

ISCO INTERNATIONAL INC  
Form 10-Q  
May 17, 2004  
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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 March 31, 2004.

**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

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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

36-3688459  
(I.R.S. Employer

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Incorporation or Organization)

Identification No.)

**451 Kingston Court Mt. Prospect, Illinois**  
(Address of Principal Executive Offices)

**60056**  
(Zip Code)

**(847) 391-9400**

(Registrant's Telephone Number, Including Area Code)

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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 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.

| <u>Class</u>                              | <u>Outstanding at April 30, 2004</u> |
|---|--------------------------------------|
| Common Stock, par value \$0.001 per share |                                      |
| Preferred Stock Purchase Rights           | 160,428,260                          |

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

|   | March 31,<br>2004<br><u>(unaudited)</u> | December 31,<br>2003<br><u></u> |
|---|---|---------------------------------|
| <b>Assets:</b>  |   |                                 |
| Current Assets:   |   |                                 |
| Cash and cash equivalents   | \$ 1,179,458                            | \$ 346,409                      |
| Inventories   | 938,139                                 | 678,361                         |
| Accounts receivable, net  | 210,082                                 | 1,169,711                       |
| Prepaid expenses and other  | 282,474                                 | 321,147                         |
|   | <u>2,610,153</u>                        | <u>2,515,628</u>                |
| Total current assets  | 2,610,153                               | 2,515,628                       |
| Property and equipment:   |   |                                 |
| Property and equipment  | 8,973,977                               | 8,957,866                       |
| Less: accumulated depreciation  | (8,453,660)                             | (8,256,489)                     |
|   | <u>520,317</u>                          | <u>701,377</u>                  |
| Net property and equipment  | 520,317                                 | 701,377                         |
| Restricted certificates of deposit  | 40,527                                  | 40,527                          |
| Intangible assets, net  | 14,466,531                              | 14,465,503                      |
|   | <u>17,637,528</u>                       | <u>17,723,035</u>               |
| Total assets  | \$ 17,637,528                           | \$ 17,723,035                   |
| <b>Liabilities and Stockholders Equity:</b>   |   |                                 |
| Current liabilities:  |   |                                 |
| Accounts payable  | \$ 102,376                              | \$ 243,647                      |
| Accrued liabilities   | 1,212,593                               | 1,536,141                       |
|   | <u>1,314,969</u>                        | <u>1,779,788</u>                |
| Total current liabilities   | 1,314,969                               | 1,779,788                       |
| Other long-term debt, less current portion  | 5,000,000                               | 5,000,000                       |
| Stockholders equity:  |   |                                 |
| Preferred stock; 300,000 shares authorized; No shares issued and outstanding at March 31, 2004 and December 31, 2003  |   |                                 |
| Common stock (\$.001 par value); 250,000,000 shares authorized; 160,410,760 and 150,149,927 shares issued and outstanding at March 31, 2004 and December 31, 2003, respectively |   |                                 |
|   | 160,411                                 | 150,150                         |
| Additional paid-in capital (net of unearned compensation)   | 163,215,910                             | 160,889,202                     |
| Accumulated deficit   | (152,053,762)                           | (150,096,105)                   |
|   | <u>163,322,559</u>                      | <u>160,933,247</u>              |

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|  |               |               |
|--|---------------|---------------|
| Total stockholders' equity                 | 11,322,559    | 10,943,247    |
| Total liabilities and stockholders' equity | \$ 17,637,528 | \$ 17,723,035 |

NOTE: The condensed consolidated balance sheet as of December 31, 2003 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)**

|  | <b>Three Months Ended</b> |                       |
|--|---------------------------|-----------------------|
|  | <b>March 31,</b>          |                       |
|  | <b>2004</b>               | <b>2003</b>           |
| Net sales  | \$ 421,950                | \$ 1,235,351          |
| Costs and expenses:                                  |                           |                       |
| Cost of sales  | 308,595                   | 629,521               |
| Research and development                             | 233,989                   | 289,713               |
| Selling and marketing                                | 223,539                   | 273,733               |
| General and administrative                           | 1,233,550                 | 2,928,659             |
| Total costs and expenses                             | <u>1,999,673</u>          | <u>4,121,626</u>      |
| Operating loss                                       | (1,577,723)               | (2,886,275)           |
| Other income (expense):                              |                           |                       |
| Interest income                                      | 1,807                     | 2,056                 |
| Non-cash interest expense                            | (250,297)                 | (212,516)             |
| Interest expense                                     | <u>(131,445)</u>          | <u>(54,361)</u>       |
|  | <u>(379,935)</u>          | <u>(264,820)</u>      |
| Net loss   | <u>\$ (1,957,658)</u>     | <u>\$ (3,151,095)</u> |
| Basic and diluted loss per share                     | <u>\$ (0.01)</u>          | <u>\$ (0.02)</u>      |
| Weighted average number of common shares outstanding | <u>154,233,040</u>        | <u>147,956,594</u>    |

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

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

|   | Three Months Ended |                |
|---|--------------------|----------------|
|   | March 31,          |                |
|   | 2004               | 2003           |
| <b>Operating Activities:</b>  |                    |                |
| Net loss  | \$ (1,957,658)     | \$ (3,151,095) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                    |                |
| Depreciation and amortization   | 209,373            | 196,959        |
| Non-cash interest (warrant) expense   | 250,297            | 212,516        |
| Non-cash compensation expense   | 48,705             | 413,050        |
| Changes in operating assets and liabilities                                 | 273,706            | 1,627,858      |
|   | (1,175,577)        | (700,712)      |
| Net cash used in operating activities                                       |                    |                |
| <b>Investing Activities:</b>  |                    |                |
| Decrease/(Increase) in restricted certificates of deposit                   |                    | 24,050         |
| Payment of patent costs   | (13,231)           | (31,957)       |
| Acquisition of property and equipment                                       | (16,111)           | (6,101)        |
|   | (29,341)           | (1,806)        |
| Net cash used in investing activities                                       |                    |                |
| <b>Financing Activities:</b>  |                    |                |
| Exercise of warrants  | 2,000,000          |                |
| Proceeds from short-term loan   |                    | 1,000,000      |
| Exercise of stock options   | 37,967             |                |
|   | 2,037,967          | 1,000,000      |
| Net cash provided by financing activities                                   |                    |                |
| Increase in cash and cash equivalents                                       | 833,049            | 297,482        |
| Cash and cash equivalents at beginning of period                            | 346,409            | 216,119        |
|   | \$ 1,179,458       | \$ 513,601     |
| Cash and cash equivalents at end of period                                  |                    |                |

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

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**ISCO INTERNATIONAL, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED)**

**Note 1 - Basis of Presentation**

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

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of results for the interim periods have been included. These financial statements and notes included herein should be read in conjunction with the Company's audited financial statements and notes for the year ended December 31, 2003 included in the Company'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 or for the entire year ending December 31, 2004. For further information, refer to the financial statements, including the notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

**Recent Accounting Pronouncements**

In January 2003, the FASB issued FASB Interpretation No. 46 (FIN No. 46), *Consolidation of Variable Interest Entities*, to expand upon existing accounting guidance that addresses when a company should include in its financial statements the assets, liabilities and activities of another entity. In December 2003, the FASB revised FIN No. 46 to provide more clarification. Until now, a company generally has included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 changes that by requiring a variable interest entity, as defined, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. FIN No. 46, as revised, did not have a material impact on the Company's consolidated financial statements.

**Note 2. Realization of Assets**

The accompanying financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company has sustained substantial losses from operations in recent years, and such losses have continued through the (unaudited) quarter ended March 31, 2004. 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

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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, 2003, 2002, and 2001, the Company incurred net losses of \$7,156,075, \$13,077,832, and \$28,189,603, respectively. The Company incurred an additional net loss of \$1,957,658 during the first three months of 2004. During the past few 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. Subject to the uncommitted nature of the credit line, the Company believes that it has sufficient funds to operate its business as identified herein and to meet its obligations through 2004, provided that the Company is able to borrow the \$1 million remaining under the uncommitted line of credit. Should this line not be available, the Company believes it has sufficient funds to operate into the third or fourth quarter 2004, and quite possibly beyond, depending on operating results. The Company intends to look into augmenting its existing capital position by utilizing the credit line as identified and/or through other sources of capital.

**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>March 31, 2004</u> | <u>December 31, 2003</u> |
|------------------|-----------------------|--------------------------|
| Raw materials    | \$ 268,000            | \$ 357,000               |
| Work in process  | 310,000               | 67,000                   |
| Finished product | 360,000               | 254,000                  |
|                  | <u>\$ 938,000</u>     | <u>\$ 678,000</u>        |

Cost of product sales for the three months ending March 31, 2004, and the twelve months ending December 31, 2003 include approximately \$0 and \$130,000, respectively, of costs in excess of the net realizable value of inventory.

**Note 5 - Stock Options and Warrants**

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). This plan reached its ten-year expiration during 2003. During the 2003 annual meeting of shareholders,

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the Company's shareholders approved a new 2003 Equity Incentive Plan to take the place of the expiring 1993 plan. Unissued options from the 1993 plan were used to fund the 2003 plan. The maximum number of shares issuable under these plans was 14,011,468.

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

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

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

On July 1, 2000, Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25 (FIN 44) was adopted by the Company. FIN 44 requires that stock options that have been modified to reduce the exercise price be subject to variable accounting. The Company accounts for employee stock options under APB Opinion No. 25 and non-employee stock options under Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation (SFAS No. 123).

On May 10, 1999, as described above, the Company re-priced certain stock options granted to employees and in accordance with US GAAP, at that time, the Company accounted for the re-priced stock options as fixed. As a result of adopting FIN 44, the Company is required to apply variable accounting to these options. If the market price of the Company's common stock increases above the July 1, 2000 market price, the Company will have to recognize additional compensation expense equal to the increase in stock price multiplied by the number of re-priced options. No additional expense will be recognized if the stock does not exceed the July 1, 2000 value. However, the impact cannot be determined as it is dependent on the change in the market price of the common stock from July 1, 2000 until the stock options are exercised, forfeited, or expire unexercised. Because the stock price on December 31, 2003 was below that of July 1, 2000, no expense has been recognized during the period.

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On February 5, 2001, the Company's board of directors authorized the re-pricing of certain out of the money stock options granted to employees during the calendar year of 2000 to the closing share price on such date, or \$1.9375 per share. This re-pricing causes these options to be subject to variable accounting as described in FIN 44. Because the stock price on March 31, 2004, was lower than the re-priced strike price no gain or loss was recognized during the period.

On April 1, 2002, the Company's board of directors authorized the re-pricing of certain out of the money stock options granted to employees. A new strike price of \$0.81 per share was established, provided the respective employees remain with the Company for at least six months following the re-pricing date. In addition, certain stock options granted to directors were repriced, with a new strike price of \$1.00 per share. As the stock price on March 31, 2004, was lower than the re-priced strike price no gain or loss was recognized during the period.

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.

On October 31, 2003, the Company's 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. This price was based on the closing price of the Company's common stock as quoted on the American Stock Exchange on October 1, 2003. The closing price of the Company's common stock on October 31, 2003 was \$0.20 per share.

During 2003, the Company's Board of Directors granted 3,570,000 new stock options to the Company's employees, including officers, and Directors. The majority of the grants to employees, including officers, were priced at 25% of the average closing price of the Company's common stock as reported on the American Stock Exchange over ten trading days prior to the date of grant. Due to the resulting discount, \$217,000 of compensation expense was recognized during the first quarter of 2004.

Certain options granted prior to 2004 were deemed subject to variable accounting. As such, a charge of \$418,000 was recognized during the fourth quarter 2003 to reflect the \$0.55 closing price of the Company's common stock as of December 31, 2003. Because the closing price of the Company's common stock on March 31, 2004 was \$0.44 per share, \$168,000 of this amount was reversed during the first quarter 2004. During July 2003, the Board of Directors cancelled approximately 2.8 million outstanding options held by certain Company employees, including officers.

During the first three months of 2004, the Company's board of directors granted 3,710,000 stock options to the Company's employees and non-employee Board members. The options granted to non-employee directors were issued at the closing market price on the date of grant. The majority of the option grants were to employees and were issued at a discount to market price based on 25% of the average closing price of the Company's common stock as reported on the American Stock Exchange for ten trading days.

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As of the reporting date, the Company had drawn \$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 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 interest rate of 9.5% and are 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 an agreement between the parties that did not provide warrants with respect to the most recent \$2 million in borrowings, a maximum of 10 million warrants were issued as a result of this transaction. During February 2004, the warrant holders exercised all of their warrants, contributing \$2 million to the Company in exchange for 10 million shares of common stock.

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 has recorded a non-cash charge of \$1.2 million through the outstanding term of the warrants (fully exercised as of March 31, 2004). The final \$250,000 of that amount was recorded during the quarter ended March 31, 2004.

As announced 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 available to be 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. Unlike the previous credit line, the supplemental facility did not include any stock warrants. The term of the previous credit line were 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, as noted above, the 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.

**Note 7 Stock Based Compensation**

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

Stock expense for the first quarters of 2004 and 2003, respectively, includes the result of options issued with an exercise price below the underlying stock's market price. The following table illustrates



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the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement 123, Accounting for Stock-Based Compensation as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FASB Statement No. 123, using the assumptions described in Note 5, to its stock-based employee plans:

|   | <b>Quarter Ended<br/>2004</b> | <b>March 31,<br/>2003</b> |
|---|-------------------------------|---------------------------|
|   | <u>          </u>             | <u>          </u>         |
| Net loss, as reported   | \$ 1,958                      | \$ 3,151                  |
| Add: Stock-based employee compensation expense included in reported net loss, net of related tax effects  | 49                            | 413                       |
| Less: Total stock-based employee compensation determined under fair value based method for awards granted, modified, or settled, net of related tax effects | 142                           | 899                       |
| Pro forma net loss  | \$ 2,051                      | \$ 3,637                  |
| 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                   |

**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 for the fiscal year ended December 31, 2003. 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. 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 solutions to optimize the reverse link for the wireless telecommunications industry. Reverse link is the signal from the mobile device to the base station. Reverse link problems often lead to dropped calls, ineffective attempts, high mobile transmit power, capacity reduction and coverage dead zone areas. The Company solves these problems utilizing its adaptive notch filter (ANF) technology, its value-leading Reverse link Radio Frequency Fidelity (RFF) technology, and a variety of other products and services.



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The continuing development of and expansion in sales of the Company's RF product lines, as well as the continued defense of its intellectual property, may require a commitment of funds to undertake product line development and potentially the expansion of manufacturing capabilities and to market and sell its RF front-end products. 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 its research and product development programs, the ability of the Company to improve or maintain product margins, the potential cost of additional plant and equipment for manufacturing and the costs involved in protecting the Company's patents or other intellectual property.

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.

## **Overview**

The Company has shifted from manufacturing in-house to an outsourced manufacturing model. Its 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, has allowed the Company to realize improved margins. Extensions of developed technology, based on substantial input from customers, have allowed the Company to launch the RF<sup>2</sup> product and consider additional solutions while controlling total R&D cost. The Company announced during the first three months of 2004 the resolution of the Laves litigation, the receipt of \$2 million from the exercise of all outstanding warrants (which were related to the credit line), and the extension of its credit line debt maturity date from March and October 2004 to April 2005. Despite these improvements, the wireless telecommunications industry is subject to risks beyond the Company's control that can negatively impact customer capital spending budgets and/or spending patterns. Despite cultivating more business opportunities during the first three months of 2004 than in prior periods, total revenue from closed and shipped business was less than expected during the period. While the Company views the varied reasons for this difficulty to be temporary in nature, nonetheless, for these and other reasons, the Company's financial statements have been prepared assuming the Company will continue as a going concern.

## **Results of Operations**

### *Three Months Ended March 31, 2004 and 2003*

The Company's net sales decreased \$813,000, or 66%, to \$422,000 for the three months ended March 31, 2004 from \$1,235,000 for the same period in 2003. This decrease was primarily due to the timing of order fulfillment. The Company quoted more than \$2 million in business during the first quarter 2004 but was unable to complete most of those transactions by March 31, 2004. The Company believes the variety of reasons cited by potential customers (competing internal projects, timing issues, etc.) to be temporary in nature. The Company anticipates its revenue during the second quarter 2004 to exceed revenue posted during the second quarter 2003 due to existing and/or anticipated future orders.

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Cost of sales decreased by \$321,000, or 51%, to \$309,000 for the three months ended March 31, 2004 from \$630,000 for the same period in 2003. The decrease in cost of sales was due to the decrease in sales volume listed above. Cost of sales is expected to increase with the anticipated increase in revenue.

The Company's research and development expenses decreased by \$56,000, or 19%, to \$234,000 for the three months ended March 31, 2004, from \$290,000 for the same period in 2003.

Selling and marketing expenses decreased by \$50,000, or 18%, to \$224,000 for the three months ended March 31, 2004, from \$274,000 for the same period in 2003.

General and administrative expenses decreased by \$1,695,000, or 58%, to \$1,234,000 for the three months ended March 31, 2004, from \$2,929,000 for the same period in 2003. This decrease was primarily attributable to a decrease in legal expenses related to the patent litigation.

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### **Liquidity and Capital Resources**

At March 31, 2004, the Company's cash and cash equivalents were \$1,179,000, an increase of \$833,000 from the balance at December 31, 2003 of \$346,000.

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.

As of the date of this filing, the Company believes that it has sufficient funds to operate its business as identified herein without the need for substantial future capital sources during 2004, provided that the Company is able to borrow the \$1 million remaining under the uncommitted line of credit. Should this credit become unavailable, the Company believes it has sufficient funds to operate until the third or fourth quarter of 2004, and quite possibly longer, subject to operating results. The Company intends to look into augmenting its existing capital position by utilizing the credit line as identified and/or through other sources of capital.

### **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 March 31, 2004. 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 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.

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**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings.**

*Laves Litigation*

On July 17, 2000 former President and CEO Edward W. Laves filed a two-count Complaint (the Complaint) in the Law Division of the Circuit Court of Cook County, Illinois. Laves sued for breach of contract (Count I) and for violation of the Illinois Wage Payment and Collection Act ( Wage Act ) (Count II). During February 2004, the parties reached settlement. Laves was paid \$700,000, half of which came from the Company and the remainder from the Company's insurance carrier, and all parties agreed to terminate proceedings, with prejudice. The Company accrued for its portion as a contingent liability as of December 31, 2003.

*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 seeks 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 denied these allegations and asked the court to enter a judgment that the patent is invalid and not infringed. Conductus and Superconductor Technologies also asserted the defense of inequitable conduct and a counterclaim for a declaration that the patent is unenforceable as well as federal and state law counterclaims, including claims of unfair competition. Conductus and Superconductor Technologies sought 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.



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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 it engaged in the post-trial motion process to overturn it. On August 21, 2003, the court issued its ruling on the post-trial motions. The court overturned the jury's determination of unfair competition on the part of the Company and denied all requests for damages, including the \$3.87 million jury award cited above. The court did not, however, overturn the jury determinations of patent invalidity and unenforceability based on inequitable conduct and denied ISCO's motion for a new trial.

During September 2003, the Company filed an appeal of this verdict requesting the reinstatement of its patent and the rights inherent within that patent, and Superconductor Technologies, Inc. filed a cross-appeal requesting reinstatement of the jury award and attorney's fees. This process is ongoing. As of the date of this document, each party had filed a brief with the court and additional filings are scheduled.

The Company intends to continue to prosecute its claims vigorously on appeal and continue to defend against defendants' counterclaims. 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.

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 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities.**

### **Recent Sales of Unregistered Securities**

During February 2004, the Company issued 10 million shares of common stock that were not registered under the Securities Act of 1933, as amended ( 1933 Act ) in reliance on an exemption pursuant to Section 4(2) of the 1933 Act. These shares were issued pursuant to the exercise of warrants by the Company's two largest shareholders, an affiliate of Elliott Associates, L.P. (Manchester Securities Corporation) and Alexander Finance, L.P. under the terms of the Company's credit line. The Company received \$2 million in aggregate strike price for the exercise of these warrants.

## **Item 5. Other Information.**

During April 2004, Michael Fenger joined the Company's Board of Directors. Mr. Fenger is Corporate Vice President and Chief Quality Officer of Motorola, Inc.

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**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 17 of this report.

(b) Reports on Form 8-K:

Current Report on Form 8-K, dated February 24, 2004, reporting the Company's announcement of an amendment to its financing agreement, the exercise of warrants by the Company's lenders, and settlement of the Laves Litigation.

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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 May, 2004.

**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><u>Exhibit<br/>Number</u></b> | <b><u>Description of Exhibit</u></b>  |
|----------------------------------|---|
| 10.1                             | Amendment to Loan Documents dated February 24, 2004 by and among Manchester Securities Corporation, Alexander Finance, L.P., ISCO International Inc., Spectral Solutions, Inc. and Illinois Superconductor, incorporated by reference to the Company's Current Report on Form 8-K filed on February 27, 2004. |
| 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.                              | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |