IsoRay, Inc.
Form 10-Q
May 13, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2008

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to ____________

Commission File No. 001-33407

ISORAY, INC.
(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of incorporation or organization)	41-1458152 (I.R.S. Employer Identification No.)
350 Hills St., Suite 106, Richland, Washington (Address of principal executive offices)	99354 (Zip Code)

Registrant's telephone number, including area code: (509) 375-1202

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer”, “accelerated filer”, and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer o
Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):
Yes o No x

Number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date:

Class	Outstanding as of May 2, 2008

Common stock, $0.001 par value	22,942,088

ISORAY, INC.

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PART I – FINANCIAL INFORMATION
IsoRay, Inc. and Subsidiaries
Consolidated Balance Sheets

	March 31, 2008 (Unaudited)	June 30, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,353,295	$ 9,355,730
Short-term investments	6,506,859	9,942,840
Accounts receivable, net of allowance for doubtful accounts of $39,780 and $99,789, respectively	808,673	1,092,925
Inventory	862,439	880,834
Prepaid expenses	400,027	458,123
Total current assets	11,931,293	21,730,452
Fixed assets, net of accumulated depreciation	6,401,331	3,665,551
Deferred financing costs, net of accumulated amortization	72,847	95,725
Licenses, net of accumulated amortization	455,539	262,074
Restricted cash	174,273	-
Other assets, net of accumulated amortization	341,036	322,360
Total assets	$ 19,376,319	$ 26,076,162
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 1,066,270	$ 1,946,042
Accrued payroll and related taxes	242,234	459,068
Accrued interest payable	1,111	1,938
Deferred revenue	-	23,874
Notes payable, due within one year	55,025	49,212
Capital lease obligations, due within one year	61,390	194,855
Asset retirement obligation, current portion	-	131,142
Total current liabilities	1,426,030	2,806,131
Notes payable, due after one year	404,019	528,246
Capital lease obligations, due after one year	3,422	25,560
Asset retirement obligation	494,788	-
Total liabilities	2,328,259	3,359,937
Commitments and contingencies (see Note 11)		
Shareholders' equity:		

Preferred stock, $.001 par value; 6,000,000 shares authorized:				
Series A: 1,000,000 shares allocated; no shares issued and outstanding		-		-
Series B: 5,000,000 shares allocated; 59,065 shares issued and outstanding		59		59
Common stock, $.001 par value; 194,000,000 shares authorized; 23,090,200 and 22,789,324 shares issued and outstanding		23,090		22,789
Additional paid-in capital		47,292,395		45,844,793
Accumulated deficit		(30,267,484)		(23,151,416)
Total shareholders' equity		17,048,060		22,716,225
Total liabilities and shareholders' equity	$	19,376,319	$	26,076,162

The accompanying notes are an integral part of these financial statements.

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IsoRay, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)

	Three months ended March 31, 2008	Three months ended March 31, 2007	Nine months ended March 31, 2008	Nine months ended March 31, 2007
Product sales	$ 1,783,642	$ 1,645,694	$ 5,397,705	$ 4,085,293
Cost of product sales	1,682,981	1,456,978	5,930,278	4,132,518
Gross margin (loss)	100,661	188,716	(532,573)	(47,225)
Operating expenses:				
Research and development	434,418	437,143	1,086,333	898,995
Sales and marketing expenses	888,448	849,744	3,091,091	2,412,691
General and administrative expenses	869,435	937,905	2,690,624	3,492,565
Total operating expenses	2,192,301	2,224,792	6,868,048	6,804,251
Operating loss	(2,091,640)	(2,036,076)	(7,400,621)	(6,851,476)
Non-operating income (expense):				
Interest income	131,442	68,760	549,993	158,947
Unrealized loss on short-term investments (see Note 4)	(187,300)	-	(187,300)	-
Financing expense	(22,826)	(56,772)	(78,140)	(177,443)
Non-operating income (expense), net	(78,684)	11,988	284,553	(18,496)
Net loss	$ (2,170,324)	$ (2,024,088)	$ (7,116,068)	$ (6,869,972)
Basic and diluted loss per share	$ (0.09)	$ (0.12)	$ (0.31)	$ (0.42)
Weighted average shares used in computing net loss per share:				
Basic and diluted	23,090,200	17,400,355	23,054,375	16,198,067

The accompanying notes are an integral part of these financial statements.

IsoRay, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

	Nine months ended March 31, 2008	Nine months ended March 31, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (7,116,068)	$ (6,869,972)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization of fixed assets	849,716	283,422
Amortization of deferred financing costs and other assets	61,521	99,387
Amortization of discount on short-term investments	(145,165)	-
Unrealized loss on short-term investments	187,300	-
Loss on settlement of ARO liability (Note 7)	(135,120)	-
Accretion of asset retirement obligation	25,670	4,690
Noncash share-based compensation	425,090	1,022,241
Changes in operating assets and liabilities:		
Accounts receivable, net	284,252	(646,869)
Inventory	18,395	(109,401)
Prepaid expenses	58,095	(244,364)
Accounts payable and accrued expenses	(879,772)	222,910
Accrued payroll and related taxes	(216,834)	(56,700)
Accrued interest payable	(827)	1,470
Deferred revenue	(23,874)	-
Net cash used by operating activities	(6,607,621)	(6,293,186)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of fixed assets	(3,112,400)	(786,614)
Additions to licenses and other assets	(250,783)	(27,657)
Change in restricted cash	(174,273)	-
Purchases of short-term investments	(13,273,653)	-
Proceeds from the sale or maturity of short-term investments	16,667,499	-
Net cash used by investing activities	(143,610)	(814,271)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on notes payable	(118,414)	(95,301)
Principal payments on capital lease obligations	(155,603)	(135,165)
Proceeds from cash sales of common shares pursuant to private placement, net of offering costs	-	19,819,962
Proceeds from cash sales of preferred stock, pursuant to exercise of warrants	-	8,709
Proceeds from cash sales of common stock, pursuant to exercise of warrants	1,010,913	6,448,181
Proceeds from cash sales of common stock, pursuant to exercise of options	11,900	1,106,333
Payment of dividend to preferred shareholders	-	(38,458)

Net cash provided by financing activities		748,796		27,114,261
Net (decrease) increase in cash and cash equivalents		(6,002,435)		20,006,804
Cash and cash equivalents, beginning of period		9,355,730		2,207,452
CASH AND CASH EQUIVALENTS, END OF PERIOD	$	3,353,295	$	22,214,256
Non-cash investing and financing activities:				
Increase in fixed assets related to asset retirement obligation	$	473,096	$	-
Cashless exercise of common stock options		-		145,000
Exchange of convertible debentures payable for shares of common stock		-		49,999

The accompanying notes are an integral part of these financial statements.

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IsoRay, Inc.
Notes to the Unaudited Consolidated Financial Statements
For the three and nine-month periods ended March 31, 2008 and 2007

1. Basis of Presentation

The accompanying consolidated financial statements are those of IsoRay, Inc., and its wholly-owned subsidiaries (IsoRay or the Company). All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying interim consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles, consistent in all material respects with those applied in the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2007. The financial information is unaudited but reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of the Company's management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2007.

2. Accounting for Uncertainty in Income Taxes

On July 1, 2007, the Company adopted Financial Accounting Standards Board Interpretation No. 48 (FIN No. 48) *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with Statement of Financial Accounting Standard (SFAS) No. 109 *Accounting for Income Taxes*, prescribing a recognition threshold and measurement attribute for the recognition and measurement of a tax position taken or expected to be taken in a tax return. In the course of its assessment, management has determined that the Company, its subsidiary, and its predecessors are subject to examination of their income tax filings in the United States and state jurisdictions for the 2003 through 2006 tax years. In the event that the Company is assessed penalties and or interest; penalties will be charged to other operating expense and interest will be charged to interest expense.

The Company adopted FIN No. 48 using the modified prospective transition method, which requires the application of the accounting standard as of July 1, 2007. There was no impact on the financial statements as of and for the three and nine months ended March 31, 2008 as a result of the adoption of FIN No. 48. In accordance with the modified prospective transition method, the financial statements for prior periods have not been restated to reflect, and do not include, the impact of FIN No. 48.

3. Loss per Share

The Company accounts for its income (loss) per common share according to SFAS No. 128, *Earnings Per Share*. Under the provisions of SFAS No. 128, primary and fully diluted earnings per share are replaced with basic and diluted earnings per share. Basic earnings per share is calculated by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding, and does not include the impact of any potentially dilutive common stock equivalents. Common stock equivalents, including warrants to purchase the Company's common stock, are excluded from the calculations when their effect is antidilutive. At March 31, 2008 and 2007, the calculation of diluted weighted average shares does not include preferred stock, options, or warrants that are potentially convertible into common stock as those would be antidilutive due to the Company's net loss position.

Securities that could be dilutive in the future as of March 31, 2008 and 2007 are as follows:

	March 31, 2008	March 31, 2007
Preferred stock	59,065	59,065
Common stock warrants	3,250,774	3,627,767
Common stock options	2,831,728	3,088,439
Convertible debentures	-	85,542
Total potential dilutive securities	6,141,567	6,860,813

4. Short-Term Investments

The Company's short-term investments are classified as available-for-sale and recorded at fair market value. The Company's short-term investments consisted of the following at March 31, 2008 and June 30, 2007:

	March 31, 2008	June 30, 2007
Municipal debt securities	$ 3,812,700	$ 3,000,000
Corporate debt securities	2,694,159	6,942,840
	$ 6,506,859	$ 9,942,840

The Company's municipal debt securities consist of auction rate securities (ARS) that are generally long term debt instruments that provide liquidity through a modified Dutch auction process that resets the applicable interest rate at predetermined intervals, usually every 28 days. ARS generally trade at par and are callable at par on any interest payment date at the option of the issuer. Interest received during a given period is based upon the interest rate determined through the auction process. Although these securities are issued and rated as long term bonds, they are priced and traded as short-term instruments because of the liquidity provided through the interest rate reset. This mechanism generally allows existing investors to rollover their holdings and continue to own their respective securities or liquidate their holdings by selling their securities at par value. The Company generally invests in these securities for short periods of time as part of its cash management program.

However, the recent uncertainties in the credit markets have prevented the Company and other investors from liquidating their holdings by selling their securities at par value as the amount of securities submitted for sale at recent ARS auctions has exceeded the market demand. These securities continue to pay interest according to their stated terms. For those securities that failed to auction, the Company continues to hold these securities and accrues interest at a higher rate than similar securities for which auctions have cleared. The Company's ARS are all AAA/Aaa rated investments and consist of various student loan portfolios with the vast majority of the student loans guaranteed by the U.S. Government under the Federal Family Education Loan Program. These securities were valued using a model that takes into consideration the financial conditions of the issuer and the bond insurers as well as the current illiquidity of the securities. If the credit ratings of the issuers deteriorate, the Company may adjust the carrying value of these investments. The Company is uncertain as to when the liquidity issues relating to these investments will improve.

None of the ARS investments in our portfolio were backed by sub-prime mortgage loans.

Although insufficient demand for certain ARS may continue, we anticipate, based on discussions with our investment advisors, that liquidity may possibly be realized through the emergence of secondary markets in the near term, particularly considering the high default interest rates, high credit ratings, the backing of the Federal Family Education Loan Program, and the historically low default rates of these securities. As such, we believe that the primary impact of the failed auctions is reduced liquidity rather than impairment of principal. In the event that we are unable to sell the investments at or above our carrying value, these securities may not provide us with a liquid source of cash.

Unrealized gains and temporary unrealized losses on these securities are recorded in other comprehensive income/loss within Shareholders' Equity. Unrealized losses that are considered other than temporary are recorded in the Consolidated Statements of Operations in unrealized loss on short-term investments. The Company has recognized the unrealized losses on the ARS as other than temporary and recorded them in the statement of operations rather than in other comprehensive income as the Company may need access to these funds before the uncertainties in the credit markets are fully resolved.

5. Inventory

Inventory consists of the following at March 31, 2008 and June 30, 2007:

	March 31, 2008	June 30, 2007
Raw materials	$ 702,210	$ 682,327
Work in process	127,614	120,242
Finished goods	32,615	78,265
	$ 862,439	$ 880,834

6. Restricted Cash

The Washington Department of Health, effective October 2007, has required the Company to provide collateral for the decommissioning of its facility. To satisfy this requirement, the Company funded two CDs totaling $172,500 in separate banks. The CDs both have original maturities of three months but are classified as long-term as the Company does not anticipate decommissioning the facility until the end of the current lease plus the lease option periods. Interest earned on the CDs is rolled-over at the maturity of each CD and becomes part of the restricted cash balance. Interest earned and added to restricted cash during the quarter ended March 31, 2008 was $1,773. These funds will be used to settle a portion of the Company’s remaining asset retirement obligations (Note 7).

7. Asset Retirement Obligations

SFAS No. 143, *Asset Retirement Obligations*, establishes standards for the recognition, measurement and disclosure of legal obligations associated with the costs to retire long-lived assets. Accordingly, under SFAS No. 143, the fair value of the future retirement costs of the Company’s leased assets are recorded as a liability on a discounted basis when they are incurred and an equivalent amount is capitalized to property and equipment. The initial recorded obligation, which was discounted using the Company’s credit-adjusted risk-free rate, is reviewed periodically to reflect the passage of time and changes in the estimated future costs underlying the obligation. The Company amortizes the initial amount capitalized to property and equipment and recognizes accretion expense in connection with the discounted liability over the estimated remaining useful life of the leased assets.

In fiscal year 2006, the Company established an initial asset retirement obligation of $63,040 which represented the discounted cost of cleanup that the Company anticipated it would have to incur at the end of its equipment and property leases in its old production facility. This amount was determined based on discussions with qualified production personnel and on historical evidence. During fiscal year 2007, the Company reevaluated its obligations based on discussions with the Washington Department of Health and determined that the initial asset retirement obligation should be increased by an additional $56,120. During the second quarter of fiscal year 2008, the Company removed all radioactive residuals and tenant improvements from its old production facility and returned the facility to the lessor. The Company had an asset retirement obligation of $135,120 accrued for this facility but total costs incurred to decommission the facility were $274,163 resulting in an additional expense of $139,043 that is included in cost of products sold. The additional expense is mainly due to unanticipated construction costs to return the facility to its previous state. The Company originally believed that the lessor would retain many of the leasehold improvements in the building, but the lessor instead required their removal.

In September 2007, a new asset retirement obligation of $473,096 was established representing the discounted cost of the Company's obligations to remove any residual radioactive materials and any unwanted leasehold improvements at the end of the lease term at its new production facility. The estimate was developed by qualified production personnel and the general contractor of the new facility. The Company has reviewed the estimate again based on its experience with decommissioning its old facility and believes that the original estimate continues to be applicable.

During the nine month periods ended March 31, 2008 and 2007, the asset retirement obligation changed as follows:

	Nine months ended March 31,			
		2008		2007
Beginning balance	$	131,142	$	67,425
New obligations		473,096		-
Settlement of existing obligation		(135,120)		-
Accretion of discount		25,670		4,690
Ending balance	$	494,788	$	72,115

8. Share-Based Compensation

Effective July 1, 2006, the Company adopted SFAS No. 123R, *Share-Based Payment*, using the modified prospective method. The following table presents the share-based compensation expense recognized in accordance with SFAS No. 123R during the three and nine months ended March 31, 2008 and 2007:

	Three months ended March 31,				Nine months ended March 31,			
		2008		2007		2008		2007
Cost of product sales	$	36,029	$	21,076	$	109,859	$	92,401
Research and development		10,971		8,418		34,071		28,132
Sales and marketing expenses		59,557		54,737		178,671		153,974
General and administrative expenses		(36,080)		40,123		102,489		747,734
Total share-based compensation	$	70,477	$	124,354	$	425,090	$	1,022,241

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Each quarter the Company reviews its forfeiture assumptions and adjusts its compensation expense when the actual pre-vesting forfeiture rate differs materially from the estimate. During the three months ended March 31, 2008, the Company recognized a credit to compensation expense due to a significant variation between the estimated pre-vesting forfeiture rate and the actual pre-vesting forfeiture rate.

As of March 31, 2008, total unrecognized compensation expense related to stock-based options was $762,148 and the related weighted-average period over which it is expected to be recognized is approximately 0.89 years.

The Company currently provides stock-based compensation under three equity incentive plans approved by the Board of Directors. Options granted under each of the plans have a ten year maximum term, an exercise price equal to at least the fair market value of the Company's common stock on the date of the grant, and varying vesting periods as determined by the Board. For stock options that vest over time, the Company recognizes compensation cost on a straight-line basis over the requisite service period for the entire award.

A summary of stock option activity within the Company's share-based compensation plans for the nine months ended March 31, 2008 is as follows:

	Number of	Weighted Average	Weighted Average Remaining	Aggregate