>2,163,475</u>               | <u>4,175,205</u> | <u>6,285,101</u>             | <u>9,371,208</u> |
| Total costs and expenses                             |                                |                  |                              |                  |
| Operating loss                                       | (1,827,374)                    | (4,040,964)      | (4,713,649)                  | (7,673,848)      |
| Other income (expense):                              |                                |                  |                              |                  |
| Interest income                                      | 1,108                          | 32,244           | 3,164                        | 53,675           |
| Other interest expense                               | (286,920)                      |                  | (553,796)                    | (168,602)        |
| Other income (expense), net                          |                                |                  |                              |                  |
|  | <u>(285,812)</u>               | <u>32,244</u>    | <u>(550,632)</u>             | <u>(114,927)</u> |
| Net loss   | \$ (2,113,186)                 | \$ (4,008,720)   | \$ (5,264,281)               | \$ (7,788,775)   |
|  | <u>(0.02)</u>                  | <u>(0.03)</u>    | <u>(0.04)</u>                | <u>(0.06)</u>    |
| Basic and diluted loss per share                     |                                |                  |                              |                  |
| Weighted average number of common shares outstanding | 147,974,927                    | 147,942,527      | 147,965,645                  | 138,623,517      |

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



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**ISCO INTERNATIONAL, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
**Six Months ended June 30, 2003**

(UNAUDITED)

|   | Common Stock        |            | Additional<br>Paid-In<br>Capital | Accumulated<br>Deficit | Unearned<br>Compensation | Total         |
|---|---------------------|------------|----------------------------------|------------------------|--------------------------|---------------|
|   | Number of<br>Shares | Amount     |                                  |                        |                          |               |
| Balance at December 31,<br>2002   | 147,944,927         | \$ 147,945 | \$ 158,672,239                   | \$(142,940,030)        | \$(499,848)              | \$ 15,380,306 |
| Exercise of stock<br>options/DSUs; \$0-0.18 per<br>share                              | 30,000              | 30         | (30)                             |                        |                          |               |
| Compensation Expense for<br>non-employee stock<br>options/other stock<br>compensation |                     |            | 425,700                          |                        | 191,400                  | 617,100       |
| Non-cash warrant expense  |                     |            | 427,393                          |                        |                          | 427,393       |
| Net Loss  |                     |            |                                  | (5,264,281)            |                          | (5,264,281)   |
| Balance at June 30, 2003  | 147,974,927         | \$ 147,975 | \$ 159,525,302                   | \$(148,204,311)        | \$(308,448)              | \$ 11,160,518 |

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)

|   | Six Months Ended<br>June 30, |                |
|---|------------------------------|----------------|
|   | 2003                         | 2002           |
| <b>Operating Activities:</b>  |                              |                |
| Net loss  | \$(5,264,281)                | \$ (7,788,775) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                              |                |
| Depreciation and amortization, excluding goodwill                           | 418,343                      | 456,186        |
| Non-cash warrant expense  | 427,393                      |                |
| Non-cash compensation expense   | 617,100                      | 204,600        |
| Changes in operating assets and liabilities                                 | 2,937,736                    | (871,162)      |
| Net cash used in operating activities                                       | (863,709)                    | (7,999,151)    |
| <b>Investing Activities:</b>  |                              |                |
| Decrease / (Increase) in restricted certificates of deposit                 | 23,684                       | (6,500)        |
| Payment of patent costs   | (56,019)                     | (99,856)       |
| Acquisition of property and equipment, net                                  | (4,857)                      | (85,960)       |
| Net cash (used in) investing activities                                     | (37,192)                     | (192,316)      |
| <b>Financing Activities:</b>  |                              |                |
| Proceeds from Shareholder Rights Offering                                   |                              | 19,764,985     |
| Proceeds from credit line   | 1,000,000                    |                |
| Exercise of stock options   |                              | 311            |
| Payments on other long-term debt  |                              | (9,425,000)    |
| Net cash provided by financing activities                                   | 1,000,000                    | 10,340,296     |
| (Decrease) / Increase in cash and cash equivalents                          | (99,101)                     | 2,148,829      |
| Cash and cash equivalents at beginning of period                            | 216,119                      | 1,720,697      |
| Cash and cash equivalents at end of period                                  | \$ 315,218                   | \$ 3,869,526   |

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 statement and notes included herein should be read in conjunction with the Company's audited financial statement and notes for the year ended December 31, 2002 included in the Company's Annual Report on Form 10-K, as amended, 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 or for the entire year ending December 31, 2003. 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, 2002.

**Recent Accounting Pronouncements**

As of the reporting date, the Company had recorded unamortized goodwill assets resulting from the acquisitions of Spectral Solutions, Inc. and the Adaptive Notch Filter division of Lockheed Martin Canada, Inc., both during 2000. Beginning January 1, 2002, goodwill is 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. During 2002, the Company completed the process of evaluating goodwill for impairment under SFAS No. 142. As the fair value, using quoted market prices for the Company, exceeded the carrying amount, the goodwill was determined to be not impaired. During October 2002, the Company performed its annual evaluation of goodwill for impairment and no impairment was determined to exist, thus no write-down was required.

The Company has concluded that no impairment exists as of the reporting date. As mentioned elsewhere in this document, litigation is still ongoing with respect to intellectual property rights between the Company and two primary competitors (which have recently merged). On April 3, 2003, the jury returned with its verdict in the '215 patent litigation with Superconductor Technologies, Inc. et. al. The jury rejected the Company's positions and determined the Company's patent to be invalid. Additionally, the jury determined that the patent inventor was engaged in inequitable conduct and subsequently awarded the defendants \$3.87 million in damages from the Company. The Company was severely disappointed by this verdict and is engaged in the post-trial motion process to overturn it. The underlying patent was a patent application acquired by the Company when it acquired Spectral Solutions, Inc. Once the court issues a final ruling in this matter, the Company intends to perform an interim test of the carrying value of goodwill for impairment.

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In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123. This Statement amends SFAS No. 123, Accounting for Stock-based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of SFAS No. 123 to require more prominent disclosures in both the annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method on reported amounts. The amendments to SFAS 123 in paragraphs 2(a)-2(e) of this Statement are effective for financial statements for fiscal years ending after December 15, 2002. The amendment to SFAS 123 in paragraph 2(f) of this Statement and the amendment to Opinion 28 in paragraph 3 are effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Company does not expect that adoption of this statement will have a material effect on its results of operations or financial position.

The Company has a stock-based employee compensation plan, which is more fully described in note 5. The Company applies APB Opinion 25, Accounting for Stock Issued to Employees, and related Interpretations in accounting for its plans. Stock expense for the first six months of 2003 and 2002, respectively, is 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, using the assumptions described in Note 5, to its stock-based employee plans:

|   | Three Months Ended<br>March 31, |         | Six Months<br>Ended June 30, |         |
|---|---------------------------------|---------|------------------------------|---------|
|   | 2003                            | 2002    | 2003                         | 2002    |
| Net loss, as reported   | \$2,113                         | \$4,009 | \$5,264                      | \$7,789 |
| Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects  | 210                             | 103     | 623                          | 205     |
| Less: Total stock-based employee compensation determined under fair value based method for awards granted, modified, or settled, net of related tax effects | 595                             | 355     | 1,494                        | 950     |
| Pro forma net loss  | \$2,498                         | \$4,261 | \$6,135                      | \$8,534 |
| Loss per share:   |                                 |         |                              |         |
| Basic as reported   | \$ 0.02                         | \$ 0.03 | \$ 0.04                      | \$ 0.06 |
| Basic pro forma   | \$ 0.02                         | \$ 0.03 | \$ 0.04                      | \$ 0.06 |
| Diluted as reported   | \$ 0.02                         | \$ 0.03 | \$ 0.04                      | \$ 0.06 |
| Diluted pro forma   | \$ 0.02                         | \$ 0.03 | \$ 0.04                      | \$ 0.06 |

**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 June 30, 2003. In addition, the Company has used, rather than provided, cash in its operations.

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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, 2002, 2001, and 2000, the Company incurred net losses of \$13,077,832, \$28,189,603, and \$18,796,183, respectively. The Company incurred an additional net loss of \$2,113,186 during the second quarter 2003, and \$5,264,281 during the six months ended June 30, 2003. During the past two 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, expanding its outsourcing of manufacturing strategy, reducing professional fees and discretionary expenditures, and negotiating favorable payment arrangements with suppliers and service providers.

As reflected elsewhere in this document, including Note 7, a jury determined in April 2003 that the Company was liable for \$3.87 million in damages to a competitor, allegedly inflicted due to the Company's prosecution of a patent claim against that competitor. The Company is engaged in the post-trial motion process in pursuit of a reversal of this determination. The amount of any payment by the Company due to the damage award is uncertain. However, in the event that a material liability may exist with respect to this verdict, the Company's funding requirement would increase and its ability to continue as a going concern would be negatively affected.

To date, the Company has financed its operations primarily through public and private equity and debt financings. The Company's liabilities currently exceed its cash and liquid assets, even with the inclusion of the remaining balance of the credit line, which is uncommitted in nature. The Company intends to attempt to augment its existing capital position by utilizing the credit line and to seek other sources of capital or debt financing. There can be no assurance that the line of credit or other funding sources will be available to the Company. If the Company is unable to obtain necessary funding in the immediate future then either its operations may be significantly curtailed or it may not be able to continue as a going concern.

**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:

|                  | <u>June 30, 2003</u> | <u>December 31, 2002</u> |
|------------------|----------------------|--------------------------|
| Raw materials    | \$556,000            | \$631,000                |
| Work in process  | 75,000               | 40,000                   |
| Finished product | 155,000              | 226,000                  |
|                  | <u>          </u>    | <u>          </u>        |
|                  | \$786,000            | \$897,000                |
|                  | <u>          </u>    | <u>          </u>        |

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**Note 5 Stock Options and Equity Transactions**

On August 19, 1993, the Board of Directors adopted the 1993 Stock Option Plan (the Plan) for employees, consultants, and directors who are not also employees of the Company (outside directors). The maximum number of shares issuable under the Plan, as amended, in 2002 was 14,011,468. The Plan is administered by a committee (the Committee) consisting of two or more outside directors appointed by the board of directors of the Company.

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 committee, on the date of grant. In the case of NSOs, the exercise price shall not be less than 25% (110% in certain cases) of the fair value of the Company's common stock, as 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 generally 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). 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, NSOs only will be granted with an exercise price of 100% of the fair value of the stock, as determined by the Committee, on the date of grant. The Plan provides that each outside director will be automatically granted 40,000 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 40,000 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 two years and expire after ten years from the grant date.

The Company entered into stock option agreements with certain employees and a consultant prior to the adoption of the Plan. These stock options expire 10 years from the date of grant. Exercise prices were determined by the Board of Directors and represented estimated fair values of the Company's common stock at 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).

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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 June 30, 2003 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 June 30, 2003, 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 June 30, 2003, 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 stock on the date of the grant. According to the Black-Scholes valuation model, the value of the option was \$4.53 per share. The option vested 25% immediately, with the balance vesting pro-rata over a three-year period. \$906,000 of non-cash compensation expense was to be amortized during the life of the options. This arrangement was terminated during December 2001, as a result of a change in the structure of the Japanese sales office. The cumulative compensation expense charged for these services through termination was \$545,000.

On February 15, 2000, the Company's board of directors granted to certain executive level employees an aggregate of 440,000 deferred stock units ( DSUs ) under the Company's 1993 Amended and Restated Stock Option Plan (the Plan ). The DSUs represent the right to receive an equivalent number of restricted shares of the Company's common stock. On the date of the grant, the DSUs were set to vest at the rate of 10% on the first anniversary of the date of the grant, with the balance vesting at a rate of 20%, 30%, and 40% at the second, third, and fourth anniversary dates, respectively. The executive level employees had the right to elect to defer receipt of the common stock subject to the DSUs to a later date. In the third quarter of 2000, the Company began to recognize compensation expense for the DSUs over the vesting period (4 years) based on their intrinsic value of \$1,925,000, which was the number of DSUs multiplied by the closing price of the Company's common stock on July 18, 2000, the measurement date (\$4.38 per share). As of July 3, 2003, all DSUs granted under this plan had been either received or cancelled. As a result of these transactions, unamortized deferred charges of \$308,448 were eliminated. No additional expense is expected for this purpose.

On February 15, 2002, the Company completed a Shareholder Rights Offering. Approximately \$20 million was raised from existing shareholders as of the recording date in exchange for the issuance of approximately 40 million shares of the Company's common stock. A portion of the proceeds were then used to repay in full \$9.8 million of debt and related accrued interest, as well as the payment of various other accrued expenses.

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During 2002, the Company's Board of Directors granted 2,172,000 new stock options to the Company's employees, including officers (option prices are generally, but not always, set at the closing price of the Company's common stock as of the date of each respective grant). Those grants include the issuance of 900,000 stock options to the CEO during December 2002 that vest immediately and are priced at 25% of the average closing price of the Company's common stock as reported on the American Stock Exchange for the trading days between December 2, 2002 and the trading day prior to the date of grant, which was a \$0.20 discount to the closing price of the Company's common stock as of the date of grant. Consequently, \$180,000 of compensation expense was recognized during December 2002, in order to account for this discount. On January 2, 2003, the Company's Board of Directors granted 2,800,000 new stock options to six of the Company's employees, including officers. 950,000 of these options vested immediately, while the remaining 1,850,000 vest monthly in 12 installments. All of the options granted on January 2, 2003 were granted at a similar discount as described above, ultimately valued at a \$0.22 discount to the closing price of the Company's common stock as of the date of the grant. A charge of \$102,000 was recognized during the second quarter 2003 to recognize the value of the discount.

During July 2003, the Board of Directors cancelled approximately 2.8 million outstanding options held by certain Company employees, including officers.

During the first six months of 2003, in addition to the disclosure above, the Company's board of directors granted 375,000 stock options to the Company's employees and non-employee Board members. These grants were issued at the closing market price on the date of grant.

**Note 6 Debt and Financial Position**

As of the reporting date, the Company had drawn \$3 million of debt financing under a credit line. An additional \$300,000 was drawn during July, 2003. During October 2002, the Company entered into an Uncommitted Line of Credit with its two largest shareholders, an affiliate of Elliott Associates, L.P. (Manchester Securities, L.P.) and Alexander Finance, L.P. This line is intended to provide up to \$4 million to the Company. This line is uncommitted, such that each new borrowing under the facility would be subject to the approval of the lenders. Borrowings on this line bear an interest rate of 9.5% and are secured by all the assets of the Company. Outstanding loans under this agreement would be required to be repaid on a priority basis should the Company receive new funding from other sources. Additionally, the lenders are entitled to receive warrants to the extent funds are drawn down on the line. The warrants bear a strike price of \$0.20 per share of common stock and expire on April 15, 2004. The credit line matures and is due, including accrued interest thereon, on March 31, 2004. Due to an agreement between the parties that did not provide warrants with respect to the most recent \$1.3 million in borrowings, a maximum of 13.5 million warrants may be issued as a result of this transaction, presuming certain antidilutive features are not triggered.

According to existing accounting pronouncements and SEC guidelines, the Company has allocated the proceeds of these borrowings between their debt and equity components. As a result of these borrowings during 2002, the Company will record a non-cash charge of \$1.2 million through the outstanding term of the warrants (April, 2004). \$215,000 and \$427,000 of that amount was recorded during the second quarter and first six months of 2003, respectively.



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The Company's liabilities exceed its cash and liquid assets even with the inclusion of the remaining balance of the credit line, which is uncommitted in nature. There can be no assurance that other funding mechanisms, whether identified or not, will allow the Company to access additional funds as required.

**Note 7 Subsequent or Other Events**

During July 2003, the Company's Board of Directors cancelled approximately 2.8 million outstanding stock options held by certain employees.

Mr. Howard Hoffmann resigned from the Board of Directors, where he had served the Company since 1998. Mr. Hoffmann served on both the Compensation and Audit Committees of the Board. The Company is grateful for his contributions during his five-years on its Board of Directors and wishes him well in his future endeavors. A search is ongoing to add to the Company's Board, now numbering six directors.

**Item 2. Management's Discussion and Analysis of Financial Conditions and Results of Operations.**

**General**

The following is a discussion and analysis of the historical results of operations and financial condition of the Company and factors affecting the Company's financial resources. This discussion should be read in conjunction with the financial statements, including the notes thereto, set forth herein under Part I. Financial Information and Item 1. Financial Statements and in the Company's Annual Report on Form 10-K, as amended, for the fiscal year ended December 31, 2002. This discussion contains forward-looking statements which involve certain risks, uncertainties and contingencies which could cause the Company's actual results, performance or achievements to differ materially from those expressed, or implied, by such forward-looking statements. Such factors include those described in Risk Factors included in the Company's Annual Report on Form 10-K, as amended. The forward-looking statements included in this report may prove to be inaccurate. In light of the significant uncertainties inherent in these forward-looking statements, you should not consider this information to be a guarantee by the Company or any other person that our objectives and plans will be achieved.

The Company provides a wide array of interference-management solutions for the wireless telecommunications industry. The Company uses both our patent-pending and proprietary adaptive notch filter ( ANF ) technology and our patented and proprietary high temperature superconductor ( HTS ) technology to monitor and suppress in-band and out-of-band interference in a wireless base station.

The continuing development of, and expansion in, sales of the Company's interference management solutions product lines will require a commitment of additional funds. The actual amount of the Company's future funding requirements will depend on many factors. The Company has an immediate need for funds. The Company's continued operations are therefore dependent upon its continued ability to raise funds through the issuance of its securities or borrowings, and its ability to acquire assets or satisfy liabilities by the issuance of stock. Management is currently seeking debt or equity financing. There is no guarantee that funding sources will be available to the Company. If the Company is unable to obtain necessary funding then either its operations may be significantly curtailed or it may not be able to continue as a going concern.

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The Company was founded in 1989 by ARCH Development Corporation, an affiliate of the University of Chicago, to commercialize superconductor technologies initially developed by Argonne National Laboratory. The Company was incorporated in Illinois on October 18, 1989 and reincorporated in Delaware on September 24, 1993. Its facilities and principal executive offices are located at 451 Kingston Court, Mt. Prospect, Illinois 60056 and telephone number is (847) 391-9400.

**Results of Operations**

*Three Months Ended June 30, 2003 and 2002*

The Company's net sales increased \$202,000, or 151%, to \$336,000 for the three months ended June 30, 2003 from \$134,000 for the same period in 2002. This increase was due to the shipment of more ANF products during the second quarter of 2003 relative to the second quarter of 2002. The Company anticipates its unit volume and related revenue to increase during the third and fourth quarters of 2003 as compared to the second quarter of 2003, due to existing and/or anticipated customer orders.

Cost of sales decreased by \$257,000, or 44%, to \$332,000 for the three months ended June 30, 2003 from \$589,000 for the same period in 2002. The decrease in cost of sales, despite the increase in sales volume, was due to a combination of production efficiencies and the Company's outsourced manufacturing program as well as a number of cost control measures adopted during the previous two years.

The Company's research and development expenses decreased by \$686,000, or 75%, to \$234,000 for the three months ended June 30, 2003, from \$920,000 for the same period in 2002. The consolidation of the Colorado and Canadian facilities into the Mount Prospect facility including related headcount reduction, as well as other cost control measures and the relative progression of product development, were the primary reasons for this reduction.

Selling and marketing expenses decreased by \$411,000, or 65%, to \$226,000 for the three months ended June 30, 2003, from \$637,000 for the same period in 2002. This decrease, in spite of the increase in sales between the two periods, was due to cost reductions implemented during 2002.

General and administrative expenses decreased by \$658,000, or 32%, to \$1,371,000 for the three months ended June 30, 2003, from \$2,029,000 for the same period in 2002. This decrease was attributable to an overall decrease in legal expenses incurred in the ongoing patent litigation as well as other cost control measures. This reduced litigation cost represents approximately \$200,000 of the \$658,000 decrease between these respective periods.

Goodwill amortization and impairment issues are further detailed in Note 1.

*Six Months Ended June 30, 2003 and 2002*

The Company's net sales decreased \$126,000, or 7%, to \$1,571,000 for the six months ended June 30, 2003 from \$1,697,000 for the same period in 2002. This decrease was due to the timing of deliveries during 2003 and the fulfillment of a large purchase order during the first quarter of 2002. The Company anticipates its unit volume and related revenue during the full year 2003 to exceed related figures during 2002 due to existing and/or anticipated customer orders.

Cost of sales decreased by \$1,165,000, or 55%, to \$962,000 for the six months ended June 30, 2003 from \$2,127,000 for the same period in 2002. The decrease in cost of sales was due to the expansion

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of the Company's outsourcing strategy, the decrease in sales volume, and various cost control measures adopted during the previous two years.

The Company's research and development expenses decreased by \$1,174,000, or 69%, to \$524,000 for the six months ended June 30, 2003, from \$1,698,000 for the same period in 2002. The consolidation of the Colorado and Canadian facilities into the Mount Prospect facility including related headcount reduction, the relative progression of product development, as well as a number of cost control measures, were the primary reasons for this reduction.

Selling and marketing expenses decreased by \$836,000, or 63%, to \$499,000 for the six months ended June 30, 2003, from \$1,335,000 for the same period in 2002. This decrease was due to cost reductions implemented during 2002.

General and administrative expenses increased by \$90,000, or 2%, to \$4,300,000 for the six months ended June 30, 2003, from \$4,210,000 for the same period in 2002. This increase was attributable to non-cash charges associated with employee equity compensation and legal expenses incurred in the ongoing patent litigation. If not for these items, which increased by approximately \$413,000 and \$482,000, respectively, during these periods, general and administrative expenses would have decreased by approximately \$805,000, or 19%, during the first six months of 2003 compared to the same period of 2002.

Goodwill amortization and impairment issues are further detailed in Note 1.

**Liquidity and Capital Resources**

At June 30, 2003, the Company's cash and cash equivalents were \$315,000, an increase of \$99,000 from the balance at December 31, 2002 of \$216,000. This increase was due to the timing of cash flows and the draw of \$1 million on the credit line during the first quarter of 2003.

The continuing development of, and expansion in, sales of the Company's interference management solutions product lines will require a commitment of additional funds. The actual amount of the Company's future funding requirements will depend on many factors, including: the amount and timing of future revenues, the level of product marketing and sales efforts to support the Company's commercialization plans, the magnitude of the Company's research and product development programs, the ability of the Company to improve product margins, the cost of additional plant and equipment for manufacturing and the costs involved in protecting the Company's patents or other intellectual property.

The Company has financed its operations primarily through public and private equity and debt financings. The Company's liabilities exceed its cash and liquid assets on hand even with the inclusion of the remaining balance of the credit line, which is uncommitted in nature. The Company's continued operations are therefore dependent upon its continued ability to raise funds through the issuance of its securities or borrowings, and its ability to acquire assets or satisfy liabilities by the issuance of stock. Management is currently seeking other debt or equity financing. There can be no assurance that the line of credit or other funding sources will be available to the Company. If the Company is unable to obtain necessary funding then either its operations may be significantly curtailed or it may not be able to continue as a going concern.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

The Company does not have any material market risk sensitive instruments.

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**Item 4. Controls and Procedures.**

- (a) An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer, or CEO, and Chief Financial Officer, or CFO, of the effectiveness of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of June 30, 2003. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act, is recorded, processed, summarized and reported as specified in Securities and Exchange Commission rules and forms.
- (b) There were no significant changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

*Laves Litigation*

On July 17, 2000 Edward W. Laves filed an action (the Complaint) in the Law Division of the Circuit Court of Cook County, Illinois, against the Company and three directors charging the Company with constructive termination under and in breach of plaintiff's employment agreement, and with violation of the Illinois Wage Payment and Collection Act. Plaintiff seeks damages estimated to exceed \$12 million. The Company filed an appearance on behalf of all Defendants on October 3, 2000. On October 6, 2000, the Company filed on Defendants' behalf a Motion to Dismiss the Complaint. On January 22, 2001, the court issued an order granting our Motion to Dismiss the claims against the Individual Defendants, but denied our Motion to Dismiss with respect to claims against the Company. On February 21, 2001, Plaintiff filed a Motion to reconsider the court's dismissal of claims against the Individual Defendants. On March 13, 2001, we filed an Answer to the Complaint and a Memorandum in Opposition to this Motion to Reconsider. By order dated March 15, 2001, the court allowed Laves leave to file an amended Motion to Reconsider, which the Plaintiff filed on April 5, 2001, along with a motion to dismiss one of the Company's affirmative defenses. Following a substitution of judges and a hearing on August 9, 2001, the court granted Plaintiff's motion to dismiss one of the Company's affirmative defenses and ordered the case transferred back to the judge originally assigned to the case for the limited purposes of ruling on Plaintiff's amended motion to reconsider the dismissal of claims against the Defendants. On September 7, 2001, following a hearing, the Judge denied Plaintiff's amended motion to reconsider and entered an order retaining jurisdiction of the matter for 30 days. On November 9, 2001, the Judge granted Plaintiff leave to file his First Amended Count II. On November 11, 2001, Plaintiff filed his amended pleading. On January 31, 2002, Plaintiff filed a corrected Unified Complaint. On February 15, 2002, all Defendants filed their Answers to the Unified Complaint. On March 5, 2002, the individual defendants served their answers to Plaintiff's interrogatories and responses to Plaintiff's discovery requests. On April 8, 2002, Laves was given leave to amend his Complaint and add Count III against the individual defendants for tortious interference with contractual obligations. Laves seeks damages against these individuals for: (1) an amount to be provided at trial estimated to exceed \$12 million; (2) \$500,000 for Laves' anxiety, mental suffering, and humiliation; (3) \$500,000 for punitive damages; and (4) pre- and post-judgment interest and costs. Discovery is scheduled to close by August 1, 2003. Any dispositive

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motions must be filed by September 5, 2003, oral fact discovery is extended until September 15, 2003 and a hearing on dispositive motions is set for September 30, 2003. A final pre-trial conference will be held on November 24, 2003, a week after the deadline for submission of pretrial material. The jury trial is set to begin December 8, 2003. ISCO considers these claims without merit and intends to defend against them vigorously.

*Patent Litigation*

In July 2001, the Company filed suit in the United States District Court for the District of Delaware against Conductus, Inc. and Superconductor Technologies, Inc. alleging infringement of U.S. Patent No. 6,263,215, entitled Cryoelectronically Cooled Receiver Front End for Mobile Radio Systems ( the 215 patent ). This suit alleges that Conductus and Superconductor Technologies base station front-end systems containing cryogenically cooled superconducting filters infringe this patent. The Company is seeking a permanent injunction enjoining Conductus and Superconductor Technologies from marketing, selling or manufacturing these products, as well as triple damages and attorneys fees. Conductus and Superconductor Technologies have denied these allegations and asked the court to enter a judgment that the patent is invalid and not infringed. Conductus and Superconductor Technologies are also asserting the defense of inequitable conduct and a counterclaim for a declaration that the patent is unenforceable. Conductus and Superconductor Technologies have also asserted federal and state law counterclaims, including claims of unfair competition. Conductus and Superconductor Technologies are seeking both compensatory and punitive damages as well as attorneys fees and costs.

On March 26, 2002, the Company replied to Conductus and Superconductor Technologies Second Amended Answer and Counterclaims and filed counterclaims alleging that Conductus and Superconductor Technologies also infringe U.S. Patent No. 6,104,934 entitled Cryoelectronic Receiver Front End and U.S. Patent No. 6,205,340 B1 entitled Cryoelectronic Receiver Front End For Mobile Radio Systems . On April 17, 2002, the court dismissed these (the Company s) counterclaims without prejudice to the Company s right to assert these counterclaims in a separate action.

On February 10, 2003, the court disposed of various motions for summary judgment filed by each party. The court denied Superconductor Technologies motion for summary judgment of invalidity of the 215 patent as well as Conductus motion for summary judgment limiting computation of damages to a reasonable royalty for sales to Dobson Communications, Inc. On Superconductor Technologies motion for summary judgment of non-infringement, the court granted the motion with respect to claim 13 of the 215 patent and otherwise denied the motion with respect to each of the other asserted claims. With regard to Conductus motion for summary judgment of non-infringement, the court granted the motion with respect to claim 13 of the 215 patent and otherwise denied the motion with respect to each of the other asserted claims. In addition, the court denied Conductus motion for summary judgment of invalidity of all asserted claims for causes of action existing prior to the date of issuance of the certificate of correction and of invalidity of claim 13. The court also denied the Company s motions for summary judgment that Superconductor Technologies internal projects are not prior art to the 215 patent and to dismiss the defendants counterclaims alleging unfair competition and interference with business relations.

On April 3, 2003, the jury returned with its verdict. The jury rejected the Company s positions and determined its patent to be invalid. Additionally, the jury determined that inequitable conduct had occurred and subsequently awarded defendants \$3.87 million in damages from the Company. The Company was severely disappointed by this verdict and in engaged in the post-trial motion process to overturn it.

The Company intends to continue to prosecute these claims vigorously and continue to defend against counterclaims in this litigation. The Company believes the patent to be valid, the counterclaims asserted against the Company to be without merit, and that it is in the best interests of the Company and its shareholders to pursue this matter vigorously.

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In November 2001, the Company filed suit against Dobson Communications, Inc. for allegedly infringing this patent. The action has been stayed, per agreement between the parties, until resolution of the matter between the Company and Conductus and Superconductor Technologies. The parties have agreed that Dobson Communications will be bound by any and all final, non-appealable determinations, holdings or findings with respect to all liability issues in the Company's case against Conductus.

**Item 6. Exhibits and Reports on Form 8-K.**

(a) Exhibits: A list of exhibits is set forth in the Exhibit Index found on page 18 of this report.

(b) Reports on Form 8-K:

On April 3, 2003, the Company announced the jury verdict related to the recent patent infringement allegation against Superconductor Technologies, Inc. and its wholly-owned subsidiary, Conductus, Inc. (STI).

On July 22, 2003, the Company reported financial results for the second quarter ended June 30, 2003. In addition, the Company announced that it had borrowed \$300,000 from the line of credit agreement with affiliates of its two largest shareholders which was entered into on October 23, 2002.

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**Signatures**

Pursuant to the requirements of Section 13 or 15(d) 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 on the 14th day of August, 2003.

**ISCO International, Inc.**

By: /s/ Amr Abdelmonem

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Dr. Amr Abdelmonem  
Chief Executive Officer (Principal  
Executive Officer)

By: /s/ Frank Cesario

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Frank Cesario  
Chief Financial Officer (Principal  
Financial and Accounting Officer)

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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description of Exhibit</b>  |
|---------------------------|--|
| 31.1                      | Certification by Chief Executive Officer pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2                      | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1                      | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                  |