ISCO INTERNATIONAL INC
Form 10-Q
May 15, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**
For the quarterly period ended March 31, 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: 000-22302

ISCO INTERNATIONAL, INC.

(Name of Registrant as Specified in Its Charter)

Delaware **(State or Other Jurisdiction of** **Incorporation or Organization)**	**36-3688459** **(I.R.S. Employer** **Identification No.)**
1001 Cambridge Drive, Elk Grove Village, Illinois **(Address of Principal Executive Offices)**	**60007** **(Zip Code)**

(847) 391-9400

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act. ¨ Yes x 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 April 30, 2006
Common Stock, par value $0.001 per share	**184,309,535**
Preferred Stock Purchase Rights	

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

ISCO INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2006 (unaudited)	December 31, 2005
Assets:		
Current Assets:		
Cash and cash equivalents	$ 2,196,738	$ 3,486,430
Inventories	3,177,901	2,715,170
Accounts receivable, net	824,490	1,677,334
Prepaid expenses and other	157,966	253,167
Total current assets	6,357,095	8,132,101
Property and equipment:		
Property and equipment	1,113,724	1,037,432
Less: accumulated depreciation	(740,020)	(720,142)
Net property and equipment	373,704	317,290
Restricted certificates of deposit	200,000	242,180
Goodwill	13,370,000	13,370,000
Intangible assets, net	838,484	844,062
Total assets	$ 21,139,283	$ 22,905,633
Liabilities and Stockholders Equity:		
Current liabilities:		
Accounts payable	$ 442,107	$ 416,095
Inventory-related material purchase accrual	166,234	530,134
Employee-related accrued liabilities	147,736	208,408
Accrued professional services	109,096	279,000
Other accrued liabilities	234,031	301,923
Total current liabilities	1,099,204	1,735,560
Deferred facility reimbursement	113,750	118,988
Notes and related accrued interest with related parties	10,711,619	10,520,369
Stockholders equity:		
Preferred stock; 300,000 shares authorized; No shares issued and outstanding at March 31, 2006 and December 31, 2005		
Common stock ($.001 par value); 250,000,000 shares authorized; 184,309,535 and 183,252,036 shares issued and outstanding at March 31, 2006 and December 31, 2005, respectively	184,310	183,252
Additional paid-in capital (net of unearned compensation)	170,770,726	170,387,752
Accumulated deficit	(161,740,326)	(160,040,288)
Total stockholders equity	9,214,710	10,530,716

Total liabilities and stockholders equity	$ 21,139,283	$ 22,905,633

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.

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ISCO INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Net sales	$ 1,325,589	$ 3,293,121
Costs and expenses:		
Cost of sales	830,435	1,921,279
Research and development	463,524	346,511
Selling and marketing	630,905	366,391
General and administrative	940,648	851,401
Total costs and expenses	2,865,512	3,485,582
Operating loss	(1,539,923)	(192,461)
Other income (expense):		
Interest income	31,135	3,994
Interest expense	(191,250)	(293,086)
Other income (expense), net	(160,115)	(289,092)
Net loss	$ (1,700,038)	$ (481,553)
Basic and diluted loss per share	$ (0.01)	$ (0.00)
Weighted average number of common shares outstanding	183,570,258	161,217,259

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, 2006	Three Months Ended March 31, 2005
Operating Activities:		
Net loss	$ (1,700,038)	$ (481,553)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	32,580	38,615
Non-cash compensation expense	220,931	252,739
Changes in operating assets and liabilities	34,971	(343,188)
Net cash used in operating activities	(1,411,556)	(533,387)
Investing Activities:		
Decrease in certificates of deposit	42,180	
Payment of patent costs	(7,124)	(18,681)
Acquisition of property and equipment	(76,292)	(11,870)
Net cash used in investing activities	(41,236)	(30,551)
Financing Activities:		
Proceeds from loan		1,000,000
Exercise of stock options	163,100	700
Net cash provided by financing activities	163,100	1,000,700
(Decrease)/Increase in cash and cash equivalents	(1,289,692)	436,762
Cash and cash equivalents at beginning of period	3,486,430	402,391
Cash and cash equivalents at end of period	$ 2,196,738	$ 839,153

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, 2005 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 of, or for, the entire year ending December 31, 2006. 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, 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. The Company does not expect adoption of SFAS No. 151 to have a material effect on its 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 the Company to the extent the Company makes an accounting change or corrects an error.

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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 Company does not believe that the adoption of SFAS No. 123(R) materially impacted its results of operations or financial position with respect to outstanding options issued prior to 2006, and expects that the adoption may or may not have a material effect on the Company s results of operations depending on the level and form of future equity-based compensation awards issued.

The effects on earnings and earnings per share if the value recognition provisions of FAS 123(R) were applied to the three-month period ending March 31, 2005 is presented in the following table:

		Three months ended March 31, 2005
Net loss, as reported	$	(482,000)
Deduct net change in stock-based employee compensation expense determined under fair-value-based method of all rewards, net of tax	$	(145,000)
Pro forma net loss	$	(627,000)
Pro forma net loss per share (basic)	$	(0.00)
Pro forma net loss per share (diluted)	$	(0.00)

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 quarter of 2005: no dividend yield, expected volatility of 105%, risk-free interest rate of 3.8%, and an expected life of 4 years.

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At March 31, 2006, a total of 7,221,000 stock options were outstanding under the Company s equity compensation plans. Stock-based compensation expense recognized during the first quarter of 2006 included compensation expense for stock options granted prior to, but not yet vested as of, January 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 first quarter of 2006 was $61,000 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 first quarter 2006.

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

	Shares	Weighted Average Grant Date Fair Value (per share)
Outstanding, December 31, 2005	None	None
Granted	6,160,000	$ 0.38
Forfeited or canceled	None	None
Vested	267,500	$ 0.39
Outstanding, March 31, 2006	5,892,500	$ 0.38

The total fair value of restricted shares vested during the three months ended March 31, 2006 and 2005 was $105,000 and none, respectively. Total non-cash equity compensation expense recognized during the first quarter 2006 was $221,000, including the $105,000 for vested restricted share grants, $61,000 for the vesting of stock options awarded prior to 2005, and $55,000 for the straight-line amortization of restricted share grants that did not vest during the first quarter 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 March 31, 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 an additional net loss of $1.7 million during the first three months of 2006. 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, 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, will require additional capital during the second half of 2006. The Company intends to look into augmenting its existing capital position by continuing to evaluate potential short-term and long-term sources of capital whether from debt, equity, hybrid, or other methods. 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.

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:

	March 31, 2006	December 31, 2005
Raw materials	$ 1,155,000	$ 1,368,000
Work in process	1,063,000	443,000
Finished product	960,000	904,000
	$ 3,178,000	$ 2,715,000

Cost of product sales for the three months ended March 31, 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 $160,000 as of both March 31, 2006 and December 31, 2005.

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Note 5 - Stock Options and Warrants

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. The maximum number of shares issuable under these plans is 26,011,468. 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 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 the NSOs that were granted prior to 2006, 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 RSGs in lieu of stock options in many circumstances, and indeed has begun doing so within both employee and non-employee compensation programs. The Company s change in view is based on the impact of the new accounting standard, industry trends, and the ability to use fewer shares to achieve intended results. 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.

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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.

During the first three months of 2006, the Company s board of directors granted 110,000 RSGs to the Company s non-employee board members, and 6,050,000 RSGs to the Company s employees, most of which are scheduled to vest over a two year period. The latter figure includes 2 million RSGs that will only vest as a result of certain performance objectives being met.

Note 6 - Debt

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 (the 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.

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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.

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.

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 ou 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 raw materials to external parties and products are then completed. Further, this system allows us to outsource procurement in the future if we choose to do so. Manufacturing partners then produce to specification with Company personnel on hand to assist with quality control. 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, has allowed us to realize improved margins and significantly reduced overhead costs. Extensions of developed technology, based on substantial input from customers, have allowed us to launch the RF^2 product family and consider additional solutions while generally controlling total R&D cost.

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Wireless telecommunications has undergone significant merger activity in recent years, a trend which may continue. These activities often result in operators with 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. During 2005, we bid on substantially larger business opportunities 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 announced several significant recent events during 2006, such as increased international sales and sourcing activities, the expansion of our customer base, and significant new product development including the launch of our first digital platform, the digital ANF (DANF), which addresses the PCS band and can be configured for other architectures/frequencies. 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, our revenue has been sporadic, consistent with buying patterns of planning processes within wireless telecommunications carriers. In the past there has been a fourth quarter effect , wherein operators were forced to spend remaining budget or lose it going forward. With the advent of significant projects such as the deployment of data networks, funds are often reallocated between periods and thus diminish the pool of funds available for normal activities. Our objective is to be included in these projects, and thus realize a higher, more stable revenue stream.

As indicated above, we are also pursuing digital technologies, including the deployment of our DANF for PCS. We believe that adding solutions for the PCS band to complement those for the traditional 850 MHz band, and by producing solutions in digital format, will allow us to extend coverage in the wireless telecommunications realm, both in more aspects of the cellular market and beyond the cellular market, and thus greatly increase our available market.

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 1001 Cambridge Drive, Elk Grove Village, IL 60007 and telephone number is (847) 391-9400.

Results of Operations

Three Months Ended March 31, 2006 and 2005

Our net sales decreased $1,967,000, or 60%, to $1,326,000 for the three months ended March 31, 2006 from $3,293,000 for the same period in 2005. This decrease was primarily due to the fulfillment of a $2 million backlog going into 2005 of RF² product solutions deployed within wireless data networks, with no comparable backlog entering 2006. 2006 was further hampered by deviations in planned customer spending, which as noted above, can create substantial volatility in sales and related revenue recognition. We anticipate that revenue during the second quarter 2006 will exceed revenue posted during the first quarter 2006 due to existing and/or anticipated future orders, some of which are evidenced by customer forecasts and letters of intent. However, we must note that forecasts and letters of intent are, by their nature, nonbinding and subject to change. We entered the second quarter 2006 with no substantial order backlog, consistent with the last two quarters of 2005 and the first quarter of 2006.

Cost of sales decreased by $1,091,000, or 57%, to $830,000 for the three months ended March 31, 2006 from $1,921,000 for the same period in 2005. The decrease in cost of sales was due to the decrease in sales volume, less certain volume-related efficiencies.

Our research and development expenses increased by $117,000, or 34%, to $464,000 for the three months ended March 31, 2006, from $347,000 for the same period in 2005. This increase is due to increased spending associated with the addition of a significant number of products to our RF^2 product family during 2005, including a multicoupler solution and a PCS spectrum portfolio. We expect to continue to invest more in R&D during 2006 than we did during 2005 as we expand both our existing product families and develop two new product lines that would be applicable in wireless technologies beyond cellular telecommunications.

Selling and marketing expenses increased by $265,000, or 72%, to $631,000 for the three months ended March 31, 2006, from $366,000 for the same period in 2005. This increase is due to the addition of personnel and initiatives associated with larger proposed projects and an increased customer base. The expectation is that these efforts are necessary for, and are expected to produce, revenue in 2006 and beyond well in excess of that generated during 2005.

General and administrative expenses increased by $90,000, or 11%, to $941,000 for the three months ended March 31, 2006, from $851,000 for the same period in 2005. The first quarter of 2006 amount was approximately in line with the average quarterly result during 2005. The largest portion of the increase during the first quarter 2006 was due to compensation-related charges, specifically approximately $70,000 in bonuses associated with new employment agreements for the Chief Executive Officer, Chief Financial Officer, and Chief Technology Officer.

Liquidity and Capital Resources

At March 31, 2006, the Company s cash and cash equivalents were $2.2 million, a decrease of $1.3 million from the balance at December 31, 2005 of $3.5 million.

During the first quarter 2006, the Company utilized its cash and accounts receivable collections to fund a $0.5 million increase in inventories, $0.7 million net reduction in accrued expenses, and operating expenses that include substantial product development and costs required to support customer field trials.

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.

As of the date of this filing, 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, will require additional capital during the second half of 2006. The Company intends to look into augmenting its existing capital position by continuing to evaluate

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potential short-term and long-term sources of capital whether from debt, equity, hybrid, or other methods. 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

No such arrangements existed as of March 31, 2006, except for leases as described and the minimum lease payments as detailed in this document.

Contractual Obligations	Payments Due by Period				
Year	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long Term Debt Obligations	$ 11,746,000		$ 11,746,000		
Capital Lease Obligations					
Operating Lease Obligations	$ 1,554,000	$ 162,000	$ 340,000	$ 363,000	$ 689,000
Purchase Obligations					
Other Long Term Liabilities Reflect on the Registrant s Balance Sheet under GAAP					
Total	$ 13,300,000	$ 162,000	$ 12,086,000	$ 363,000	$ 689,000

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 March 31, 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 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.

None.

Item 1A. Risk Factors.

There have been no material changes to the risk factors described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibits: A list of exhibits is set forth in the Exhibit Index found on page 16 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 15th day of May 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

Exhibit Number	Description of Exhibit
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