

ISCO INTERNATIONAL INC  
Form 10-Q  
August 14, 2006  
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## SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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### Form 10-Q

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(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, 2006.

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 001-22302

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## ISCO INTERNATIONAL, INC.

(Name of Registrant as Specified in Its Charter)

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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)

Registrant's Telephone Number, Including Area Code (847) 391-9400

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

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

Class	Outstanding at July 30, 2006
Common Stock, par value \$0.001 per share	185,962,034

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements.****ISCO INTERNATIONAL, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>June 30, 2006 (unaudited)</b>	<b>December 31, 2005</b>
<b>Assets:</b>		
Current Assets:		
Cash and cash equivalents	\$ 5,557,286	\$ 3,486,430
Inventories	2,907,753	2,715,170
Accounts receivable, net	2,693,644	1,677,334
Prepaid expenses, settlement receivable, and other	70,710	253,167
<b>Total current assets</b>	<b>11,229,393</b>	<b>8,132,101</b>
Property and equipment:		
Property and equipment	1,130,498	1,037,432
Less: accumulated depreciation and amortization	(760,911)	(720,142)
<b>Net property and equipment</b>	<b>369,587</b>	<b>317,290</b>
Restricted certificates of deposit	200,000	242,180
Goodwill	13,370,000	13,370,000
Intangible assets, net	835,395	844,062
<b>Total assets</b>	<b>\$ 26,004,375</b>	<b>\$ 22,905,633</b>
<b>Liabilities and Stockholders' Equity:</b>		
Current liabilities:		
Accounts payable	\$ 393,363	\$ 416,095
Inventory-related material purchase accrual	545,000	530,134
Employee-related accrued liabilities	372,562	208,408
Accrued professional services	88,843	279,000
Other accrued liabilities	180,663	301,923
<b>Total current liabilities</b>	<b>1,580,431</b>	<b>1,735,560</b>
Deferred facility reimbursement	110,000	118,988
Notes and related accrued interest with related parties	15,905,705	10,520,369
Stockholders' equity:		
Preferred stock; 300,000 shares authorized; No shares issued and outstanding at June 30, 2006 and December 31, 2005		
Common stock (\$.001 par value); 250,000,000 shares authorized; 185,507,034 and 183,252,036 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively		
	185,507	183,252
Additional paid-in capital (net of unearned compensation)	171,193,845	170,387,752
Accumulated deficit	(162,971,113)	(160,040,288)
<b>Total stockholders' equity</b>	<b>8,408,239</b>	<b>10,530,716</b>

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Total liabilities and stockholders' equity	\$ 26,004,375	\$ 22,905,633
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NOTE: The condensed consolidated balance sheet as of December 31, 2005 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.

**Table of Contents****ISCO INTERNATIONAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net sales	\$ 3,446,280	\$ 2,484,159	\$ 4,771,869	\$ 5,777,280
Costs and expenses:				
Cost of sales	2,058,819	1,194,403	2,889,254	3,115,682
Research and development	474,415	554,649	937,939	901,160
Selling and marketing	852,192	445,479	1,483,097	811,871
General and administrative	1,118,432	911,901	2,059,080	1,763,301
Total costs and expenses	4,503,858	3,106,432	7,369,370	6,592,014
Operating loss	(1,057,578)	(622,273)	(2,597,501)	(814,734)
Other income (expense):				
Interest income	20,878	4,460	52,013	8,454
Interest expense	(194,087)	(193,375)	(385,337)	(486,461)
	(173,209)	(188,915)	(333,324)	(478,007)
Net loss	\$ (1,230,787)	\$ (811,188)	\$ (2,930,825)	\$ (1,292,741)
Basic and diluted loss per share	\$ (0.01)	\$ (0.00)	\$ (0.02)	\$ (0.01)
Weighted average number of common shares outstanding	184,411,485	162,491,230	183,993,196	161,535,245

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

**Table of Contents****ISCO INTERNATIONAL, INC.****CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY****Six Months ended June 30, 2006****(UNAUDITED)**

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total
	Number of Shares	Amount			
Balance at December 31, 2005	183,252,036	\$ 183,252	\$ 170,387,752	\$ (160,040,288)	\$ 10,530,716
Exercise of Stock Options and vesting of Restricted Shares	2,254,998	2,255	171,546		173,801
Equity Compensation Expense			631,423		631,423
Short Swing Profit Recovery			3,124		3,124
Net Loss				(2,930,825)	(2,930,825)
Balance at June 30, 2006	185,507,034	\$ 185,507	\$ 171,193,845	\$ (162,971,113)	\$ 8,408,239

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

**Table of Contents****ISCO INTERNATIONAL, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(UNAUDITED)**

	<b>Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Operating Activities:</b>		
Net loss	\$ (2,930,875)	\$ (1,292,741)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization, excluding goodwill	68,260	70,134
Patent-related charge		199,819
Non-cash compensation expense	631,423	508,313
Changes in operating assets and liabilities	(805,167)	(324,160)
Net cash used in operating activities	(3,036,359)	(838,635)
<b>Investing Activities:</b>		
Decrease in restricted CD s	42,180	
Payment of patent costs	(16,887)	(25,696)
Acquisition of property and equipment, net	(95,003)	(52,429)
Net cash used in investing activities	(69,710)	(78,125)
<b>Financing Activities:</b>		
Short swing profit recovery	3,124	
Proceeds from borrowings	5,000,000	1,000,000
Exercise of stock options and vesting of restricted stock	173,801	227,450
Net cash provided by financing activities	5,176,925	1,227,450
(Decrease)/Increase in cash and cash equivalents	2,070,856	310,690
Cash and cash equivalents at beginning of period	3,486,430	402,391
Cash and cash equivalents at end of period	\$ 5,557,286	\$ 713,081

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 we, the Company, or ISCO ). All significant intercompany balances and transactions have been eliminated in consolidation.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America ( US GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of results for the interim periods have been included. These financial statements and notes included herein should be read in conjunction with ISCO s audited financial statements and notes for the year ended December 31, 2005 included in ISCO s Annual Report on Form 10-K filed with the Securities and Exchange Commission. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for any subsequent quarter of for the entire year ending December 31, 2006. For further information, refer to the financial statements, including the notes thereto, included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

**Recent Accounting Pronouncements**

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

In June 2005, the FASB issued SFAS No. 154 Accounting Changes and Error Corrections ( SFAS No. 154 ), which will require entities that voluntarily make a change in an accounting principle to apply that change retrospectively to prior periods financial statements, unless such retrospective application would be impracticable. SFAS No. 154 supersedes Accounting Principles Board Opinion No. 20, Accounting Changes ( APB No. 20 ), which previously required that most voluntary changes in accounting principle be recognized by including in the current period s net income the cumulative effect of changing to the new accounting principle. SFAS No. 154 also makes a distinction between retrospective application of an accounting principle and the restatement of financial statements to reflect the correction of an error. Another significant change in practice under SFAS No. 154 will be the requirement that if an entity changes its method of depreciation, amortization, or depletion for long-lived, non-financial assets, the change must be accounted for as a change in accounting estimate. Under APB No. 20, such a change would have been reported as a change in accounting principle. SFAS No. 154 applies to accounting changes and error corrections that are made in fiscal years beginning after December 15, 2005 and will have an effect on us to the extent we make an accounting change or correct an error.

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During June 2006, the FASB issued FIN 48, Accounting for Uncertainty in Income Taxes, which will impact the recognition, measurement, and disclosure of positions taken for income tax purposes. The Interpretation is effective for fiscal years beginning after December 15, 2006 (2007 in ISCO's case). Because ISCO has historically posted losses and has maintained a full valuation allowance on its available future income tax benefit, we do not expect this Interpretation to have a material effect on our results of operations or financial position.

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

SFAS No. 123(R) replaces FASB Statement No. 123 (SFAS No. 123), Accounting for Share-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. The provisions of SFAS No. 123(R) are required to be applied by public companies that do not file as small business issuers, as of the first interim or annual reporting period that begins after June 15, 2005, and all other public companies as of the first interim or annual reporting period that begins after December 15, 2005. On April 14, 2005, the SEC adopted a new rule amending the effective date for Statement 123(R). The amended rule allows registrants to implement Statement 123(R) as of the first annual period beginning after June 15, 2005, which was January 1, 2006 for the Company.

On January 1, 2006 the Company adopted SFAS No. 123(R), under the modified prospective application transition method without restatement of prior interim periods. This will result in the Company recognizing compensation cost based on the requirements of SFAS No. 123(R) for all equity-based compensation awards issued after the effective date of this statement. For all equity-based compensation awards that were unvested as of that date, compensation cost is recognized for the unamortized portion of compensation cost not previously included in the SFAS No. 123 pro forma footnote disclosure. The adoption of SFAS No. 123(R) is expected to have a material effect on the Company's results of operations with respect to equity issuances during 2006 and beyond, beginning with a non-cash charge expected to total in excess of \$1.5 million throughout 2006.

The effects on earnings and earnings per share if the value recognition provisions of FAS 123(R) were applied to the three-month and six-month periods ended June 30, 2005 is presented in the following tables:

	<b>Three months ended June 30, 2005</b>	<b>Six months ended June 30, 2005</b>
Net loss, as reported	\$ (811,000)	\$ (1,293,000)
Deduct net change in stock-based employee compensation expense determined under fair-value-based method of all rewards, net of tax	\$ (159,000)	\$ (292,000)
Pro forma net loss	\$ (970,000)	\$ (1,585,000)
Pro forma net loss per share (basic)	\$ (0.01)	\$ (0.01)
Pro forma net loss per share (diluted)	\$ (0.01)	\$ (0.01)

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Report as Rounded

Outstanding, December 31, 2005	8,146,436	8,146,000
Granted		
Forfeited or canceled	(635,000)	(635,000)
Exercised	(845,000)	(845,000)
Outstanding, June 30, 2006	6,666,436	6,666,000

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in the first six months of 2005: no dividend yield, expected volatility of 105%, risk-free interest rate of 3.8%, and an expected life of 4 years.

At June 30, 2006, a total of 6,666,000 stock options were outstanding under the Company's equity compensation plans. Stock-based compensation expense recognized during the second quarter of 2006 included compensation expense for stock options granted prior to, but not yet vested as of, April 1, 2006, based on the grant date fair value estimated in accordance with the pro forma provisions of FAS 123. Included in stock-based compensation expense in the second quarter and first six months of 2006 were \$17,000 and \$78,000, respectively, related to stock options.

**Restricted Share Rights**

Restricted share grants offer employees the opportunity to earn shares of the Company's stock over time. These grants generally vest over two years for employees and one year for non-employee directors. The Company recognizes 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. Included within these grants are also performance-based shares, that is, shares that vest based on accomplishing particular objectives as opposed to vesting over time. No performance-based shares were vested during the three month and six month periods ending June 30, 2006.

The following table summarizes the restricted stock award activity during the first six months of 2006.

		Weighted	
		Average Grant Date	
	Shares	Fair Value (per share)	
Outstanding, December 31, 2005	None	None	
Granted	13,280,000	\$	0.35
Forfeited or canceled	150,000	\$	0.39
Vested	1,410,000	\$	0.35
Outstanding, June 30, 2006	11,720,000	\$	0.35

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The total fair value of restricted shares vested during the three and six month periods ended June 30, 2006 was \$402,000 and \$507,000, respectively. Total non-cash equity compensation expense recognized during the three and six month periods ended June 30, 2006 were \$410,000 and \$631,000, respectively. Non-cash equity expense for the three and six month periods ended June 30, 2006, included \$402,000 and \$507,000 for vested restricted share grants, \$17,000 and \$78,000, respectively, for the vesting of stock options awarded prior to 2005, and (\$9,000) and \$46,000, respectively, for the straight-line amortization of restricted share grants that did not vest during the three and six month periods ended June 30, 2006.

**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, 2006. In addition, the Company has used, rather than provided, cash in its operations.

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

The Company has incurred, and continues to incur, losses from operations. For the years ended December 31, 2005, 2004, and 2003, the Company incurred net losses of \$3 million, \$7 million, and \$7.2 million, respectively. Although financial performance has improved, the Company incurred additional net losses of \$1.2 million and \$2.9 million, respectively, during the three and six month periods ended June 30, 2006. The Company's strategy included the consolidation of its manufacturing and research and development facilities, increasing the efficiency of the Company's processes, focusing development efforts on products with a greater probability of commercial sales, reducing professional fees and discretionary expenditures, and negotiating favorable payment arrangements with suppliers and service providers. More importantly, the Company configured itself along an outsourcing model, thus allowing for relatively large, efficient production without the associated overhead. The combination of these factors has been highly effective in bringing the Company closer to profitability (from a net loss as high as \$28 million during 2001) while enabling it to deliver significant quantities of solutions. 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 listed above.

To date, the Company has financed its operations primarily through public and private equity and debt financings. Projected increases in working capital requirements from larger expected quarterly revenues during 2006 and beyond, and also the expected deployment of additional financial resources in the expansion of the Company's business and product offering that are expected to provide additional revenue opportunities, required the \$5 million of capital that was added during June 2006 (see Note 6 Debt and Financial Position). The Company believes it has sufficient financial resources to operate its business as intended during the remainder of 2006 and into 2007. The Company's uncommitted line of credit facility matures during August 2007, an event which will require the Company to have additional capital available, whether in the form of an extension of this arrangement or a new arrangement, by that date. The primary covenant in the Company's existing uncommitted line of credit involves the right of the lenders to receive debt repayment from the proceeds of new financing activities. This covenant may restrict the Company's ability to apply the proceeds of a financing event toward operations until the debt is repaid in full.

**Table of Contents****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:

	<b>June 30, 2006</b>	<b>December 31, 2005</b>
Raw materials	\$ 1,655,000	\$ 1,368,000
Work in process	803,000	443,000
Finished product	450,000	904,000
	\$ 2,908,000	\$ 2,715,000

Cost of product sales for the six months ending June 30, 2006, and the twelve months ended December 31, 2005 include approximately \$0 and \$0, respectively, of costs in excess of the net realizable value of inventory (including obsolete materials).

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 \$200,000 and \$160,000 as of June 30, 2006 and December 31, 2005, respectively.

**Note 5 - Stock Options and Equity Transactions**

On August 19, 1993, the Board of Directors adopted the 1993 Stock Option Plan for employees, consultants, and directors who were not also employees of the Company (outside directors). This plan reached its ten-year expiration during 2003. During the 2003 annual meeting of shareholders, the Company's shareholders approved a new 2003 Equity Incentive Plan to take the place of the expiring 1993 plan. Unissued options from the 1993 plan were used to fund the 2003 plan. During the 2005 annual meeting of shareholders, the Company's shareholders approved 12 million additional shares of stock to be included in the 2003 Plan, and clarified the ability for the 2003 Plan to utilize up to 5 million unused shares originally allocated to the 1993 Plan. During the 2006 annual meeting of shareholders, the Company's shareholders approved a grant of up to 6 million shares to the Company's President and CEO, John Thode. The maximum number of shares issuable under these plans is 32,011,468. These Plans are collectively referred to as the Plan.

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

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vesting provisions that are not based solely on employees rendering of additional service to the Company. Beginning in 2006, the Compensation Committee of the Board approved grants of RSGs to be used as compensation for outside directors in lieu of NSOs.

For outside directors, the Company's non-employee director compensation policy provides that each outside director will be automatically granted RSGs on the date of their initial election to the Board of Directors. On the date of the annual meeting of the stockholders of the Company, each outside director who is elected, reelected, or continues to serve as a director, shall be granted additional RSGs, except for those outside directors who are first elected to the Board of Directors at the meeting or three months prior. RSGs or NSOs granted typically vest ratably over the service period, which is usually one year, and expire after ten years from the grant date.

During 2005, the Board elected to utilize a transition rule provided under FAS 123(R), and accelerated the vesting to December of 2005 a total of 364,198 options that were priced above the Company's stock price (i.e., out of the money options) and scheduled to vest after 2005. There was no compensation expense recognized upon the acceleration of the options in 2005. The majority of these accelerated options were scheduled to vest during the first quarter 2006. By employing this method, these options were excluded from the Company's FAS 123(R) calculation in the first quarter 2006. Beginning in 2006, the Board has indicated an interest in providing restricted stock grants in lieu of stock options in many circumstances, and indeed has begun doing so within both employee and non-employee compensation programs. The impact of the new accounting standard, industry trends, and the ability to use fewer shares to achieve intended results are a few of the reasons behind this change in view. The Board has also expressed an intention to continue to utilize performance-based equity incentives for more cases of equity compensation than in years past.

On October 31, 2003, the Board of Directors authorized the re-pricing of certain out of the money stock options granted to directors. A new strike price of \$0.24 per share was established. Due to the adoption of FAS123(R), these options are now accounted for under the new standard, and as such not automatically adjusted on a quarterly basis based solely on changes in share price.

On January 2, 2003, the 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 vested monthly in 12 installments. All of the options granted on January 2, 2003 were granted at a discount based on 25% of the average closing price of the Company's common stock as reported on the American Stock Exchange over ten trading days and ultimately valued at a \$0.22 discount to the closing price of the Company's common stock as of the date of the grant. During July 2003, the Board of Directors cancelled approximately 2.8 million outstanding options held by certain Company employees, including officers. During January 2004, a total of 3.7 million options were granted to the employees of the Company, including officers, at a similar 25% discount. Such options vested for 1 or 2 years. An expense was recognized for the value of the discount through the vesting period. Additionally, certain of these 2003 options were accounted for using variable accounting. Due to the adoption of FAS123(R), these options are now accounted for under the new standard, and as such not automatically adjusted on a quarterly basis based solely on changes in share price.

On August 2, 2005, the Company completed a financing transaction with its two largest shareholders (including their affiliates). These entities, including affiliates, are also the Company's lenders, with a total of \$10.3 million in principal and interest due as of September 30, 2005. In exchange for 20 million shares of common stock, the Company received \$4.4 million. In addition, the \$10.3 million in debt, including accrued interest, which was due April 2006, is now due August 2007. Finally, the lenders agreed to waive their right to be repaid with new financing proceeds, allowing the Company to utilize the funds for product development or otherwise as it chooses. Pursuant to the provisions of Section 16 of the Securities Exchange Act of 1934, these entities also remitted approximately \$0.6 million in profits from sales of Company common stock during the six months preceding this financing.

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During the three and six month periods ended June 30, 2006, the Company's board of directors granted 220,000 and 330,000 RSGs, respectively, to the Company's non-employee board members, and 900,000 and 6,950,000 RSGs, respectively, to the Company's employees, most of which are scheduled to vest over a two year period. The latter figure includes grants to Dr. Amr Abdelmonem, the Company's Chief Technology Officer, of 1.5 million RSGs that will vest over a two year period and 2 million RSGs that will only vest as a result of certain performance objectives being met. During the June 2006 annual meeting of shareholders, the Company's shareholders approved a grant of 6 million RSGs to the Company's President and Chief Executive Officer, John Thode. Two million of these RSGs will vest over a two year period and the other 4 million will only vest as a result of certain performance objectives being met.

**Note 6 - Debt and Financial Position**

**2002 Credit Line**

As of the reporting date, the Company has drawn \$8.5 million of debt financing under a credit line, as described below. 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 Corporation) and Alexander Finance, L.P. This line initially provided up to \$4 million to the Company. This line was uncommitted, such that each new borrowing under the facility would be subject to the approval of the lenders. Borrowings on this line bore an initial interest rate of 9.5% and were collateralized 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 were entitled to receive warrants to the extent funds were drawn down on the line. The warrants bore a strike price of \$0.20 per share of common stock and were to expire on April 15, 2004. The credit line was to mature and be due, including accrued interest thereon, on March 31, 2004. Due to a subsequent agreement between the parties no warrants were issued with subsequent borrowings.

According to existing accounting pronouncements and SEC guidelines, the Company allocated the proceeds of these borrowings between their debt and equity components. As a result of these borrowings during 2002, the Company recorded a non-cash charge of \$1.2 million through the outstanding term of the warrants (April, 2004). \$250,000 and \$862,000 of that amount were recorded during 2004 and 2003, respectively. These warrants were valued at \$1.2 million of the \$2 million debt instrument based on a Black-Scholes valuation that included the difference between the value of the Company's common stock and the exercise price of the warrants on the date of each warrant issuance and a 30% discounted face value of the notes, leaving the remaining \$0.8 million as the underlying value of the debt. This \$1.2 million was amortized over the vesting period of the warrants (six quarters from the fourth quarter 2002 through the first quarter 2004).

During October 2003, the Company entered into an agreement with its lenders to supplement the credit line with an additional \$2 million, \$1 million of which was drawn immediately and \$1 million subsequently drawn upon the Company's request and subject to the approval of the lenders. This supplemental facility bore a 14% rate of interest and was due October 31, 2004. The term of the previous credit line was not affected by this supplement, and as such the \$4 million borrowed under that line, plus accrued interest, remained due March 31, 2004.

During February 2004, these credit lines were extended to a due date of April 2005, with interest after the initial periods to be charged at 14%. No warrants or other inducements were issued with respect to these extensions. Additionally, lenders exercised their 10 million warrants during February 2004, agreeing to let the Company use the funds for general purposes as opposed to repaying debt.

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During July 2004, the Company and its lenders agreed to increase the aggregate loan commitments under the credit line from \$6,000,000 to \$6,500,000. Simultaneously, the Company drew the remaining \$1,500,000 of the financing.

During November 2004, the Company and its lenders agreed to increase the line of credit to up to an additional \$2 million to an aggregate loan commitment of \$8,500,000, \$1 million of which was drawn immediately by the Company with the remaining \$1 million drawable upon the Company's request and subject to the approval of the lenders, which occurred during January 2005.

During February 2005, the consolidated credit line was extended until April 1, 2006. Interest during the extension period was to be charged at 9%. No warrants or other inducements were issued with respect to this extension.

On August 2, 2005, the Company and its lenders agreed to extend the due date from April 2006 until August 2007, and the lenders also agreed to waive the Company's obligation to repay its debt with proceeds from an equity financing transaction with its lenders, including affiliates, in August 2005. No warrants or other inducements were issued as a result of this transaction.

## 2006 Convertible Debt

During June 2006 the Company entered into a Securities Purchase Agreement (the "Agreement") and convertible notes (the "Notes") with Alexander Finance, L.P., and Manchester Securities Corporation L.P. (together, the "Lenders"), pursuant to which the Lenders have agreed, to each loan the Company \$2,500,000, or an aggregate of \$5,000,000, in convertible debt. The Lenders, including affiliates, are the Company's two largest shareholders. The transaction is structured as a private placement of securities pursuant to Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act") and Rule 506 promulgated thereunder.

The Notes will mature on June 22, 2010 and bear an interest rate of 5% due at maturity. Both the principal amount and any accrued interest on the Notes is convertible into the Company's common stock at a rate of \$0.33 per share, subject to certain anti-dilution adjustments. The Lenders have the right to convert the Notes, both principal and accrued interest, into shares of common stock at the rate of \$0.33 per share at any time. The Company has the right to redeem the Notes in full in cash at any time beginning two years after the date of the Agreement. The conversion rate of the Notes will be subject to customary anti-dilution protections, provided that the number of additional shares of common stock issuable as a result of changes to the conversion rate will be capped so that the aggregate number of shares of common stock issuable upon conversion of the Notes will not exceed 19.99% of the aggregate number of shares of common stock presently issued and outstanding.

The Notes are secured on a first priority basis by all of the Company's intangible and tangible property and assets. Payment of the Notes are guaranteed by the Company's two subsidiaries, Spectral Solutions, Inc. and Illinois Superconductor Canada Corporation. The Agreement contains customary representations, warranties and covenants. The Company is required to file a registration statement covering the resale of the shares of common stock issuable upon conversion of the Notes with the Securities and Exchange Commission within 45 days following the issuance of the Notes. Concurrently with the execution of the Agreement, the Lenders have waived their right under the Company's existing line of credit arrangement to receive the financing proceeds from the issuance of the Notes, allowing the Company to use the funds for product development or general working capital purposes. No fees have been paid to any financial advisor, placement agent, broker or finder in connection with the transactions contemplated by the Agreement and the Notes.

Assuming the Notes are held for the full four year term, 18,505,719 shares of common stock would be required upon settlement, for both principal and interest. This amount is approximately 10% of the



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approximately 184 million shares of common stock currently issued and outstanding. As of June 22, 2006, the Lenders, including their affiliates, owned approximately 43% of the Company's outstanding shares. As a result of this transaction, the combined holdings of the Lenders would be approximately 48% of the Company's outstanding common stock.

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

#### **Forward Looking Statements**

Because we want to provide investors with more meaningful and useful information, this Quarterly Report on Form 10-Q contains, and incorporates by reference, certain forward-looking statements that reflect our current expectations regarding its future results of operations, performance and achievements. We have tried, wherever possible, to identify these forward-looking statements by using words such as anticipates, believes, estimates, expects, designs, plans, intends, looks, may, and similar expressions. These statements reflect our current expectations and are based on information currently available to us. Accordingly, these statements are subject to certain risks, uncertainties and contingencies, including the factors set forth under Item 1A, Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2005, which could cause our actual results, performance or achievements for 2006 and beyond to differ materially from those expressed in, or implied by, any of these statements. You should not place undue reliance on any forward-looking statements. Except as otherwise required by federal securities laws, we undertake no obligation to release publicly the results of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date of this prospectus or to reflect the occurrence of unanticipated events.

#### **General**

We have shifted from manufacturing in-house to an outsourced manufacturing model wherein we supply parts and raw materials to third parties, who then complete the products to our specifications. This system allows us to outsource procurement in the future if we choose to do so. Our products are designed for efficient production in this manner, emphasizing solid-state electronics over mechanical devices with moving parts. The decrease in cost associated with these developments, coupled with enhanced product functionality, have significantly reduced overhead costs since 2002 and allowed us to realize consistently improved margins. In addition, because we have built upon and expanded upon our earlier developed technology, based on substantial input from customers, to launch the RF<sup>2</sup> product family and consider additional solutions, we have generally controlled total research and development ( R&D ) costs.

The wireless telecommunications market has experienced significant merger activity in recent years, a trend which may continue. These activities often result in operators attempting to manage and maintain disparate technologies and spectrum assets, and the need to integrate those assets. In addition, the deployment of data applications is adding to the industry requirement to integrate disparate technologies into base stations and other fixed points of access, resulting in the need to manage multiple wireless signals and keep them from interfering with each other. We are focused on providing solutions that address these types of requirements and, as a result of this focus, we bid on substantially larger business opportunities during 2005 and 2006 than we had in recent years. These proposals often are accompanied by long approval cycles and up-front product development costs. We believe the potential benefits to outweigh these costs, and expect to continue to bid on these types of business opportunities. We also continue to pursue an increasing number of smaller projects to complement these larger opportunities.

We announced several significant events to date during 2006. For instance, in January and February 2006, we entered into employment agreements with three executive officers: an agreement with Mr. John S. Thode, to continue to serve as our President and Chief Executive Officer, an agreement with Dr. Amr Abdelmonem, to continue to act as our Executive Vice President and Chief Technology Officer, and an agreement with Mr. Frank J. Cesario, to continue to serve as our Chief Financial Officer. We also announced sales and product developments such as increased international sales and sourcing activities, the expansion of our customer base, and significant new product development including the launch of our

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first digital platform, the digital ANF (dANF), which is designed for use in the PCS (1900 MHz) band and can be configured for other architectures/frequencies. The second quarter of 2006 saw more than \$5 million of customer orders received a record for quarterly orders and revenue and a substantial increase over previous periods as well an infusion of \$5 million in capital through the issuance of convertible notes to affiliates of our two largest stockholders who are also our existing lenders. Despite these improvements, the wireless telecommunications industry is subject to risks beyond our control that can negatively impact customer capital spending budgets (as occurred during 2003) and/or spending patterns (as occurred during 2004 and the first quarter of 2006). For these and other reasons, and despite our expectation that 2006 results will exceed 2005 results, our financial statements have been prepared assuming we will continue as a going concern.

As an after-market vendor, we have experienced uneven revenue, reflecting the buying patterns of wireless telecommunications carriers. We and other after-market vendors historically have experienced a fourth quarter effect in which operators used a disproportionately large percentage of their capital budgets at the end of their fiscal year rather than lose it going forward. More recently, as operators have embarked on significant projects such as the deployment of and upgrades to data networks, wireless operators have often reallocated funds from their voice networks to other activities, and from fiscal year planning to project planning. We have been adjusting our product line and sales strategy to try to take advantage of these trends and, thus, realize a higher, more stable revenue stream.

As indicated above, we are also pursuing digital technologies, including the deployment of our dANF platform for PCS. We believe that by producing solutions in digital format and adding solutions for the PCS band to complement those for the traditional 850 MHz band, we will extend coverage in the wireless telecommunications realm and greatly increase our available market, both in an expanded reach in the cellular market and new opportunities in the non-cellular market. If we are successful in this effort, we expect to open a much broader addressable market and thus have the opportunity to enjoy substantially larger revenues.

We were founded in 1989 by ARCH Development Corporation, an affiliate of the University of Chicago, to commercialize superconductor technologies initially developed by Argonne National Laboratory. We were incorporated in Illinois on October 18, 1989 and reincorporated in Delaware on September 24, 1993. Our facilities and principal executive offices are located at 1001 Cambridge Drive, Elk Grove Village, IL 60007 and our telephone number is (847) 391-9400.

## **Results of Operations**

### *Three Months Ended June 30, 2006 and 2005*

Our net sales increased \$962,000, or 39%, to \$3,446,000 for the three months ended June 30, 2006 from \$2,484,000 for the same period in 2005. This increase was due to the expansion of our RF<sup>2</sup> product family and the shipment of more RF<sup>2</sup> products to customers during the second quarter of 2006 relative to the second quarter of 2005. We anticipate our unit volume and related revenue to increase during the third quarter of 2006 as compared to the third quarter of 2005, due to existing and/or anticipated customer orders. Our order backlog entering the third quarter of 2006 was approximately \$1.8 million, up from a negligible backlog at the same time of 2005.

Cost of sales increased by \$865,000, or 72%, to \$2,059,000 for the three months ended June 30, 2006 from \$1,194,000 for the same period in 2005. The increase in cost of sales was due primarily to the 39% increase in sales volume, but to a lesser extent by a less favorable product mix (40% gross margin during the current period as compared to approximately 50% during the same period of 2005).

Our research and development ( R&D ) expenses decreased by \$81,000, or 15%, to \$474,000 for the three months ended June 30, 2006, from \$555,000 for the same period in 2005. However, we

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expensed \$200,000 of capitalized patent-related charges during the second quarter 2005, as we deemed such items to be unlikely to generate significant future revenues. Excluding this non-cash patent charge, spending actually increased by \$119,000, or 34%, from the prior year period. We added a significant number of products to our RF<sup>2</sup> product family during 2006, including a Ground Mounted Amplifier (GMA), but focused most of our spending on the digital ANF platform (dANF). The first dANF product for PCS was completed during the first half of 2006, and additional products within this platform are expected to come out during the next several quarters. Finally, we are developing a fully digital ANF platform, which we expect to be applicable beyond the base station in wireless telecommunications. We expect to continue to invest more in R&D than during 2006 as we develops these products.

Selling and marketing expenses increased by \$407,000, or 91%, to \$852,000 for the three months ended June 30, 2006, from \$445,000 for the same period in 2005. The increase in expense was attributable to the continued addition of personnel in this area as we pursue larger business opportunities and additional customers. We have also performed extensive customer development activities as we have added new customers and launched new products, particularly the dANF product platform, an area expected to increase during the third quarter. Thus, we expect to continue to incur at least this level of selling and marketing expenses in future periods.

General and administrative expenses increased by \$206,000, or 23%, to \$1,118,000 for the three months ended June 30, 2006, from \$912,000 for the same period in 2005. This increase was attributable to an increase in cash and non-cash equity compensation charges as compared to the prior period. Other than non-cash equity compensation charges, General and Administrative costs are expected to stay approximately the same during the rest of the year.

*Six Months Ended June 30, 2006 and 2005*

Our net sales decreased \$1,005,000, or 17%, to \$4,772,000 for the six months ended June 30, 2006 from \$5,777,000 for the same period in 2005. This decrease was due primarily to the timing of order fulfillment, as sales activity actually increased from 2005 to 2006. We entered 2005 with approximately \$2 million in order backlog and added approximately \$3.8 million in new orders to ship \$5.8 million during the first six months of 2005. During 2006, we received approximately \$6.4 million in orders (primarily June 2006), shipping \$4.8 million during the first six months of 2006 (primarily June 2006) and expect to fulfill the backlog during the third quarter 2006. We anticipate our unit volume and related revenue to increase during the remainder of 2006 as compared to the second half of 2005, due to existing and/or anticipated customer orders.

Cost of sales decreased by \$227,000, or 7%, to \$2,889,000 for the six months ended June 30, 2006 from \$3,116,000 for the same period in 2005. The decrease in cost of sales was due primarily to the 17% decrease in sales volume, but was also impacted by a less favorable product mix (approximately 40% gross margin during 2006 vs. 46% during 2005).

Our R&D expenses increased by \$37,000, or 4%, to \$938,000 for the six months ended June 30, 2006, from \$901,000 for the same period in 2005. Because we expensed \$200,000 of capitalized patent-related charges during the second quarter 2005, the actual increase in spending is really 26%. We added a significant number of products to our RF<sup>2</sup> product family during 2006, including a Ground Mounted Amplifier (GMA), but focused most of our spending on the digital ANF platform (dANF). The first dANF product for PCS was completed during the first half of 2006, and additional products within this platform are expected to come out during the next several quarters. Finally, we are developing a fully digital ANF platform, which it expects to be applicable beyond the base station in wireless telecommunications. We expect to continue to invest more in R&D than during 2006 as we develop these products.

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Selling and marketing expenses increased by \$671,000, or 83%, to \$1,483,000 for the six months ended June 30, 2006, from \$812,000 for the same period in 2005. The increase in expense was attributable to the continued addition of personnel in this area as we pursue larger business opportunities and additional customers. We have also performed extensive customer development activities as we have added new customers and launched new products, particularly the dANF product platform, an area expected to increase during the third quarter. Thus, we expect to continue to incur at least this level of selling and marketing expenses in future periods.

General and administrative expenses increased by \$296,000, or 17%, to \$2,059,000 for the six months ended June 30, 2006, from \$1,763,000 for the same period in 2005. This increase was attributable to an increase in cash and non-cash equity compensation charges as compared to the prior period. Other than non-cash equity compensation charges, General and Administrative costs are expected to stay approximately the same during the rest of the year.

## **Liquidity and Capital Resources**

At June 30, 2006, the Company's cash and cash equivalents were \$5,557,000, an increase of \$2,071,000 from the balance at December 31, 2005 of \$3,486,000.

During the first six months of 2006, the Company realized \$5 million from the issuance of convertible debt, funded a \$1 million increase in accounts receivable due to the highest quarterly revenue in our history recorded during the second quarter, and spent roughly \$1.9 million in cash on the business, including the development of next generation products.

The continuing development and expansion of sales of the Company's RF 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, and the costs involved in protecting the Company's patents or other intellectual property.

To date, the Company has financed its operations primarily through public and private equity and debt financings. Projected increases in working capital requirements from larger expected quarterly revenues during 2006 and beyond, and also the expected deployment of additional financial resources in the expansion of the Company's business and product offering that are expected to provide additional revenue opportunities, required the \$5 million of capital that was added during June 2006 (see Note 6 Debt and Financial Position). The Company believes it has sufficient financial resources to operate its business as intended during the remainder of 2006 and into 2007. The Company's uncommitted line of credit facility matures during August 2007, an event which will require the Company to have additional capital available, whether in the form of an extension of this arrangement or a new arrangement, by that date. The primary covenant in the Company's existing uncommitted line of credit involves the right of the lenders to receive debt repayment from the proceeds of new financing activities. This covenant may restrict the Company's ability to apply the proceeds of a financing event toward operations until the debt is repaid in full.

## **Contractual Obligations, Commitments, and Off Balance Sheet Arrangements**

The following table lists the contractual obligations and commitments that existed as of June 30, 2006:

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Contractual Obligations	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Year					
Long Term Debt Obligations	\$ 17,852,000		\$ 11,746,000	\$ 6,106,000	
Operating Lease Obligations	\$ 1,510,000	\$ 165,000	\$ 345,000	\$ 370,000	\$ 630,000
Total	\$ 19,362,000	\$ 165,000	\$ 12,091,000	\$ 6,476,000	\$ 630,000

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

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

**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, 2006. 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 changes in the Company's internal control over financial reporting identified in connection with the evaluation of such controls 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 1A. Risk Factors.**

There have been no material changes to prior disclosures in our 2005 Annual Report on Form 10-K.

**Item 4. Submission of Matters to a Vote of Security Holders.**

At our annual meeting of shareholders held on June 16, 2006, the following proposals were approved by the margins indicated:

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	Number of Shares	
	Voted For	Withheld
1. To elect seven (7) Directors, to serve for one year and until a successor is elected and qualified:		
Mr. John Thode	159,199,650	3,055,997
Mr. Jim Fuentes	158,772,256	3,483,391
Dr. Amr Abdelmonem	159,179,101	3,076,546
Dr. George Calhoun	158,677,732	3,577,915
Mr. Mike Fenger	158,938,910	3,316,737
Mr. Ralph Pini	159,173,100	3,082,547
Mr. Tom Powers	159,032,813	3,222,834

	Voted For	Number of Shares		Broker
		Against	Abstain	Non- Votes
2. To approve the proposed restricted stock grant to John Thode, the Company's President and Chief Executive Officer, and the corresponding amendment to the Company's 2003 Equity Incentive Plan, as amended	17,754,999	4,910,973	500,347	139,096,203
3. To ratify the appointment of Grant Thornton LLP as the independent auditors of our financial statements for the fiscal year ending December 31, 2006.	159,435,551	2,425,980	394,116	none

**Item 6. Exhibits**

Exhibits: A list of exhibits is set forth in the Exhibit Index found on page 21 of this report.

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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 14<sup>th</sup> day of August 2006.

**ISCO International, Inc.**

By: /s/ John Thode

Mr. John Thode

President and Chief Executive

Officer (Principal Executive Officer)

By: /s/ Frank Cesario

Frank Cesario

Chief Financial Officer (Principal

Financial and Accounting Officer)



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**EXHIBIT INDEX**

<b>Exhibit 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.