ISCO INTERNATIONAL INC
Form 10-Q
November 14, 2003

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2003.

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

For the transition period from ______________ to _______________

Commission file number 000-22302

ISCO INTERNATIONAL, INC.

(Name of Registrant as Specified in Its Charter)

Delaware	**36-3688459**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
451 Kingston Court Mt. Prospect, Illinois	**60056**
(Address of Principal Executive Offices)	(Zip Code)

Registrant s Telephone Number, Including Are Code **(847) 391-9400**

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

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

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

Class	Outstanding at October 31, 2003
Common Stock, par value $0.001 per share Preferred Stock Purchase Rights	148,124,927

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ISCO INTERNATIONAL, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2003	December 31, 2002
	(unaudited)	
Assets:		
Current Assets:		
Cash and cash equivalents	$ 307,734	$ 216,119
Inventories	918,861	896,572
Accounts receivable, net	342,298	1,551,912
Prepaid expenses, settlement receivable, and other	118,947	471,918
Total current assets	1,687,840	3,136,521
Property and equipment:		
Property and equipment	8,971,688	8,968,732
Less: accumulated depreciation	(8,058,189)	(7,463,289)
Net property and equipment	913,499	1,505,443
Restricted certificates of deposit	91,099	114,508
Intangible assets, net	14,466,047	14,426,528
Total assets	$ 17,158,485	$ 19,183,000
Liabilities and Stockholders Equity:		
Current liabilities:		
Accounts payable	$ 133,122	$ 193,458
Accrued liabilities	3,109,317	1,609,236
Current debt	4,000,000	
Total current liabilities	7,242,439	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 September 30, 2002 and December 31, 2001, respectively		
Common stock ($.001 par value); 250,000,000 shares authorized; 148,124,927 and 147,944,927 shares issued and outstanding at September 30, 2003 and December 31, 2002, respectively	148,125	147,945
Additional paid-in capital (net of unearned compensation)	159,545,429	158,172,391
Accumulated deficit	(149,777,508)	(142,940,030)
Total stockholders equity	9,916,046	15,380,306
Total liabilities and stockholders equity	$ 17,158,485	$ 19,183,000

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 September 30,		Nine Months Ended September 30,	
	2003	**2002**	**2003**	**2002**
Net sales	$ 377,500	$ 429,645	$ 1,948,952	$ 2,127,005
Costs and expenses:				
Cost of sales	297,995	541,304	1,259,942	2,668,189
Research and development	232,281	659,287	756,293	2,357.633
Selling and marketing	214,246	387,522	713,545	1,723,013
General and administrative	904,395	1,653,416	5,204,238	6,058,902
Total costs and expenses	1,648,917	3,241,529	7,934,018	12,807,737
Operating loss	(1,271,417)	(2,811,884)	(5,985,066)	(10,680,732)
Other income (expense):				
Interest income	940	6,241	4,104	59,915
Interest expense	(302,720)		(856,516)	(168,602)
Other income (expense), net	(301,780)	6,241	(852,412)	(108,687)
Net loss	$ (1,573,197)	$ (2,805,643)	$ (6,837,478)	$ (10,789,419)
Basic and diluted loss per share	$ (0.01)	$ (0.02)	$ (0.05)	$ (0.08)
Weighted average number of common shares outstanding	147,986,340	147,944,927	147,972,619	141,764,798

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
Nine Months ended September 30, 2003

(UNAUDITED)

	Common Stock					
	Number of Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Unearned Compen-sation	Total
Balance at December 31, 2002	147,944,927	$147,945	$158,672,239	$(142,940,030)	$(499,848)	$15,380,306
Exercise of DSU s	30,000	30	(30)			
Exercise of stock options	150,000	150	16,350			16,500
Cancellation of Options and DSU s			(308,448)		308,448	
Compensation Expense for non-employee stock options/other stock compensation			520,686		191,400	712,086
Non-cash warrant expense			644,632			644,632
Net Loss				(6,837,478)		(6,837,478)
Balance at September 30, 2003	148,124,927	$148,125	$159,545,429	$(149,777,508)		$ 9,916,046

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

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ISCO INTERNATIONAL, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30,	
	2003	**2002**
Operating Activities:		
Net loss	$(6,837,478)	$(10,789,419)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization, excluding goodwill	628,496	698,582
Non-cash warrant expense	644,632	
Non-cash compensation expense	712,086	306,900
Changes in operating assets and liabilities	2,980,040	(1,177,543)
Net cash used in operating activities	(1,872,224)	(10,961,480)
Investing Activities:		
Decrease / (Increase) in restricted certificates of deposit	23,409	(9,750)
Payment of patent costs	(73,114)	(177,061)
Acquisition of property and equipment, net	(2,956)	(124,707)
Net cash used in investing activities	(52,661)	(311,518)
Financing Activities:		
Proceeds from Shareholder Rights Offering		19,764,985
Credit Line Proceeds	2,000,000	
Exercise of stock options	16,500	311
Payments on other long-term debt		(9,425,000)
Net cash provided by financing activities	2,016,500	10,340,296
Increase/(Decrease) in cash and cash equivalents	91,615	(932,702)
Cash and cash equivalents at beginning of period	216,119	1,720,697
Cash and cash equivalents at end of period	$ 307,734	$ 787,995

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 interim 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 interim financial statements and notes included herein should be read in conjunction with the Company s audited financial statements and notes therein 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 SEC). 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.

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 September 2003, the Company performed an evaluation of goodwill for impairment and no impairment was determined to exist, thus no write-down was required.

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.

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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 nine 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 September 30,
	2003	2002
Net loss, as reported	$1,573	$2,805
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	89	103
Less: Total stock-based employee compensation determined under fair value based method for awards granted, modified, or settled, net of related tax effects	19	488
Pro forma net loss	$1,503	$3,190
Loss per share:		
Basic as reported	$ 0.01	$ 0.02
Basic pro forma	$ 0.01	$ 0.02
Diluted as reported	$ 0.01	$ 0.02
Diluted pro forma	$ 0.01	$ 0.02

	Nine Months	Ended September 30,
	2003	2002
Net loss, as reported	$6,837	$10,789
Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects	712	308
Less: Total stock-based employee compensation determined under fair value based method for awards granted, modified, or settled, net of related tax effects	1,513	1,437
Pro forma net loss	$7,638	$11,918

Loss per share:		
Basic as reported	$ 0.05	$ 0.08
Basic pro forma	$ 0.05	$ 0.08
Diluted as reported	$ 0.05	$ 0.08
Diluted pro forma	$ 0.05	$ 0.08

In January 2003, the FASB issued FASB Interpretation No.46, Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46). FIN 46 requires that if an entity has a controlling financial interest in a variable interest entity, the assets, liabilities and results of activities of the variable interest entity should be included in the consolidated financial statements of the entity. FIN 46 requires that its provisions are effective immediately for all arrangements entered into after January 31, 2003. For those arrangements entered into prior to February 1, 2003, the FIN 46 provisions are required to be adopted at the beginning of the first interim or annual period beginning after December 15, 2003.

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The Company does not expect that the provisions of FIN 46 will have a material impact on the Company s results of operations or financial position.

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivative instruments and Hedging Activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003. The Company believes that the adoption of SFAS No. 149 will not have a material impact on the Company s results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The Company believes that the adoption of SFAS No. 150 will not have a material impact on the Company s results of operations or financial position.

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 September 30, 2003. 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, 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 $1,573,197 during the third quarter 2003, and $6,837,478 during the nine months ended September 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.

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

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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

The Company follows SFAS No. 128, Earnings Per Share, which requires a dual presentation of basic and diluted earnings per share on the face of the statements of operations. 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 and warrants are not included in the per share calculations since the effect of their inclusion would be antidilutive. Excluded from this calculation, as indicated, were approximately 8.0 million outstanding options (both vested and unvested).

Note 4 Inventories

Inventori