

INDUSTRIAL SERVICES OF AMERICA INC /FL
Form 10-K
March 27, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

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

For Fiscal Year Ended December 31, 2006

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.: 0-20979

INDUSTRIAL SERVICES OF AMERICA, INC.
(Exact name of registrant as specified in its charter)

Florida
(State or other jurisdiction of
incorporation or organization)

59-0712746
(I.R.S. Employer
Identification No.)

7100 Grade Lane
P.O. Box 32428
Louisville, Kentucky 40232
(502) 368-1661
(Address, including zip code, and telephone number,
including area code, of registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$.005 par value
(Title of class)

Indicate by check mark if the registrant is a well-seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes ___ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes
___ No X

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

(Check one): Large accelerated filer Accelerated filer Non-accelerated filer

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

Aggregate market value of the 1,861,574 shares of voting Common Stock held by non-affiliates of the registrant at the closing sales price on June 30, 2006: \$10,704,050.

Number of shares of Common Stock, \$.005 par value, outstanding as of the close of business on March 22, 2007: 3,640,899.

DOCUMENT INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2007 Annual Meeting of Shareholders are incorporated by reference into Item 10 through Item 14 of Part III of this report.

PART I

Item 1. Business.

General

Industrial Services of America, Inc. (herein "ISA," the "Company," "we," "us," "our," or other similar terms), is a Louisville, Kentucky-based logistic management services company that offers total package waste and recycling management services to commercial, industrial and logistic customers nationwide, as well as providing recycling and scrap processing and waste handling equipment sales and service.

Available Information

We make available, free of charge, through our website www.isa-inc.com, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, and amendments to those reports as soon as reasonably practicable after we have electronically filed with the Securities and Exchange Commission. We also make available on our website our audit committee charter, our Business Ethics Policy and Code of Conduct and our Code of Ethics for the CEO, CFO and senior financial officers. Please note that our Internet address is included in this annual report on Form 10-K as an inactive textual reference only. Information contained on our website is not incorporated by reference into this annual report on Form 10-K and should not be considered a part of this report.

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Our principal products and services are ferrous and non-ferrous scrap metals, management services, and waste equipment sales, rental and service. Our goal is to remain dedicated to the recycling, management services, and equipment industry while sustaining steady growth at an acceptable profit, adding to our net worth, and providing positive returns for our stockholders.

Recycling Operations -- ISA Recycling

Since October 2005, we have focused much of our attention on our recycling business segment. We sell processed ferrous and non-ferrous scrap material to end-users such as steel mini-mills, integrated steel makers and foundries and refineries. We purchase ferrous and non-ferrous scrap material primarily from industrial and commercial generators of steel, iron, aluminum, copper, stainless steel and other metals as well as from other scrap dealers who deliver these materials directly to our facilities. We process these materials by sorting, shearing, cutting and/or baling. We also continue to focus on initiating growth in our management services business segment and our waste and recycling equipment sales, service and leasing division.

Ferrous Operations

Ferrous Scrap Purchasing - We purchase ferrous scrap from two primary sources: (i) industrial and commercial generators of steel and iron; and (ii) scrap dealers, peddlers, and other generators and collectors who sell us steel and iron scrap, known as obsolete scrap. Market demand and the composition, quality, size and weight of the materials are the primary factors that determine prices paid to these material providers.

Ferrous Scrap Processing - We prepare ferrous scrap material for resale through a variety of methods including sorting, shearing, cutting and baling. We produce a number of differently sized, shaped and grade products depending upon customer specifications and market demand.

Sorting - After purchasing ferrous scrap material, we inspect it to determine how we should process it to maximize profitability. In some instances, we may sort scrap material and sell it without further processing. We separate scrap material for further processing according to its size, composition and grade by using conveyor systems, front-end loaders, crane-mounted electromagnets and claw-like grapples.

Shearing or Cutting - Pieces of oversized ferrous scrap material, such as obsolete steel girders and used pipe, which are too large for other processing are cut with hand torches, crane-mounted alligator shears or stationary guillotine shears.

Baling - We process light-gauge ferrous materials such as clips, sheet iron and by-products from industrial and commercial processes, such as stampings, clippings and excess trimmings, by baling these materials into large, uniform blocks. We use cranes and conveyors to feed the material into a hydraulic press, which compresses the material into uniform blocks.

Ferrous Scrap Sales - We sell processed ferrous scrap material to end-users such as steel mini-mills, integrated steel makers and foundries, and brokers who aggregate materials for other large users. Most customers purchase processed ferrous scrap material through negotiated spot sales contracts, which establish the quantity purchased for the month and the pricing. The price we charge for ferrous scrap materials depends upon market supply and demand, as well as quality and grade of the scrap material.

Non-Ferrous Operations

Non-Ferrous Scrap Purchasing - We purchase non-ferrous scrap from two primary sources: (i) industrial and commercial non-ferrous scrap material providers who generate or sell waste aluminum, copper, stainless steel, other nickel-bearing metals, brass and other metals; and (ii) peddlers, scrap dealers, generators and collectors who deliver directly to our facilities material that they collect from a variety of sources. We also collect non-ferrous scrap from sources other than those that are delivered directly to our processing facilities by placing retrieval boxes at these sources. The boxes are subsequently transported to our processing facilities.

Non-Ferrous Scrap Processing - We prepare non-ferrous scrap metals, principally aluminum, copper, brass and stainless steel to sell by sorting, shearing, cutting or baling.

Sorting - Our sorting operations separate and identify non-ferrous scrap by using front-end loaders, grinders, hand torches and spectrometers. Our ability to identify metallurgical composition maximizes margins and profitability. We sort non-ferrous scrap material for further processing according to type, grade, size and chemical composition. Throughout the sorting process, we determine whether the material requires further processing before we sell it.

Shearing or Cutting - Pieces of oversized non-ferrous scrap material, which are too large for other processing methods, are cut with alligator shears.

Baling - We process non-ferrous metals such as aluminum cans, sheet and siding by baling these materials into large uniform blocks. We use front-end loaders and conveyors to feed the material into a hydraulic press, which compresses the material into uniform blocks.

Non-Ferrous Scrap Sales - We sell processed non-ferrous scrap material to end-users such as foundries, aluminum sheet and ingot manufacturers, copper refineries and smelters, and brass and bronze ingot manufacturers. Prices for the majority of non-ferrous scrap materials change based upon the daily publication of spot and futures prices on COMEX or the London Metals Exchange.

Management Services Operations -- Computerized Waste Systems (CWS)

Our management services operations are in the business of commercial, retail and industrial waste and recycling management services. CWS offers a "total package" concept to commercial, retail and industrial customers for their waste and recycling management needs. Combining waste reduction and diversion, and waste equipment technology, CWS creates waste and recycling programs tailored to each customer's needs. The services we offer include locating and contracting with a hauling company and recycler at a reasonable cost for each participating location. CWS does not own waste-transporting trucks or landfills. We do not operate or partner with any of the national hauling or recycling companies, and none of these companies own us. We are able to maintain a neutral position for the benefit of our customers. We have designed and developed proprietary computer software that provides our personnel with relevant information on each customer's locations, as well as pertinent information on service providers, disposal rates, costs of equipment, including installation and shipping, disposal rates and recycling prices. This software has allowed us to build a database for serving our customers that have locations nationwide as well as Canada and Mexico. This software enables us to generate detailed monthly customized billing reports, and price tracking to accommodate our

customers' needs.

Our management services division provides our customers evaluation, management, monitoring, auditing and cost reduction of non-hazardous solid waste removal and recycling activities. CWS has developed a network of over 2,300 hauling, landfill, recycling and equipment manufacturing and maintenance service providers throughout the United States and Canada. Through this network, we are able to provide pricing estimates for current and potential customers. CWS customer service representatives have access to this information through the computer software designed and developed to enhance the value offered to our customers. Through this information retrieval system and database, customer service representatives can review the accuracy of recent billings for hauling, landfill and recycling rates.

Prior to the expiration of the Home Depot contract on October 30, 2005, we derived a significant portion of our revenues from Home Depot, accounting for approximately 56% of 2005 and 51% of 2004 total revenues. The impact to our gross profit was limited to 24% in 2005 and 23% in 2004.

Waste and Recycling Equipment Sales and Services Operations-WESSCO-Waste and Sales Service Company

Our waste equipment sales and services operation, WESSCO, is in the business of commercial and industrial waste and recycling handling equipment sales, rental and maintenance. By offering competitively priced waste and recycling handling equipment from a number of different manufacturers, we are able to tailor equipment packages for individual customer needs. We do not manufacture any equipment, but we do refurbish, recondition and add options when necessary. We sell, rent and repair all types of industrial and commercial waste and recycling handling equipment such as compactors, balers and containers.

"Total Package" Concept

We record revenues and costs in the period of delivery. Our management services division has third party service providers providing same day service for all waste removal and recycling services for our customers. Our recycling division purchases ferrous and nonferrous materials, cardboard and paper on a daily basis. We record these purchases in the period received. We record revenue and cost in the period of delivery. The products or services have value to the customer on a standalone basis. These services make up the "total package" concept.

Company Background

ISA was incorporated in October 1953 in Florida under the name Alson Manufacturing, Inc. From the date of incorporation through January 5, 1975, Alson designed and manufactured various forms of electrical products. In 1979, the Board of Directors and the shareholders of Alson commenced liquidation of all the tangible assets of Alson. On October 27, 1983, Harry Kletter, our Chairman of the Board and Chief Executive Officer, acquired 419,500 shares of ISA Common Stock. The existing directors resigned and five new directors were elected.

On July 1, 1984, we began a solid waste handling and disposal equipment sales organization under the name Waste Equipment Sales and Services Company, which we refer to as WESSCO. On January 1, 1985, we merged with Computerized Waste Systems, Inc., a Massachusetts corporation. CWS was a corporation specializing in offering solid waste management consultations for large multi-location companies involved

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in the retail, restaurant and industrial sectors. At the time of the merger, CWS was concentrating on large retail chains, but has changed its emphasis to include commercial and industrial customers. This strategy created an additional target market for us. Subsequent to the merger with CWS, we moved the CWS headquarters from Springfield, Massachusetts to Louisville, Kentucky. At the time of the merger, much of the customer base and marketing efforts were concentrated in the Northeast. With the move to Louisville, we began to expand its marketing efforts, which are now nationwide as well as Canada.

On July 1, 1997, we acquired the assets of a non-ferrous scrap metal recycling facility located at 7100 Grade Lane, Louisville, Kentucky, thus expanding our recycling product lines.

In January 1998, we acquired the business of a ferrous scrap and corrugated paper recycling facility located at 7100 Grade Lane, Louisville, Kentucky. This acquisition was the beginning of our ferrous scrap metal, non-ferrous scrap metal and corrugated paper processing segment known as ISA Recycling.

On June 1, 1998, we acquired all of the business, property, rights and assets of a ferrous and non-ferrous scrap metal recycling facility located in North Vernon, Indiana. On July 8, 2002, we acquired a five-acre tract at 1565 East 4th Street, Seymour Indiana. In the fourth quarter of 2002, we moved our metal recycling facilities from North Vernon, Indiana to Seymour, Indiana.

On February 15, 2005 we added a location in Lexington, Kentucky. We are using this property as a transfer station for ferrous and nonferrous material. There are no processing operations at this facility. We have discontinued operations in this facility during the first quarter of 2007 and are now subleasing the property to an unaffiliated third party.

Industry Background

Our operations primarily involve the collection and processing of ferrous and non-ferrous scrap metals. We collect industrial scrap metal and obsolete scrap metal, process it into reusable forms and supply the recycled scrap metals to our customers.

We manage non-hazardous solid waste and recyclables for retail, commercial and industrial customers. As such, the multi-billion dollar solid waste collection and disposal business drives the industry. The size of this industry has increased for the past several years and should continue to increase as landfill space decreases. Although society and industry have developed an increased awareness of environmental issues and recycling has increased, waste production also continues to increase. Because of environmental concerns, new regulations and cost factors, it has become difficult to obtain the necessary permits to build any new landfills. Management believes that with the consolidation taking place in the waste industry, it will become increasingly difficult for a customer to receive a fair price. We are, therefore, in a position to represent the best interest of the customer; this fact can only enhance our business.

In addition to increasing landfill costs, regulatory measures and more stringent control of material bound for disposal ("flow control") are making the management of solid waste an increasingly difficult problem. The United States Environmental Protection Agency is expected to continue the present trend of restricting the amount of potentially recyclable material bound for landfills. Many states have passed, or are contemplating, measures that would require industrial and commercial companies to recycle a minimum percentage of their waste stream and restrict the percentage of recyclable materials in any commercial load of waste material. Many states have already passed restrictive regulations requiring a plan for the reduction of waste or the segregation of recyclable materials from the waste stream at the source. ISA management believes that these restrictions may create additional marketing opportunities as waste disposal needs become more specialized. Some large

industrial and commercial companies have hired in-house staff to handle the solid waste management and recycling responsibilities, but have found that without adequate resources and staff support, in-house handling of these responsibilities may not be an effective alternative. We offer these establishments a solution to this increasing burden.

Competition

On a commercial/industrial waste management level, we have competition from a variety of sources. Much of it is from companies that concentrate their efforts on a regional level. We believe that with the proprietary database of regional and national pricing, we will maintain our edge on a national basis.

There has been increased competition from national hauling and recycling companies. The large national hauling and recycling companies often attempt to handle all locations for a "national chain" customer. This scenario poses a potential conflict of interest since these hauling companies and recyclers can attain greater profitability from increases in hauling and disposal revenues and fluctuations in recycling prices. In addition to having an interest in higher hauling and disposal rates, the national hauling companies do not have operations in every community. Additionally, we have encountered evidence of some reluctance from independent hauling and recycling companies to work with national hauling and recycling companies for locations not serviced by these national companies.

There is also competition from some equipment manufacturers. The primary interest of these companies is selling, leasing and renting equipment and offering management services in order to secure these sales or leases. There is a cost involved in using the equipment and the money saved must justify the amount spent on this equipment.

The metal recycling business is highly competitive and is subject to significant changes in economic and market conditions. Certain ISA competitors have greater financial, marketing and physical resources. There can be no assurance that we will be able to obtain our desired market share based on the competitive nature of this industry.

An important difference between us and the majority of our competition is our management process. Our systematic approach attempts to provide consistent results for the customer. At the implementation stage, we actively bid out every location that a new customer requests. We repeat this bidding process any time a customer receives notice of an undocumented price increase or at regular intervals as indicated in the contract. At subsequent stages, we will evaluate a customer's solid waste and recycling program and provide alternatives for improvement.

We have developed a network of maintenance, hauling, disposal, equipment and recycling companies throughout the country and in Canada, and due to the volume of business we have awarded to them, these companies will often offer us discounted hauling, disposal and maintenance rates and increased recycling prices. However, no company or service provider in the hauling, disposal, recycling, equipment and/or maintenance industries owns or controls us. We deal with those companies and service providers that can supply quality service and products at a favorable price and understand that as long as we serve our customers well, we and our service providers will have the opportunity to bid on future accounts.

Few, if any, of our competitors have a national network of service providers similar to the one we have developed over our years of operation. Although the major hauling and recycling companies have operating companies in most major and intermediate-sized cities, they do not have nationwide geographic coverage. Therefore, for large commercial and industrial clients, they must obtain bids from local hauling, disposal and recycling companies that may perceive them to be future competitors. We have positioned ourselves to negotiate with the haulers,

landfill operators and recyclers while servicing our customers on a nationwide basis.

Employees

As of December 31, 2006, ISA had one hundred and two (102) full-time employees as follows: recycling 69, management services 16, sales/leasing 4 and administration/information technology 13. None of our employees is a member of a union.

Effect of State and Federal Environmental Regulations

Any environmental regulatory liability relating to our operations is generally borne by the customers with whom we contract and the service providers in their capacity as transporters, disposers and recyclers. Our policy is to use our best efforts to secure indemnification for environmental liability from our customers and service providers. Although we believe that our business does not subject us to potential environmental liability, we continue to use our best efforts to be in compliance with federal, state and local environmental laws, including but not limited to the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, the Hazardous Materials Transportation Act, as amended, the Resource Conservation and Recovery Act, as amended, the Clean Air Act, as amended, and the Clean Water Act. Such compliance has not historically constituted a material expense to us.

The collection and disposal of solid waste and rendering of related environmental services as well as recycling operations and issues are subject to federal, state and local requirements, which regulate health, safety, the environment, zoning and land-use. Federal, state and local regulations vary, but generally govern hauling, disposal and recycling activities and the location and use of facilities and also impose restrictions to prohibit or minimize air and water pollution. In addition, governmental authorities have the power to enforce compliance with these regulations and to obtain injunctions or impose fines in the case of violations, including criminal penalties. The EPA and various other federal, state and local environmental, health and safety agencies and authorities, including the Occupational Safety and Health Administration of the U.S. Department of Labor administer those regulations.

We strive to conduct our operations in compliance with applicable laws and regulations. While such amounts expended in the past or that we anticipate spending in the future have not had and are not expected to have a material adverse effect on our financial condition or operations, the possibility remains that technological, regulatory or enforcement developments, the results of environmental studies or other factors could materially alter this expectation.

Each state in which we operate has its own laws and regulations governing solid waste disposal, water and air pollution and, in most cases, releases and cleanup of hazardous substances and liability for such matters. Several states have enacted laws that will require counties to adopt comprehensive plans to reduce, through waste planning, composting, recycling, or other programs, the volume of solid waste landfills. Several states have recently enacted these laws. Legislative and regulatory measures to mandate or encourage waste reduction at the source and waste recycling also are under consideration by Congress and the EPA.

Finally, various states have enacted, or are considering enacting, laws that restrict the disposal within the state of solid or hazardous wastes generated outside the state. While courts have declared unconstitutional laws that overtly discriminate against out of state waste, courts have upheld some laws that are less overtly discriminatory. Challenges to other such laws are pending. The outcome of pending litigation and the likelihood that jurisdictions will adopt other such laws that will survive constitutional challenge are uncertain.

ITEM 1A. Risk Factors

Risk Factors

This Annual Report on Form 10-K includes "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, including, in particular, certain statements about our plans, strategies and prospects. Although we believe that our plans, intentions and expectations reflected in or suggested by such forward-looking statements are reasonable, we cannot assure you that such plans, intentions or expectations will be achieved. Important factors that could cause our actual results to differ materially from our forward-looking statements include those set forth in this Risk Factors section. All forward-looking statements attributable to us or any persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth below. Unless the context requires otherwise, all references to the "company," "we," "us" or "our" include Industrial Services of America, Inc. and subsidiaries.

If any of the following risks, or other risks not presently known to us or that we currently believe to not be significant, develop into actual events, then our business, financial condition, results of operations, cash flows or prospects could be materially adversely affected.

Risks Related to Our Operations

Our business has increasing involvement in ferrous, non-ferrous and fiber recycling. Currently, the prices of metals are high, but changes in demand, including foreign demand, regulation, economic slowdowns or increased competition could result in a reduction of our revenue and consequent decrease in our common stock price.

Many companies offer or are engaged in the development of products or the provisions of services that may be or are competitive with our current products or services, although we do not believe any competition offers the unique mixture of the services and products we provide in the waste management area. Many entities have substantially greater financial, technical, manufacturing, marketing, distribution and other resources than we possess. In addition, the industry is constantly changing as a result of consolidation that may create additional competitive pressures in our business environment.

An increase in the price of fuel may adversely affect our business.

Our operations are dependent upon fuel, which we generally purchase in the open market on a daily basis. Direct fuel costs include the cost of fuel and other petroleum-based products used to operate our fleet of cranes and heavy equipment. We are also susceptible to increases in indirect fuel costs which include fuel surcharges from vendors. During 2004, 2005 and 2006, we experienced increases in the cost of fuel and other petroleum-based products. A portion of these increases we passed on to our customers. However, because of the competitive nature of the industry, there can be no assurance that we will be able to pass on current or future increases in fuel prices to our customers. Due to political instability in oil-producing countries, fuel prices may continue to increase in 2007. A significant increase in fuel costs could adversely affect our business.

We could incur substantial costs in order to comply with, or to address any violations under, environmental laws that could significantly increase our operating expenses and reduce our operating income.

Our operations are subject to various environmental statutes and regulations, including laws and regulations addressing materials used in the processing of our products. In addition, certain of our operations are subject to federal, state and local environmental laws and regulations that impose limitations on the discharge of pollutants into the air and water and establish standards for the treatment, storage and disposal of solid and hazardous wastes. Failure to maintain or achieve compliance with these laws and regulations or with the permits required for our operations could result in substantial operating costs and capital expenditures, in addition to fines and civil or criminal sanctions, third party claims for property damage or personal injury, cleanup costs or temporary or permanent discontinuance of operations. Certain of our facilities have been in operation for many years and, over time, we and other predecessor operators of these facilities have generated, used, handled and disposed of hazardous and other regulated wastes. Environmental liabilities could exist, including cleanup obligations at these facilities or at off-site locations where materials from our operations were disposed of, which could result in future expenditures that cannot be currently quantified and which could reduce our profits.

Our financial statements are based upon estimates and assumptions that may differ from actual results.

We have prepared our financial statements in accordance with U.S. generally accepted accounting principles and necessarily include amounts based on estimates and assumptions we made. Actual results could differ from these amounts. Significant items subject to such estimates and assumptions include the carrying value of long-lived assets, valuation allowances for accounts receivable, liabilities for potential litigation, claims and assessments, and liabilities for environmental remediation and deferred taxes.

We depend on our senior management team and the loss of any member could prevent us from implementing our business strategy.

Our success is dependent on the management and leadership skills of our senior management team. We have not entered into employment agreements with any of our senior management personnel. The loss of any members of our management team or the failure to attract and retain additional qualified personnel could prevent us from implementing our business strategy and continuing to grow our business at a rate necessary to maintain future profitability.

Seasonal changes may adversely affect our business and operations.

Our operations may be adversely affected by periods of inclement weather which could decrease the collection and shipment volume of recycling materials.

Risks Related to Our Common Stock

Future sales of our common stock could depress our market price and diminish the value of your investment.

Future sales of shares of our common stock could adversely affect the prevailing market price of our common stock. If our existing shareholders sell a large number of shares, or if we issue a large number of shares, the market price of our common stock could significantly decline. Moreover, the perception in the public market that our existing shareholders and in particular members of the Kletter family might sell shares of common stock could depress the market for our common stock.

The market price for our common stock may be volatile.

In recent periods, there has been volatility in the market price for our common stock. In addition, the market price of our common stock could fluctuate substantially in the future in response to a number of factors, including the following:

- our quarterly operating results or the operating results of our companies in the waste management or ferrous, non-ferrous and fiber recycling industry;
- changes in general conditions in the economy, the financial markets or the ferrous, non-ferrous and fiber recycling industry;
- loss of significant customers, as was the case with the loss of Home Depot; and
- increases in materials and other costs.

In addition, in recent years the stock market has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market prices of securities issued by many companies for reasons unrelated to their operating performance. These broad market fluctuations may materially adversely affect our stock price, regardless of our operating results.

Item 2. Properties.

Related Parties Agreements -- K&R

On February 16, 1998 our Board of Directors ratified and formalized an existing relationship in connection with (i) our leasing of facilities from K&R, LLC and (ii) the provision of consulting services from K&R to us. K&R is our affiliate because our Chief Executive Officer is our principal shareholder and he owns 100% of K&R.

Lease Agreement. This K&R lease, effective as of January 1, 1998, covers approximately 20.5 acres of land and the improvements thereon, which are located at 7100 Grade Lane in Louisville, Kentucky. The principal improvements consist of the following:

- an approximately 22,750 square foot building used as the corporate and CWS offices;
- an approximately 8,286 square foot building used for sales/leasing and information technology offices;
- an approximately 13,995 square foot building used as the paper recycling plant;
- an approximately 12,000 square foot building used for the metals recycling plant;
- an approximately 51,760 square foot building used as the recycling offices and warehouse space;
- and the remaining 15,575 square feet of space contained in five (5) buildings ranging in size from approximately 256 to 8,000 square feet.

The initial term of the K&R lease is for ten years with two five-year option periods available thereafter. The base rent for the first five years was \$450,000 per annum. The rent for the second five years, beginning January 1, 2003, became \$505,272 per annum, payable at the beginning of each month in an amount equal to \$42,106. This fixed minimum rent adjusts each five years, including for each of the option periods, in accordance with the consumer price index. The fixed minimum rent also increases to \$750,000 per annum, in an amount equal to \$62,500 per month in the event of our change in control. We must pay, as additional rent, all real estate taxes, insurance, utilities, maintenance and repairs, replacements (including replacement of roofs if necessary) and other expenses. The K&R lease provides for our indemnification of K&R for all damages arising out of our use of or the condition of the leased premises excepting from K&R's negligence.

In 2004, we paid for repairs totaling \$302,160 that we made to the buildings and property that we lease from K&R, located at 7100 Grade Lane, Louisville, Kentucky. K&R executed an unsecured promissory note, dated March 25, 2005 but effective December 31, 2004, to us for the principal sum of \$302,160. K&R makes payments on the promissory note of principal and interest in ninety-six (96) monthly installments of \$3,897.66. The rate of interest is five and one-half percent (5.5%) per annum. Failure of K&R to make any payment when due under this note within fifteen (15) days of its due date shall constitute a default. After the fifteen day period, the note shall bear interest at a rate equal to fifteen percent (15%) per annum and we have the right to exercise our remedies to collect full payment of the note.

In an addendum to the K&R lease as of January 1, 2005, the rent was increased \$4,000 as a result of the improvements made to the property in 2004. For years 2005 and 2006, our payments to K&R of \$4,000 for additional rent and the payment from K&R of \$3,897.66 for the promissory note were offset.

K&R Consulting Agreement. The K&R consulting agreement remains in effect until December 31, 2007, with automatic annual renewals thereafter unless one party provides written notice to the other party of its intent not to renew at least six months in advance of the next renewal date. K&R shall provide strategic planning for mergers and acquisitions. We are responsible for all of K&R's expenses and pay to K&R \$240,000 in equal monthly installments of \$20,000 in connection with the K&R consulting activities.

The K&R consulting agreement terminates upon a non-defaulting party providing written notice to the other party of its intent to terminate. The recipient of the notice has 10 days to cure monetary defaults and 30 days to cure non-monetary defaults. Upon termination, K&R agrees not to engage, directly or indirectly, in the business conducted by, or hire our employees for a period of five years and within 100 miles of any of our operations.

We compensate our principal shareholder and Chief Executive Officer through consulting fees paid pursuant to the K&R consulting agreement.

Lease and Sublease Agreements -- Lexington

We have subleased the Lexington property to an unaffiliated third party for a term commencing March 1, 2007 and ending December 31, 2012 for \$4,500 per month. We currently lease this property from an unrelated party for \$4,500 per month; the lease terminates December 31, 2012. If for any reason the sublessee defaults, we remain liable for the remainder of the lease payments through December 31, 2012.

Lease Agreement -- Pineville, Louisiana

On February 6, 2007, we leased 7.7 acres of real property, including a 38,000 square foot warehouse and a 400 square foot office, in Pineville, Louisiana for \$5,250 per month for twenty-four months beginning March 1, 2007 and ending February 28, 2009, with an option to purchase the property for a purchase price of \$575,000.

Item 3. Legal Proceedings.

Effective as of May 5, 2006, we entered into an agreement with Andrew M. Lassak to settle Mr. Lassak's claims against us in Lassak v. Industrial Services of America, Inc., et al, No. 04-423-CA (Fla. 19th Cir. Ct. filed June 2, 2004). Lassak's demands and claims included rights to purchase 240,500 shares of our common stock for \$1.25 per share, rights to purchase 149,500 shares of our common stock for \$3.00 per share, and demand and piggyback registration rights as well as cashless exercise rights with respect to such options. Since the inception of the suit, we had disputed Lassak's claims and had denied any liability for Lassak's claims and demands. Pursuant to the settlement agreement, we allowed Lassak to exercise a reduced number of the options he was seeking -- 40,000 at an exercise price of \$1.25 per share. Lassak tendered to us the full exercise price for the 40,000 options and we filed a registration statement for the underlying shares with the Securities and Exchange Commission on May 24, 2006. The registration was declared effective by the Securities and Exchange Commission on June 12, 2006. We then delivered 40,000 registered shares to Lassak, thereby satisfying all our requirements under the settlement agreement and effectively concluding this matter.

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

None.

Item 4a. ISA Executive Officers.

| Name | Served as an Executive Officer From | Age | Position with the Registrant and Other Principal Occupations |
|---------------|-------------------------------------|-----|--|
| Harry Kletter | 1983 | 80 | ISA Chairman of the Board and Chief Executive Officer from May 2, 2000 to present. ISA Chairman of the Board and Chief Visionary Officer from February 3, 2000 to May 2, 2000. Mr. Kletter served as Chairman of the Board and Chief Executive Officer from July 31, 1992 to February 3, |

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2000, President of ISA from July 31, 1992 to December 1997, from January 1990 to July 1991, and from October 1983 to January 1988; Mr. Kletter is also Chairman and sole shareholder of K&R, LLC.

| | | | |
|-------------------------|---------------------------|----|--|
| Alan L. Schroering | 2000 | 42 | ISA Chief Financial Officer since May, 2001. Mr. Schroering served as an ISA board member from June 2000 to May 2001. Mr. Schroering has served as Treasurer from October 2001 to present. Mr. Schroering served in several accounting positions with National Processing Company from April 1998 to May 2000. Mr. Schroering served previously in several accounting positions with ISA from November 1984 to March 1998. |
| Ed List | June 2005 - December 2006 | 61 | ISA Chief Operating Officer from June 1, 2004 to December 31, 2006. He served previously as Vice President/Senior Accounts Manager CWS for ISA from May 2000 to June 2004. |
| Bob Cuzzort | January 2006 - June 2006 | 58 | ISA Executive Vice President, Corporate Operations from January 2005 to June 22, 2006. ISA Chief Operating Officer from July 2001 to April 2003. Director of Human Resources from March 2001 to April 2003. He served previously in charge of special projects for ISA from October 2000 to March 2001. Mr. Cuzzort served as general manager of Bassett Furniture Direct from March 1998 to August 2000. He served in several management positions with Haverty Furniture Company, Inc. from January 1970 to February 1998. |
| Michael P. Shannonhouse | April 2005 - August 2006 | 30 | ISA Secretary from April 16, 2004 through August 10, 2006. Served as acting ISA Secretary from October 20, 2003 to April 16, 2004, and ISA Director of Legal Affairs from October 20, 2003 to August 10, 2006. Prior to accepting his position with ISA, Mr. Shannonhouse worked as a law clerk in private practice from 2002 to 2003. Mr. Shannonhouse is employed with Atherton & Associates, a law firm in Louisville, Kentucky, and performs legal services for us through this firm. Mr. Shannonhouse is acting as a recording secretary for the ISA Board meeting minutes. |

None of the above officers is related to any other except that Mr. List is the son-in-law of Mr. Kletter. With respect to certain arrangements with certain officers of ISA relating to executive compensation, see section entitled "Executive Compensation - Certain Transactions" in ISA's Proxy Statement for the 2007 Annual Meeting of Shareholders as incorporated herein by reference at Item 11.

PART II

Item 5. Market for ISA's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Effective August 29, 1996, the \$.01 par value ISA common stock became listed on the Small Cap Market (the "Small Cap Market") of the NASDAQ Stock Market under the symbol "IDSA." Prior to August 29, 1996, our common stock traded on the Over the Counter Bulletin Board

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operated by the National Association of Securities Dealers, Inc. High and low sales price of the common stock price is summarized as follows:

| <u>Quarter Ended</u> | <u>2006</u> | | <u>2005</u> | | <u>2004</u> | |
|----------------------|-------------|------------|-------------|------------|-------------|------------|
| | High | Low | High | Low | High | Low |
| March 31 | \$ 5.20 | \$3.22 | \$ 7.50 | \$5.94 | \$23.75 | \$2.06 |
| June 30 | \$ 8.00 | \$4.82 | \$ 6.10 | \$3.70 | \$21.50 | \$9.91 |
| September 30 | \$ 6.31 | \$5.58 | \$ 6.60 | \$3.69 | \$14.89 | \$5.68 |
| December 31 | \$ 6.72 | \$5.26 | \$ 3.70 | \$2.85 | \$13.36 | \$7.60 |

There were approximately 383 shareholders of record as of December 31, 2006.

On February 26, 2004, we approved a two for one stock split distributed on March 30, 2004 to shareholders of record on March 16, 2004. The stock split required retroactive restatement of all historical share and per share data.

Until August 8, 2000, we had always had a policy intending that we would retain earnings to help finance our expansion programs. On August 8, 2000, our Board of Directors approved a change in the dividend policy whereby our Board of Directors could declare dividends, which we did declare and pay on one occasion in the amount of \$.10 per share on September 21, 2004. Our Board of Directors has the discretionary power to declare dividends within the constraints of our loan agreement with the Branch Banking and Trust Company.

On November 15, 2005, our Board of Directors authorized a new program to repurchase up to 200,000 shares of our common stock at current market prices. In 2006 we repurchased 5,509 shares and in 2005 we repurchased 10,000 shares. We repurchased 673,400 shares of our common stock in a prior stock repurchase program that began in August 2000.

Issuer Purchases of Equity Securities

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as part of Publicly Announced Plans or Programs | Maximum Number of Shares that may yet be Purchased Under the Plans or Programs |
|--------|----------------------------------|------------------------------|--|--|
| Oct-05 | - | | | |
| Nov-05 | 10,000 | \$ 2.9762 | 10,000 | 190,000 |
| Dec-05 | - | | | |
| Jan-06 | 5,509 | \$2.9658 | 15,509 | 184,491 |

The following performance graph compares the performance of ISA's Common Stock to the Standard & Poors 500 and to a peer group for the period commencing December 2001. Since there is no nationally recognized industry index consisting of consultants in the business of retail and industrial waste management sales and service of waste handling equipment to be used as a peer group index, ISA constructed its own peer group. This peer group is comprised of four companies which represent the other public companies in the industry -- Casella Waste Systems, Inc., Republic Services, Inc., Waste Connections, Inc., and Waste Holdings, Inc. The returns of each member of the peer group are weighted according to each member's stock market capitalization as of the beginning of the period measured. The graph assumes that the value of the investment in ISA's Common Stock and each index was \$100 at December 2001 and that all dividends were reinvested.

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www.researchdatagroup.com/S&P.htm

| | 12/01 | 12/02 | 12/03 | 12/04 | 12/05 | 12/06 |
|--------------------------------------|--------|--------|--------|--------|--------|--------|
| Industrial Services Of America, Inc. | 100.00 | 95.69 | 206.22 | 762.23 | 300.24 | 528.08 |
| S & P 500 | 100.00 | 77.90 | 100.24 | 111.15 | 116.61 | 135.03 |
| Peer Group | 100.00 | 105.59 | 125.92 | 165.05 | 180.23 | 206.95 |

Item 6. Selected Financial Data.

Selected Financial Data

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| | <u>2006</u> | <u>2005</u> | <u>2004</u> | <u>2003</u> | <u>2002</u> |
|---|------------------|-------------------|-------------------|-------------------|-------------------|
| (Amounts in Thousands, Except Per Share Data) | | | | | |
| Year ended December 31: | | | | | |
| Total revenue | \$ <u>62.082</u> | \$ <u>117.382</u> | \$ <u>139.588</u> | \$ <u>118.494</u> | \$ <u>101.279</u> |
| Net income (loss) | <u>2,188</u> | <u>1,102</u> | <u>1,497</u> | <u>668</u> | <u>(164)</u> |
| Earnings (loss) | | | | | |
| per common share: | | | | | |
| Basic | \$ <u>0.61</u> | \$ <u>0.31</u> | \$ <u>0.43</u> | \$ <u>0.21</u> | \$ <u>(0.05)</u> |
| Diluted | \$ <u>0.61</u> | \$ <u>0.31</u> | \$ <u>0.42</u> | \$ <u>0.21</u> | \$ <u>(0.05)</u> |
| Cash dividends declared | | | | | |
| per common share * | \$ <u>-</u> | \$ <u>-</u> | \$ <u>0.10</u> | \$ <u>-</u> | \$ <u>-</u> |
| At year end: | | | | | |
| Total assets | \$ <u>19.332</u> | \$ <u>17.884</u> | \$ <u>21.079</u> | \$ <u>19.988</u> | \$ <u>18.913</u> |
| Long-term debt and capital lease | | | | | |
| obligations, net of current maturities | \$ <u>2.858</u> | \$ <u>153</u> | \$ <u>1,272</u> | \$ <u>3,748</u> | \$ <u>3,748</u> |

* adjusted for two-for-one stock split effective February 26, 2004

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation.

The following discussion and analysis should be read in conjunction with the information set forth under Item 6, "Selected Financial Data" and our consolidated financial statements and the accompanying notes thereto included elsewhere in this report.

The following discussion and analysis contains certain financial predictions, forecasts and projections which constitute "forward-looking statements" within the meaning of the federal securities laws. Actual results could differ materially from those financial predictions, forecasts and projections and there can be no assurance that we will achieve such financial predictions, forecasts and projections. Please see Item 1A, "Risk Factors" for items that could affect our financial predictions, forecasts and projections.

General

We are focusing our attention now and in the future towards our recycling business segment. We sell processed ferrous and non-ferrous scrap material to end-users such as steel mini-mills, integrated steel makers, foundries and refineries. We purchase ferrous and non-ferrous scrap material primarily from industrial and commercial generators of steel, iron, aluminum, copper, stainless steel and other metals as well as from other scrap dealers who deliver these materials directly to our facilities. We process these materials by sorting, shearing, cutting and/or baling. We will also continue to focus on initiating growth in our management services business segment and our waste and recycling equipment sales, service and leasing division.

We continue to pursue a growth strategy in the waste management services arena by adding new locations of existing customers as well as marketing our services to potential customers. Currently, we service 1,721 customer locations throughout the United States and we utilize an active database of over 6,100 vendors to provide timely, thorough and cost-effective service to our customers.

Our goal is to remain dedicated to the recycling, management services, and equipment industry while sustaining steady growth at an acceptable profit, adding to our net worth, and providing positive returns for stockholders. We intend to increase efficiencies and productivity in our core business while remaining alert for possible acquisitions, strategic partnerships, mergers and joint-ventures that would enhance our profitability.

We have operating locations in Louisville and Lexington, Kentucky, and Seymour, Indiana. We plan to close the Lexington location in the first quarter of 2007. We do not have operating locations outside the United States.

Liquidity and Capital Resources

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As of December 31, 2006, we held cash and cash equivalents of \$1,331,807.

On December 22, 2006, ISA executed a new revolving credit facility with BB&T increasing the borrowing line from \$5.0 million to \$10.0 million to provide ISA with working capital to support the current needs of our business. This revolving credit facility has a three year term, provides for advances of up to eighty percent (80%) of ISA's eligible accounts receivable and up to the forty percent (40%) of eligible inventory, and up to one hundred (100%) of ISA's net book value of eligible equipment less an outstanding indebtedness on the equipment. The revolving credit facility bears interest at the one month Libor rate, as published in the Wall Street Journal, plus two and twenty-five one-hundredths percent (2.25%) per annum, 7.57% as of December 31, 2006, and is secured by all ISA assets (except rental fleet equipment). The revolving credit facility contains certain restrictive and financial covenants. At December 31, 2006, ISA was in compliance with all restrictive covenants.

We also have a \$2.0 million loan with Fifth Third Bank secured by our rental fleet equipment. Indebtedness under this loan agreement accrues interest at a fixed interest rate of 6.83%. The maturity date under this agreement is June 2011 with a ten-year amortization schedule. As of December 31, 2006 we had borrowed \$1,929,016 and as of December 31, 2005, there were no borrowings against this loan. The terms of the loan agreement place certain restrictive covenants on us, including maintenance of a specified tangible net worth, debt to net worth and EBITDA ratio. Consequently, these covenants restrict our ability to incur as much additional debt as we may desire for future growth. At December 31, 2006, we were in compliance with all restrictive covenants.

During 2006, we purchased \$2,352,509 of property and equipment, including \$186,178 in equipment under a capital lease. In the recycling segment we spent \$1,334,583 for an automobile crusher, a forklift, a loader, a Mack truck, a front scale, open top containers, crane improvements, and upgrades to our radiation detection system. In the equipment sales, leasing and service segment, we purchased \$902,120 in rental equipment that we located at customer sites. This rental fleet equipment consists of solid waste handling and recycling equipment such as compactors, containers and balers. It is our intention to continue to pursue this market. We purchased office equipment of \$78,251 and spent \$37,555 on buildings and improvements.

We implemented the use of a purchasing card with a credit limit of \$6.0 million in the second quarter of 2004. We have included the balance due on the purchasing card as part of accounts payable. The outstanding balance on the purchasing card at December 31, 2006 was \$687,437 with a due date of January 27, 2007; the entire balance was paid before the due date. The card accrues interest at prime plus 5.9% after the first twenty-five days of the purchase; our intention is to pay off the full balance every month so as to not incur finance charges. To date we have not incurred any interest charges on this purchasing card. The card requires monthly minimum payments on any balance outstanding at month end. We receive rebates on an annual basis for all purchases made with the card.

We expect that existing cash flow from operations and available credit under our existing credit facilities, including the purchasing card, will be sufficient to meet our cash needs in 2007.

Critical Accounting Policies

In preparing financial statements in conformity with accounting principles generally accepted in the United States, we make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. We believe that we consistently apply judgments and estimates and that such consistent application results in financial statements and accompanying notes that fairly represent all

periods presented. However, any errors in these judgments and estimates may have a material impact on our statement of operations and financial condition. Critical accounting policies, as defined by the Securities and Exchange Commission, are those that are most important to the portrayal of our financial condition and results of operations and require our most difficult and subjective judgments and estimates of matters that are inherently uncertain.

Revenue recognition

We recognize revenues from processed ferrous and non-ferrous scrap metal sales when title passes to the customer. We recognize revenues from services as the service is performed. We accrue sales adjustments related to price and weight differences and allowances for uncollectible receivables against revenues as incurred.

Accounts receivable and allowance for doubtful accounts receivable

Accounts receivable consist primarily of amounts due from customers from product and brokered sales. The allowance for doubtful accounts receivable totaled \$100,000 and \$50,000 at December 31, 2006 and 2005, respectively. Our determination of the allowance for doubtful accounts receivable includes a number of factors, including the age of the balance, past experience with the customer account, changes in collection patterns and general industry conditions.

Potential credit losses from our significant customers could adversely affect our results of operations or financial condition. General weakness in the steel and metals sectors during the period from 1998 to 2001 previously led to bankruptcy filings by many of our customers, which caused us to recognize additional allowances for doubtful accounts receivable. While we believe our allowance for doubtful accounts is adequate, changes in economic conditions or any weakness in the steel and metals industries could adversely impact our future earnings.

Inventory

Our inventories primarily consist of ferrous and non-ferrous scrap metals and we value at the lower of average purchased cost or market. We determine quantities of inventories based on our inventory systems, which are subject to periodic physical verification using estimation techniques including observation, weighing and other industry methods. Prices of commodities we own may be volatile. We are exposed to risks associated with fluctuations in the market price for both ferrous and non-ferrous metals, which are at times volatile. We attempt to mitigate this risk by seeking to rapidly turn our inventories.

Property and Equipment

We carry the value of land on our books at cost. We report premises and equipment at cost less accumulated depreciation and amortization. We charge depreciation and amortization for financial reporting purposes to operating expense using the straight-line method over the estimated useful lives of the assets. Estimated useful lives are up to 40 years for buildings and leasehold improvements, 1 to 10 years for office and operating equipment, and 5 years for rental equipment. Our determination of estimated useful life includes past experience and normal deterioration. We include maintenance and repairs in selling, general and administrative expenses. We include gains and losses on

disposition of premises and equipment in gain (loss) on sale of assets.

Valuation of long-lived assets and goodwill

We regularly review the carrying value of certain long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be realizable. If an evaluation is required, we compare the estimated future undiscounted cash flows associated with the asset to the asset's carrying amount to determine if an impairment of such asset is necessary. The effect of any impairment would be to expense the difference between the fair value of such asset and its carrying value. During the year ended December 31, 2006, we determined no impairment existed.

Effective January 1, 2002, we adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," which requires that we review goodwill at least annually for impairment based on the fair value method. At December 31, 2006, we determined, based on current industry and other market information, that no impairment existed.

Income Taxes

We account for income taxes under the asset and liability method. We recognize deferred tax assets and liabilities for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. We measure deferred tax assets and liabilities using enacted tax rates expected to apply to taxable income in the years in which we expect to recover or settle those temporary differences. We recognize the effect on deferred tax assets and liabilities of a change in tax rates in income in the period that includes the enactment date.

Results of Operations

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The following table presents, for the years indicated, the percentage relationship that certain captioned items in our Consolidated Statements of Operations bear to total revenues and other pertinent data:

| <u>Year ended December 31,</u> | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|-------------|-------------|-------------|
| Consolidated Statements of Operations Data: | | | |
| Total revenue | 100.0% | 100.0% | 100.0% |
| Total cost of goods sold..... | 85.4% | 93.5% | 94.1% |
| Selling, general and administrative Expenses | 9.0% | 5.0% | 4.0% |
| | | | |
| Income before other income (expense)..... | 5.6% | 1.5% | 1.9% |

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Total revenue decreased \$55,299,811 or 47.1% to \$62,082,048 in 2006 compared to \$117,381,859 in 2005. Management services revenue decreased \$67,888,697 or 84.2% to \$12,712,073 in 2006 compared to \$84,451,367 in 2005. This change is primarily due to the loss of Home Depot as a customer in October 2005. Recycling revenue increased \$15,014,085 or 50.1% to \$44,967,023 in 2006 compared to \$29,952,938 in 2005. This change is due to an increase of 19% in the volume of shipments and an increase of 36% in average cost per ton. Equipment, service and leasing revenue decreased \$1,249,770 or 42.0% to \$1,727,784 in 2006 compared to \$2,977,554 in 2005. This decrease is primarily due to decreases in equipment sales and service revenue, offset by growth in equipment rental revenue.

Total cost of goods sold decreased \$56,780,120 or 51.7% to \$52,996,441 in 2006 compared to \$109,776,561 in 2005. Management services cost of goods sold decreased \$66,616,456 or 82.6% to \$13,984,314 in 2006 compared to \$80,600,770 in 2005. This change is primarily due to the loss of Home Depot as a customer. Additionally, we reduced cost of goods sold by \$1,272,241 in 2006 due to a change in management's estimate related to the liability associated with this operation which includes the contract settlement with our former customers. Recycling cost of goods sold increased \$12,177,245 or 44.7% to \$39,448,957 in 2006 compared to \$27,271,712 in 2005 due to an increase in the volume of shipments as well as an increase in the volume of purchases of 8% and an increase in average cost per ton of 55.6%. Equipment, service and leasing cost of goods sold decreased \$1,068,668 or 56.1% to \$835,411 in 2006 compared to \$1,904,079 in 2005. This decrease is primarily due to the decrease in equipment sales.

Selling, general and administrative expenses decreased \$206,646 or 3.6% to \$5,609,959 in 2006 compared to \$5,816,605 in 2005. The decrease in SG&A is due to a decrease in labor and related benefits (\$306,000) offset by an increase in bad debt expense (\$93,464).

- Labor and related benefits decreased \$306,000 due to the loss of Home Depot as a customer.
- Bad debt expense increased \$93,464 primarily due to the write-off of All County & Delta Management in 2006.

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As a percentage of total revenue, selling, general and administrative expenses were 9.0% in 2006 compared to 5.0% in 2005.

Interest expense increased \$138,706 or 187% to \$212,722 in 2006 compared to \$74,016 in 2005 due to an increase in long term debt in 2006 compared to a payoff of debt during 2005. Other income was \$32,930 in 2006 compared to other income of \$3,424 in 2005. This increase of \$29,506 is primarily due to bankruptcy recoveries.

Significant components of other income (expense) are as follows:

| Description | Fiscal Year Ended December 31 | |
|-----------------------------------|-------------------------------|-----------|
| | 2006 | 2005 |
| Bankruptcy recoveries | \$ 22,787 | \$ 12,061 |
| Interest on K&R note | 6,845 | (11,782) |
| Other | 3,298 | 3,145 |
| Total other income (expense), net | \$ 32,930 | \$ 3,424 |

Income tax provision increased \$585,496 to \$1,325,929 in 2006 compared to \$740,433 in 2005. The effective tax rate in 2006 was 37.7 % compared to approximately 40.2% in 2005 based on federal and state statutory rates. The provision for income taxes increased 4.2% to 37.7% for the year ended December 31, 2006 compared to 33.5% for the nine months ended September 30, 2006.

The provision for income taxes increased 4.2% to 37.7% for the year ended December 31, 2007 compared to 33.5% for the nine months ended September 30, 2006.

The parties agreed mutually to decrease the taxable base of the common stock awarded to Andrew M. Lassak on June 15, 2006. Based on the increase in profit in the fourth quarter of 2006, the impact of the tax benefit of the common stock had less impact on the income tax provision for the year ended December 31, 2006 compared to the income tax provision for the nine months ended September 30, 2006.

Financial Condition at December 31, 2006 compared to December 31, 2005

Cash and cash equivalents decreased \$389,494 to \$1,331,807 as of December 31, 2006 compared to \$1,721,301 as of December 31, 2005.

Net cash from operating activities decreased \$5,075,653 to net cash used of (\$1,216,923) as of December 31, 2006 compared to \$3,858,730 as of December 31, 2005. This decrease was directly related to the decrease in accounts payable of \$3.7 million which is primarily due to the loss of Home Depot as a customer in October 2005.

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We used net cash from investing activities of \$2,058,807 for the year ending December 31, 2006 compared to \$1,678,318 for the same period in 2005. The difference of \$380,489 was primarily due to \$348,446 more in property and equipment purchases in 2006 than in 2005.

Net cash from financing activities increased \$4,475,037 to \$2,886,236 for the year ending December 31, 2006 compared to net cash used of (\$1,588,801) for the same period in 2005. Proceeds from long term debt totaled \$10,710,875 in 2006, and payments on long-term debt were \$7,770,984 in 2006 and \$1,000,000 in 2005.

On December 22, 2006, we executed a new revolving credit facility with BB&T increasing the borrowing line from \$5.0 million to \$10.0 million to provide us with working capital to support the current needs of our business. This revolving credit facility has a three year term expiring December 22, 2009, and provides for advances of up to eighty percent (80%) of ISA's eligible accounts receivable and up to the forty percent (40%) of eligible inventory, and up to one hundred (100%) of ISA's net book value of eligible equipment less an outstanding indebtedness on the equipment. The revolving credit facility bears interest at the one month Libor rate, as published in the Wall Street Journal, plus two and twenty-five one-hundredths percent (2.25%) per annum, and is secured by all our assets (except rental fleet equipment). As of December 31, 2006 we had borrowed \$1,010,875 and as of December 31, 2005, there were no borrowings against the credit facility. The revolving credit facility contains certain restrictive and financial covenants. At December 31, 2006, we were in compliance with all restrictive covenants.

We also have a \$2.0 million loan with Fifth Third Bank secured by our rental fleet equipment. Indebtedness under this loan agreement accrues interest at a fixed interest rate of 6.83%. The maturity date under this agreement is June 2011 with a ten-year amortization schedule. As of December 31, 2006 we had borrowed \$1,929,016 and as of December 31, 2005, there were no borrowings against this loan. The terms of the loan agreement place certain restrictive covenants on us, including maintenance of a specified tangible net worth, debt to net worth and EBITDA ratio. Consequently, these covenants restrict our ability to incur as much additional debt as we may desire for future growth. At December 31, 2006, we were in compliance with all restrictive covenants.

We implemented the use of a purchasing card with a credit limit of \$6.0 million in the second quarter of 2004. We include the balance due on the purchasing card as part of accounts payable. The outstanding balance on the purchasing card at December 31, 2006 was \$687,437.

We believe our principal sources of liquidity from available funds on hand, cash generated from operations and the availability of borrowing under our senior revolving credit facility and purchasing card will be sufficient to fund operations in fiscal year 2007. Our primary sources of funds are our ability to generate cash from operations and the availability of borrowing under our senior revolving credit facility to meet our liquidity obligations, which could be affected by factors such as a decline in demand for our products, loss of key contract customers such as occurred with Home Depot in 2005, our ability to generate profits and other unforeseen circumstances. The availability of our revolving credit facility, is contingent on complying with certain debt covenants. We do not expect the covenants to limit or restrict our ability to borrow on the facility in fiscal year 2007.

Trade accounts receivable after allowances for doubtful accounts increased \$523,596 or 11.6% to \$5,026,441 as of December 31, 2006. The primary reason for the increase in trade accounts receivable after allowances for doubtful accounts is an increase in the volume of shipments and an increase in the selling prices in the recycling segment.

Recycling accounts receivable increased \$1,307,628 or 50.4% to \$3,903,681 as of December 31, 2006 compared to \$2,596,053 as of December 31, 2005. This change is primarily due to an increase in the volume of shipments and an increase in the selling prices in the recycling segment. On average, volume of ferrous shipments in gross tons increased 15% as of December 31, 2006 compared to December 31, 2005. On average, sales prices increased \$20 per gross ton or 8.9% to \$244 as of December 31, 2006 compared to \$224 as of December 31, 2005. On

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average, volume of nonferrous shipments in pounds increased 13% as of December 31, 2006 compared to December 31, 2005. On average, sales prices increased 57.0% as of December 31, 2006 compared to December 31, 2005.

CWS accounts receivable decreased \$704,467 or 39.3% to \$1,089,080 as of December 31, 2006 compared to \$1,793,547 as of December 31, 2005. This change is primarily due to the loss of Home Depot as a customer.

WESSCO accounts receivable decreased \$85,431 or 100% to \$0 as of December 31, 2006 compared to \$85,431 as of December 31, 2005. This change is primarily due to a decrease in equipment sales.

Inventories consist principally of ferrous and nonferrous scrap materials and waste equipment machinery held for resale. We value inventory at the lower of cost or market. Inventory increased \$939,617 or 37.8% to \$3,428,226 as of December 31, 2006 compared to \$2,488,609 as of December 31, 2005. Inventories as of December 31, 2006 and December 31, 2005 consist of the following:

| | December 31, <u>2006</u> | December 31, <u>2005</u> |
|---------------------------|-------------------------------------|-------------------------------------|
| Ferrous | \$ 1,667,937 | \$ 1,380,050 |
| Non-Ferrous | 1,678,655 | 961,085 |
| Waste equipment machinery | 56,200 | 120,922 |
| Other | <u>25,434</u> | <u>26,552</u> |
| Total inventories | <u>\$ 3,428,226</u> | <u>\$ 2,488,609</u> |

For the year ended December 31, 2006, we shipped 76,331 gross tons of ferrous material. During the same period, we purchased 72,475 gross tons of ferrous material. For the year ended December 31, 2005, we shipped 66,155 gross tons of ferrous material. During the same period, we purchased 66,947 gross tons of ferrous material. We did not write down ferrous inventory in 2006. As of December 31, 2005, ferrous inventory consisted of 7,750 gross tons at a unit cost of \$178.07 per gross ton. As of December 31, 2006, ferrous inventory consisted of 9,400 gross tons at a unit cost of \$177.44 per gross ton. For the year ended December 31, 2006, the purchase price plus processing costs of ferrous material averaged \$157.25 per gross ton compared to \$136.31 per gross ton in 2005.

For the year ended December 31, 2006, we shipped 22,258,977 pounds of nonferrous material. During the same period, we purchased 20,362,645 pounds of nonferrous material. For the year ended December 31, 2005, we shipped 19,622,793 pounds of nonferrous material. During the same period, we purchased 18,660,006 pounds of nonferrous material. We did not write down nonferrous inventory in 2006. As of December 31, 2006, nonferrous inventory consisted of 1,601,554 pounds with a unit cost of \$0.960 per pound. As of December 31, 2005, nonferrous inventory consisted of 1,569,770 pounds at a unit cost of \$0.612 per pound. For the year ended December 31, 2006, the purchase price plus processing costs of non-ferrous material has averaged \$0.960 per pound compared to \$0.608 per pound in 2005.

| Year | Inventory Type | Gross Tons | Unit Cost | Amount |
|------|----------------|------------|-----------|-------------|
| 2005 | Ferrous | 7,750 | \$178.07 | \$1,380,050 |

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| | | | | |
|-------------|-----------------------|---------------|------------------|---------------|
| 2006 | Ferrous | 9,400 | 177.44 | 1,667,937 |
| Year | Inventory Type | Pounds | Unit Cost | Amount |
| 2005 | Nonferrous | 1,569,770 | \$0.61 | \$ 961,085 |
| 2006 | Nonferrous | 1,748,600 | 0.96 | 1,678,655 |

Inventory Aging for the year ended December 31, 2006 (Days Outstanding)

| Description | 1-30 | 31-60 | 61-90 | Over 90 | Total |
|-----------------------|--------------|------------|------------|------------|--------------|
| Equipment & parts | \$ 33,720 | \$ 22,480 | \$ - | \$ - | \$ 56,200 |
| Ferrous Materials | 864,489 | 448,842 | 166,509 | 188,097 | 1,667,937 |
| Non-ferrous materials | 1,467,679 | 41,840 | 42,989 | 126,147 | 1,678,655 |
| Other | 25,434 | - | - | - | 25,434 |
| | \$ 2,391,322 | \$ 513,162 | \$ 209,498 | \$ 314,244 | \$ 3,428,226 |

Inventory aging for the year ended December 31, 2005 (Days Outstanding):

| Description | 1-30 | 31-60 | 61-90 | Over 90 | Total |
|-----------------------|--------------|------------|------------|------------|-------------|
| Equipment & parts | \$ 29,437 | \$ 22,400 | \$ - | \$ 69,085 | \$ 120,922 |
| Ferrous Materials | 731,924 | 353,962 | 182,650 | 111,514 | 1,380,050 |
| Non-ferrous materials | 737,190 | 108,394 | 53,300 | 62,201 | 961,085 |
| Other | 26,552 | - | - | - | 26,552 |
| | \$ 1,525,103 | \$ 484,756 | \$ 235,950 | \$ 242,800 | \$2,488,609 |

Accounts payable trade decreased \$3,737,224 or 45.1% to \$4,545,057 as of December 31, 2006 compared to \$8,282,281 as of December 31, 2005. Recycling accounts payable increased \$202,592 or 18.5% to \$1,298,537 as of December 31, 2006 compared to \$1,095,945 as of December 31, 2005. This increase is primarily due to the increase in volume of commodity purchases at respective year-ends and increased commodity purchase prices of ferrous and nonferrous materials. Our accounts payable payment policy in the recycling segment is consistent between years.

CWS accounts payable decreased \$3,886,325 or 56.7% to \$2,969,252 as of December 31, 2006 compared to \$6,855,577 as of December 31, 2005. This change is primarily due to the loss of Home Depot as a customer.

WESSCO accounts payable decreased \$51,159 or 20.0% to \$205,168 as of December 31, 2006 compared to \$256,327 as of December 31, 2005. This change is due to a decrease in equipment sales.

Working capital increased \$4,415,407 to \$3,524,0982 as of December 31, 2006 compared to a deficit of \$861,309 as of December 31, 2005. Net income of \$2,188,579, depreciation of \$1,745,905, and pay down of accounts payable of \$3,737,224 were positive contributors to working capital in 2006. During 2006, we used these positive working capital contributors to purchase property and equipment of \$2,166,331.

Contractual Obligations

The following table provides information with respect to our known contractual obligations for the year ended December 31, 2006.

Payments due by period

| Obligation Description | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
|---------------------------------|-------------|------------------|-----------|-----------|-------------------|
| Capital Lease Obligations (1) | 296,386 | 228,533 | 67,853 | 0 | 0 |
| Operating Lease Obligations (2) | 738,418 | 612,245 | 122,798 | 3,375 | 0 |
| Total | \$1,034,804 | \$840,778 | \$190,651 | \$ 3,375 | \$0 |

(1) We lease various pieces of equipment that qualify for capital lease treatment. These lease arrangements require monthly lease payments expiring at various dates through May 2008.

(2) We lease the Louisville, Kentucky facility from a related party under an operating lease expiring December 2007. We have monthly rental payments of \$42,106 through December 2007. In the event of a change of control, the monthly payments become \$62,500. See Item 1. Business -- Related Parties Agreements.

We also lease a management services operations facility and various pieces of equipment in Dallas, Texas for which monthly payments of \$2,525 are due through September 2007. We have subleased the Lexington property to an unaffiliated third party for a term commencing March 1, 2007 and ending December 31, 2012 for \$4,500 per month. We currently lease this property from an unaffiliated third party for \$4,500 per month; the lease terminates December 31, 2012. If for any reason the sublessee defaults, we remain liable for the remainder of the lease payments through December 31, 2012.

On February 6, 2007, we leased 7.7 acres of real property, including a 38,000 square foot warehouse and a 400 square foot office, in Pineville, Louisiana for \$5,250 per month for twenty-four months beginning March 1, 2007 and ending February 28, 2009, with an option to purchase the property for a purchase price of \$575,000.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Total revenue decreased \$22,206,217 or 15.9% to \$117,381,859 in 2005 compared to \$139,588,076 in 2004. Management services revenue decreased \$8,823,712 or 9.5% to \$84,451,367 in 2005 compared to \$93,275,079 in 2004. This change is primarily due to the loss of Home Depot as a customer in October 2005. Recycling revenue decreased \$13,309,875 or 30.8% to \$29,952,938 in 2005 compared to \$43,262,813 in 2004. This change is due to a decrease of 31% in the volume of shipments (the volume of shipments in 2004 was abnormally high). Equipment, service and leasing revenue decreased \$72,630 or 2.4% to \$2,977,554 in 2005 compared to \$3,050,184 in 2004. This decrease is primarily due

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to decreases in cardboard and rental equipment sales offset by growth in equipment sales attributable to a larger sales staff.

Total cost of goods sold decreased \$21,609,599 or 16.4% to \$109,776,561 in 2005 compared to \$131,386,160 in 2004. Management services cost of goods sold decreased \$8,843,157 or 9.9% to \$80,600,770 in 2005 compared to \$89,443,927 in 2004. This change is primarily due to the loss of Home Depot as a customer. Recycling cost of goods sold decreased \$12,857,324 or 32.0% to \$27,271,712 in 2005 compared to \$40,129,036 in 2004 due to a decrease in the volume of shipments as well as a decrease in the volume of purchases of 30%. Equipment, service and leasing cost of goods sold increased \$90,882 or 5.0% to \$1,904,079 in 2005 compared to \$1,813,197 in 2004. This increase is primarily due to the growth in equipment sales attributable to the expansion of the sales staff.

Selling, general and administrative expenses increased \$252,582 or 4.5% to \$5,816,605 in 2005 compared to \$5,564,023 in 2004. The increase in SG&A is due to increases in depreciation (\$93,000), accounting (\$45,000), insurance (\$44,000), legal (\$35,000), labor (\$26,000) and repairs and other expenses (\$72,000), offset by a decrease in operating supplies (\$63,000) expense.

| | |
|---|---|
| - | Depreciation increased \$93,000 due to a large purchase of containers in September 2004. We are using these containers in Florida and New Orleans, primarily for cleanup due to the hurricanes. |
| - | Accounting expenses increased \$45,000 due to consultations with our independent accountants on periodic SEC reviews, Sarbanes-Oxley compliance and increased tax work. |
| - | Insurance increased \$44,000 because of increases in general liability insurance and directors and officers insurance. |
| - | Labor and consulting expenses increased \$26,000 due to the addition of sales, accounting and administrative employees, and due to an increase in health insurance costs. |
| - | Legal expenses increased \$35,000 primarily due to expenses related to the Lassak case. |
| - | Equipment repairs and maintenance increased \$72,000 due to increased repairs and maintenance in the equipment, service and leasing segment. We have \$877,751 more in rental equipment than we did in the fourth quarter of 2004. Additionally, the price of steel, used for fabrication, has increased since last year. |
| - | Operating supplies decreased \$63,000 because of a decrease in repairs on equipment in the recycling segment due to a lower volume of material that needed to be processed. |

As a percentage of total revenue, selling, general and administrative expenses were 5.0% in 2005 compared to 4.0% in 2004.

Interest expense decreased \$117,570 or 61.4% to \$74,016 in 2005 compared to \$191,586 in 2004 due to payoff of debt during 2005. Other income was \$3,424 in 2005 compared to other income of \$21,832 in 2004. This decrease of \$18,408 is primarily due to 2004 income of \$13,300 derived from Canadian exchange rates.

Significant components of other income (expense) are as follows:

| Description | Fiscal Year Ended December 31 | |
|-----------------------------------|-------------------------------|-----------|
| | 2005 | 2004 |
| Exchange rates | \$ (11,782) | \$ 13,300 |
| Bankruptcy recoveries | 12,061 | 10,946 |
| Other | 3,145 | (2,414) |
| Total other income (expense), net | \$ 3,424 | \$ 21,832 |

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Income tax provision decreased \$271,568 to \$740,433 in 2005 compared to \$1,012,001 in 2004. The effective tax rate in 2005 and 2004 was approximately 40% based on the federal and state statutory rates.

Financial Condition at December 31, 2005 compared to December 31, 2004

Cash and cash equivalents increased \$591,611 to \$1,721,301 as of December 31, 2005 compared to \$1,129,690 as of December 31, 2004.

Net cash from operating activities decreased \$1,591,620 to \$3,858,730 as of December 31, 2005 compared to \$5,450,350 as of December 31, 2004. This decrease was directly related to the decrease in accounts payable of \$3,800,395 which is primarily due to the loss of Home Depot in October 2005.

We used net cash for investing activities of \$1,678,318 for the year ending December 31, 2005 compared to \$2,144,045 for the same period in 2004. The difference was primarily due to an advance we made to a related party of \$302,160 in 2004, as compared to our receipt of payments on this note receivable totaling \$37,770 in 2005.

We used net cash for financing activities of \$1,588,801 for the year ending December 31, 2005 compared to \$2,839,387 for the same period in 2004. Payments on long-term debt were \$1,000,000 in 2005 compared to \$2,762,908 in 2004. The payments in 2004 included an advance principal payment of maturities of long-term debt due in 2005 of \$180,000. We retired the remaining long-term debt of \$1,000,000 in 2005.

We paid our first dividend of \$353,547 in 2004. We will continue to monitor our cash position and may pay dividends in the future. We received proceeds of \$436,141 from the exercise of common stock options in 2004. This strong cash flow from the exercise of common stock options will not continue in the future based on only 20,000 options remaining outstanding, all with an exercise price of \$1.25 as of December 31, 2005. We did not plan to grant new stock options in the immediate future.

On January 14, 2005, we replaced our previous \$3.8 million senior revolving credit facility with a new \$5 million senior revolving credit facility that expires in January 2008. At December 31, 2005, we did not have any short-term borrowings outstanding. The credit facility requires us to comply with certain debt covenants. We were in compliance with these covenants at December 31, 2005.

We implemented the use of a purchasing card with a credit limit of \$6.0 million in the second quarter of 2004. We include the balance due on the purchasing card as part of accounts payable. The outstanding balance on the purchasing card at December 31, 2005 was \$1,465,860.

Trade accounts receivable after allowances for doubtful accounts decreased \$4,074,483 or 47.5% to \$4,502,845 as of December 31, 2005. The primary reason for the decrease in trade accounts receivable after allowances for doubtful accounts is the loss of Home Depot as a customer.

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Recycling accounts receivable decreased \$188,806 or 6.8% to \$2,596,053 as of December 31, 2005 compared to \$2,784,859 as of December 31, 2004. Aggressive collection methods had a direct impact on decreasing accounts receivable in the recycling segment, as well as decreases in the volume of shipments and sale prices. On average, volume of ferrous shipments in gross tons decreased 31% as of December 31, 2005 compared to December 31, 2004. On average, sales prices decreased \$34 per gross ton or 13% to \$224 as of December 31, 2005 compared to \$258 as of December 31, 2004. On average, volume of nonferrous shipments in pounds decreased 22.7% as of December 31, 2005 compared to December 31, 2004. On average, sales prices increased 6.2% as of December 31, 2005 compared to December 31, 2004.

CWS accounts receivable decreased \$3,786,957 or 67.9% to \$1,793,547 as of December 31, 2005 compared to \$5,580,504 as of December 31, 2004. This change is primarily due to the loss of Home Depot as a customer.

WESSCO accounts receivable decreased \$103,069 or 54.7% to \$85,431 as of December 31, 2005 compared to \$188,500 as of December 31, 2004. This change is primarily due to decreases in cardboard and rental equipment sales.

Inventories consisted principally of ferrous and nonferrous scrap materials and waste equipment machinery held for resale. We valued inventory at the lower of cost or market. Inventory increased \$336,235 or 15.6% to \$2,488,609 as of December 31, 2005 compared to \$2,152,374 as of December 31, 2004. Inventories as of December 31, 2005 and December 31, 2004 consisted of the following:

| | December 31, <u>2005</u> | December 31, <u>2004</u> |
|---------------------------|-------------------------------------|-------------------------------------|
| Ferrous | \$ 1,380,050 | \$ 1,140,905 |
| Non-Ferrous | 961,085 | 870,038 |
| Waste equipment machinery | 120,922 | 118,249 |
| Other | <u>26,552</u> | <u>23,182</u> |
| Total inventories | <u>\$ 2,488,609</u> | <u>\$ 2,152,374</u> |

For the year ended December 31, 2005, we shipped 66,155 gross tons of ferrous material. During the same period, we purchased 66,947 gross tons of ferrous material. For the year ended December 31, 2004, we shipped 95,444 gross tons of ferrous material. During the same period, we purchased 94,552 gross tons of ferrous material. For the year ended December 31, 2004, we wrote down ferrous inventory by 3,131 gross tons. The remaining ferrous inventory was not impaired. We included the ferrous inventory charges of \$721,382 in cost of sales in 2004. We took these ferrous inventory charges to adjust inventory for the accumulation of water, dirt, and other materials that had no value. These materials existed in almost every load and we needed to make periodic adjustments to correct the amount of inventory available for sale. We instituted new methods of purchasing to reduce the possibility of these types of write-downs in the future. We did not write down ferrous inventory in 2005. As of December 31, 2004, ferrous inventory consisted of 5,763 gross tons with a unit cost of \$197.97 per gross ton. As of December 31, 2005, ferrous inventory consisted of 7,750 gross tons at a unit cost of \$178.07 per gross ton. For the year ended December 31, 2005, the purchase price plus processing costs of ferrous material averaged \$136.31 per gross ton compared to \$230.40 per gross ton in 2004.

For the year ended December 31, 2005, we shipped 19,622,793 pounds of nonferrous material. During the same period, we purchased 18,660,006 pounds of nonferrous material. For the year ended December 31, 2004, we shipped 26,497,088 pounds of nonferrous material. During the same period, we purchased 27,216,918 pounds of nonferrous material. For the year ended December 31, 2004, we wrote down nonferrous inventory by 13,438 pounds. The remaining nonferrous inventory was not impaired. We included the nonferrous inventory charges of \$8,641 in cost of sales in 2004. We took these nonferrous inventory charges to adjust inventory for the accumulation of water, dirt, and other

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materials that had no value. These materials existed in almost every load and we needed to make periodic adjustments to correct the amount of inventory available for sale. We improved our training methods and instituted new methods of purchasing to reduce the possibility of these types of write-downs in the future. We did not write down nonferrous inventory in 2005. As of December 31, 2004, nonferrous inventory consisted of 1,364,863 pounds with a unit cost of \$0.637 per pound. As of December 31, 2005, nonferrous inventory consisted of 1,569,770 pounds at a unit cost of \$0.612 per pound. For the year ended December 31, 2005, the purchase price plus processing costs of non-ferrous material averaged \$0.608 per pound compared to \$0.643 per pound in 2004.

| Year | Inventory Type | Gross Tons | Unit Cost | Amount |
|------|----------------|------------|-----------|-------------|
| 2004 | Ferrous | 5,763 | \$197.97 | \$1,140,905 |
| 2005 | Ferrous | 7,750 | \$178.07 | \$1,380,050 |

| Year | Inventory Type | Pounds | Unit Cost | Amount |
|------|----------------|-----------|-----------|------------|
| 2004 | Nonferrous | 1,364,863 | \$0.64 | \$ 870,038 |
| 2005 | Nonferrous | 1,569,770 | \$0.61 | \$ 961,085 |

Inventory aging for the year ended December 31, 2005 (Days Outstanding):

| Description | 1-30 | 31-60 | 61-90 | Over 90 | Total |
|-----------------------|--------------|------------|------------|------------|-------------|
| Equipment & parts | \$ 29,437 | \$ 22,400 | \$ - | \$ 69,085 | \$ 120,922 |
| Ferrous Materials | 731,924 | 353,962 | 182,650 | 111,514 | 1,380,050 |
| Non-ferrous materials | 737,190 | 108,394 | 53,300 | 62,201 | 961,085 |
| Other | 26,552 | - | - | - | 26,552 |
| | \$ 1,525,103 | \$ 484,756 | \$ 235,950 | \$ 242,800 | \$2,488,609 |

Inventory Aging for the year ended December 31, 2004 (Days Outstanding)

| Description | 1-30 | 31-60 | 61-90 | Over 90 | Total |
|-----------------------|--------------|------------|------------|-----------|--------------|
| Equipment & parts | \$ - | \$ 93,111 | \$ - | \$ 25,138 | \$ 118,249 |
| Ferrous Materials | 616,089 | 387,907 | 136,909 | - | 1,140,905 |
| Non-ferrous materials | 726,302 | 124,157 | 12,664 | 6,915 | 870,038 |
| Other | 23,182 | - | - | - | 23,182 |
| | \$ 1,365,573 | \$ 605,175 | \$ 149,573 | \$ 32,053 | \$ 2,152,374 |

Accounts payable trade decreased \$3,800,395 or 31.5% to \$8,282,281 as of December 31, 2005 compared to \$12,082,676 as of December 31, 2004. Recycling accounts payable decreased \$438,030 or 28.6% to \$1,095,945 as of December 31, 2005 compared to \$1,533,975 as of December 31, 2004. This decrease was primarily due to the decrease in volume of commodity purchases at respective year-ends and decreased commodity purchase prices of ferrous materials. Our accounts payable payment policy in the recycling segment was consistent between years.

CWS accounts payable decreased \$3,569,331 or 34.2% to \$6,855,577 as of December 31, 2005 compared to \$10,424,908 as of December 31, 2004. This change was primarily due to the loss of Home Depot as a customer.

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WESSCO accounts payable increased \$132,534 or 107.1% to \$256,327 as of December 31, 2005 compared to \$123,793 as of December 31, 2004. This change was due to an increase in equipment sales, which was the result of an expansion of the sales staff.

Working capital increased \$73,657 to a deficit of \$861,309 as of December 31, 2005 compared to a deficit of \$934,966 as of December 31, 2004. Net income of \$1,101,597, depreciation of \$1,709,668 and tax benefits related to common stock options exercised of \$451,377 were positive contributors to working capital in 2005. During 2005, we used these positive working capital contributors to make advance principal payments on debt of \$1,000,000 and purchase property and equipment of \$1,817,885.

Inflation and Prevailing Economic Conditions

To date, inflation has not and is not expected to have a significant impact on our operation in the near term. We have no long-term fixed-price contracts and we believe we will be able to pass through most cost increases resulting from inflation to our customers. We are susceptible to the cyclical nature of the commodity business. In response to these economic conditions, we have focused on the management consulting area of the business and are working to liquidate inventories while we make efforts to enhance gross margins.

Impact of Recently Issued Accounting Standards

SFAS No. 154, Accounting Changes and Error Corrections, replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 was issued May 2005 and is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not expect this standard to significantly impact our financial statements.

The Financial Accounting Standards Board has published SFAS No. 157, Fair Value Measurements, to eliminate the diversity in practice that exists due to the different definitions of fair value and the limited guidance for applying those definitions in GAAP that are dispersed among the many accounting pronouncements that require fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). SFAS No. 157 also stipulates that, as a market-based measurement, fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability, and establishes a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs).

SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, although earlier application is encouraged. Additionally, prospective application of the provisions of SFAS No. 157 is required as of the beginning of the fiscal year in which it is initially applied, except when certain circumstances require retrospective application.

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Interpretation No. 48, Accounting for Uncertainty in Income Taxes -- an interpretation of FASB Statement No. 109 (issued June 2006), clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this standard on January 1, 2007 did not have an impact on our consolidated financial statements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk.

Fluctuating commodity prices affect market risk in our recycling segment. We mitigate this risk by selling our product on a monthly contract basis. Each month we negotiate selling prices for all commodities. Based on these monthly agreements, we determine purchase prices based on a margin needed to cover processing and administrative expenses.

We are exposed to interest rate risk on our floating rate borrowings. As of December 31, 2006, variable rate borrowings consisted of outstanding borrowings of \$1,010,875 under our credit agreement. Borrowings on our credit agreement bear interest at the prime rate less 1/8. Any increase in prime rate would lead to higher interest expense. We do not have any interest rate swaps or caps in place, which would mitigate our exposure to fluctuations in the interest rate on this indebtedness. Based on our average anticipated borrowings under our credit agreement in fiscal 2007, a hypothetical increase or decrease in the prime rate by 1% would increase or decrease interest expense on our variable borrowings by approximately \$10,000 per year, with a corresponding change in cash flows.

Item 8. Consolidated Financial Statements and Supplementary Data.

Our consolidated financial statements required to be included in this Item 8 are set forth in Item 15 of this report.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None

Item 9A. Controls and Procedures.

(a) Evaluation of disclosure controls and procedures.

Based on the evaluation of the ISA Chief Executive Officer and the ISA Chief Financial Officer of our disclosure controls and procedures as of December 31, 2006, it has been concluded that the disclosure controls and procedures are effective for the purposes contemplated by Rules

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13a-15(e) and 15d - 15(e) promulgated by the Securities and Exchange Commission.

(b) Changes in internal controls over financial reporting.

There have been no significant changes to ISA's internal controls or in other factors that have materially affected, or are reasonably likely to materially affect, these controls over financial reporting subsequent to December 31, 2006.

Item 9B. Other Information.

None

PART III

Item 10. ISA Directors and Executive Officers. *

Item 11. Executive Compensation *

Item 12. Security Ownership of Certain Beneficial Owners, Management and Related Stockholder Matters. *

Item 13. Certain Relationships and Related Transactions. *

Item 14. Principal Accountant Fees and Services. *

* The information required by Items 10, 11, 12, 13 and 14 is or will be set forth in the definitive proxy statement relating to the 2007 Annual Meeting of Shareholders of ISA which is to be filed with the Securities and Exchange Commission pursuant to Regulation 14A within 120 days after ISA's year end for the year covered by this report under the Securities Exchange Act of 1934, as amended. Such definitive proxy statement relates to an annual meeting of shareholders and the portions therefrom required to be set forth in this Form 10-K by Items 10, 11, 12, 13 and 14 are incorporated herein by reference pursuant to General Instruction G(3) to Form 10-K.

PART IV

Item 15. Exhibits and Consolidated Financial Statement Schedules.

(a)(1) The following consolidated financial statements of Industrial Services of America, Inc. are filed as a part of this report:

| | <u>Page</u> |
|--|-------------|
| Report of Independent Registered Public Accounting Firms | F-1 |
| Consolidated Balance Sheets as of December 31, 2006 and 2005 | F-3 |
| Consolidated Statements of Income for the years ended December 31, 2006, 2005 and 2004 | F-4 |
| Consolidated Statements of Shareholders' Equity for the years ended December 31, 2006, 2005 and 2004 | F-5 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004 | F-6 |
| Notes to Consolidated Financial Statements | F-7 |

(a)(2) Consolidated Financial Statement Schedules.

| | |
|---|------|
| Schedule II--Valuation and Qualifying Accounts for the years ended December 31, 2006, 2005 and 2004 | F-28 |
|---|------|

(a)(3) List of Exhibits

Exhibits filed with, or incorporated by reference herein, this report are identified in the Index to Exhibits appearing in this report. The Management Agreement and the Consulting Agreement required to be filed as exhibits to this Form 10-K pursuant to Item 14(c) are noted by an asterisk (*) in the Index to Exhibits.

(b) Exhibits.

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The exhibits listed on the Index to Exhibits are filed as a part of this report.

(c) Consolidated Financial Statement Schedules.

Schedule II--Valuation and Qualifying Accounts for the year ended December 31, 2006, 2005 and 2004 are incorporated by reference at page F-29 of the ISA Consolidated Financial Statements.

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.

INDUSTRIAL SERVICES OF AMERICA, INC.

Dated: March 27, 2007

By : /s/ Harry Kletter

Harry Kletter, Chairman of the Board

and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature

Title

Date

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| | | |
|---|--|----------------|
| <u>/s/ Harry Kletter</u> Harry Kletter | Chairman of the Board and Chief Executive Officer (Principal Executive Officer) | March 27, 2007 |
| <u>/s/ Alan L. Schroering</u> Alan L. Schroering | Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | March 27, 2007 |
| <u>/s/ David W. Lester</u> David W. Lester | Director | March 27, 2007 |
| <u>/s/ Orson Oliver</u> Orson Oliver | Director | March 27, 2007 |
| <u>/s/ Roman Epelbaum</u> Roman Epelbaum | Director | March 27, 2007 |
| <u>/s/ Albert Cozzi</u> Albert Cozzi | Director | March 27, 2007 |
| <u>/s/ Craig Feltner</u> Craig Feltner | Director | March 27, 2007 |
| <u>/s/ Richard Ferguson</u> Richard Ferguson | Director | March 27, 2007 |

INDEX TO EXHIBITS

| <u>Exhibit Number</u> | | <u>Description of Exhibits</u> |
|-----------------------|----|---|
| 3.1 | ** | Certificate of Incorporation of ISA is incorporated by reference to Exhibit 3.1 of ISA's report of Form 10-KSB for the year ended December 31, 1995. |
| 3.2 | ** | Bylaws of ISA are incorporated by reference to Exhibit 3.2 of ISA's report on Form 10-KSB for the year ended December 31, 1995. |
| 10.1 | ** | Independent Consulting Services Agreement, dated as of March 31, 1995, and executed on June 25, 1996, by and between ISA and Douglas I. Maxwell, III ("Maxwell"), is incorporated by reference to Exhibit 4(a) of ISA Statement on Form S-8 of the Registration, filed on June 26, 1996 (File No. 333-06915). |
| 10.2 | ** | Confidential Information and Non-Competition Agreement Independent Contractor, dated as of March 31, 1995, and executed on June 26, 1996, by and between ISA and Maxwell, is incorporated by reference to Exhibit 10.1 of Registration Statement on Form S-8 of ISA, filed on June 26, 1996 (File No. 333-06915). |

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- 10.3 ** Stock Option Agreement, dated as of March 31, 1995, and executed on June 26, 1996, by and between ISA and Maxwell, is incorporated by reference to Exhibit 4(b) of Registration Statement on Form S-8 of ISA, filed on June 26, 1996 (File No. 333-06915).
- 10.4 ** Independent Consulting Services Agreement, dated as of March 31, 1995, and executed on June 26, 1996, by and between ISA and Neil C. Sullivan ("Sullivan"), is incorporated by reference to Exhibit 4(a) of Registration Statement on Form S-8 of ISA, filed on June 26, 1996 (File No. 333-06909).
- 10.5 ** Confidential Information and Non-Competition Agreement Independent Contractor, dated as of March 31, 1995, and executed on June 26, 1996, by and between ISA and Sullivan, is incorporated by reference to Exhibit 10.1 of Registration Statement on Form S-8 of ISA, filed on June 26, 1996 (File No. 333-06909).
- 10.6 ** Stock Option Agreement, dated as of March 31, 1995, and executed on June 26, 1996, by and between ISA and Sullivan, is incorporated by reference to Exhibit 4(b) of Registration Statement on Form S-8 of ISA, filed on June 26, 1996 (File No. 333-06909).
- 10.7 ** Acquisition of Assets Agreement, dated as of July 1, 1997, by and between ISA and The Metal Center set forth in an Asset Purchase Agreement, is incorporated by reference, as the sole Exhibit on Form 8-K of ISA, filed July 15, 1997 (File No. 0-20979).
- 10.8 ** Assignment of Contracts, dated September 4, 1997, by and between ISA and MGM Services, Inc. is incorporated by reference to Exhibit 10.11 of ISA's report on Form 10-K for the year ended December 31, 1997.
- 10.9 ** Employment Agreement, dated as of October 15, 1997, by and between ISA and Garber is incorporated by reference to Exhibit 10.12 of ISA's report on Form 10-K for the year ended December 31, 1997.
- 10.10 ** Lease Agreement, dated January 1, 1998, by and between ISA and K&R, is incorporated by reference herein, to Exhibit 10.10 on Form 8-K of ISA, filed March 3, 1998 (File No. 0-20979).*
- 10.11 ** Consulting Agreement, dated as of January 2, 1998, by and between ISA and K&R, is incorporated by reference herein, to Exhibit 10.11 on Form 8-K of ISA, filed March 3, 1998 (File No. 0-20979).*
- 10.12 ** Amendment to Employment Agreement, dated as of February 5, 1998, by and between ISA and Garber, amending original agreement dated October 15, 1997 is incorporated by reference to Exhibit 10.15 of ISA's report on Form 10-K for the year ended December 31, 1997.
- 10.13 ** Stock Option Agreement, effective as of October 31, 1997, by and between ISA and Glenn Bierman is incorporated by reference herein to Exhibit 10.13 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000.
- 10.14 ** Stock Option Agreement, effective as of October 27, 1997, by and between ISA and Sean Garber is incorporated by reference herein to Exhibit 10.14 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000.

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| | | |
|-------|----|---|
| 10.15 | ** | Stock Option Agreement, effective as of October 31, 1997, by and between ISA and Sean Garber is incorporated by reference herein to Exhibit 10.15 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.16 | ** | Amendment No. 1 to Option Agreement, effective as of February 5, 1998, by and between ISA and Sean Garber is incorporated by reference herein to Exhibit 10.16 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.17 | ** | Stock Option Agreement, effective as of February 16, 1998, by and between ISA and Harry Kletter is incorporated by reference herein to Exhibit 10.17 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.18 | ** | Consulting Agreement, dated as of June 2, 1998, by and between ISA and Andrew M. Lassak is incorporated by reference herein to Exhibit 10.18 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.19 | ** | Consulting Agreement, dated as of June 2, 1998, by and among ISA, Joseph Charles & Associates, Inc. and Andrew M. Lassak is incorporated by reference herein to Exhibit 10.19 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.20 | ** | Asset Purchase Agreement, effective as of June 1, 1998, by and among ISA, ISA Indiana, Inc., R.J. Fitzpatrick Smelters, Inc., and R.K. Fitzpatrick and Cheryl Fitzpatrick is incorporated by reference herein to Exhibit 10.20 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.21 | ** | Lease Agreement, effective June 1, 1998, by and between R.K. Fitzpatrick and Cheryl Fitzpatrick, R.J. Fitzpatrick Smelters, Inc., and ISA Indiana, Inc. is incorporated by reference herein to Exhibit 10.21 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.22 | ** | Environmental Indemnity Agreement, effective as of June 1, 1998, by and between R.K. Fitzpatrick and Cheryl Fitzpatrick, R.J. Fitzpatrick Smelters, Inc., and ISA Indiana, Inc. is incorporated by reference herein to Exhibit 10.22 of ISA's report on Form 10-K for the year ended December 31, 1999, as filed on April 14, 2000. |
| 10.23 | ** | Promissory Note dated May 8, 1997, from Registrant to Bank of Louisville in the original principal amount of \$2,000,000.00 is incorporated by reference herein to Exhibit 10.23 of ISA's report on Form 10-K for the year ended December 31, 2000, as filed on March 30, 2001. |
| 10.24 | ** | Loan Agreement dated November 30, 2000, by and between ISA and Bank of Louisville is incorporated by reference herein to Exhibit 10.24 of ISA's report on Form 10-K for the year ended December 31, 2000, as filed on March 30, 2001. |
| 10.25 | ** | Change in Terms Agreement dated November 30, 2000, by and between ISA and Bank of Louisville is incorporated by reference herein to Exhibit 10.25 of ISA's report on Form 10-K for the year ended December 31, 2000, as filed on March 30, 2001. |
| 10.26 | ** | Change in Terms Agreement dated March 26, 2001, by and between ISA and Bank of Louisville is incorporated by reference herein to Exhibit 10.26 of ISA's report on Form 10-K for the year ended December 31, 2000, as filed on March |

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30, 2001.

| | | |
|-------|----|--|
| 10.27 | ** | Penske Lease and Purchase Agreement effective July 8, 2004, for three years at a rental of \$3,000 per month with an option to purchase for \$425,000. |
| 10.28 | ** | Stock Option Agreement, dated June 11, 1996, by and between ISA and R. Jerry Falkner, is incorporated by reference to Exhibit 10.3 of ISA's report on Form 10-K for the year ended December 31, 1996. |
| 10.29 | ** | Stock Option Agreement, dated March 1, 2000, by and between ISA and Andrew M. Lassak and related letter agreement dated November 3, 1999 is incorporated by reference herein to Exhibit 10.29 of ISA's report on Form 10-K for the year ended December 31, 2004, as filed on March 4, 2005. |
| 10.30 | ** | Contract of Purchase, dated March 24, 2005, by and between the Southern States Cooperative, Incorporated and the Harry Kletter Family Limited Partnership (HKFLP), as assigned by assignment of contract of purchase, dated April 24, 2005 from HKFLP to ISA Real Estate, LLC is incorporated by reference herein to Exhibit 10.30 of ISA's report on Form 10-K for the year ended December 31, 2004, as filed on March 4, 2005. |
| 10.31 | ** | Lease, dated April 30, 2005, from ISA Real Estate, LLC to Southern States Cooperative, Incorporated is incorporated by reference herein to Exhibit 10.31 of ISA's report on Form 10-K for the year ended December 31, 2004, as filed on March 4, 2005. |
| 10.32 | ** | Promissory Note for K&R, LLC in favor of ISA in the principal amount of \$302,160, dated March 25, 2006, and effective December 31, 2005, is incorporated by reference herein to Exhibit 10.32 of ISA's report on Form 10-K for the year ended December 31, 2005, as filed on March 31, 2006. |
| 10.33 | | Loan and Security Agreement dated June 30, 2006, by and between ISA and Fifth Third Bank. |
| 10.34 | | Promissory Note dated June 30, 2006, from ISA to Fifth Third Bank. |
| 10.35 | | Revolving Credit Facility Agreement dated December 22, 2006, by and between ISA and BB&T. |
| 10.36 | | Promissory Note dated December 22, 2006, from ISA to BB&T. |
| 10.37 | | Lease dated as of February 6, 2007, by and between Parks Wood Products, as Lessor, and ISA Real Estate, LLC, as Lessee. |
| 10.38 | | Sub-Lease dated as of February 28, 2007, by and between ISA, as Sublessor, and Cohen Brothers of Lexington, Inc., as Sublessee. |
| 11 | | Statement of Computation of Earnings Per Share (See Note 9 to Notes to Consolidated Financial Statements). |
| 16 | | Letter from Crowe Chizek and Company, LLC dated April 28, 2005, regarding change in certifying accountant is incorporated by reference herein to Exhibit 16 of ISA's report on Form 8-K/A, as filed on April 28, 2005. |
| 31.1 | | Rule 13a-14(a) Certification of Harry Kletter for the Form 10-K for the year ended December 31, 2006. |
| 31.2 | | |

Rule 13a-14(a) Certification of Alan Schroering for the Form 10-K for the year ended December 31, 2006.

32.1 Section 1350 Certification of Harry Kletter and Alan Schroering for the Form 10-K for the year ended December 31, 2006.

*Denotes a management contract of ISA required to be filed as an exhibit pursuant to Item 601(10)(iii) of Regulation S-K under the Securities Act of 1933, as amended.

**Previously filed.

**INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES**

CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
Louisville, Kentucky

CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Industrial Services of America, Inc. and Subsidiaries

Louisville, Kentucky

We have audited the accompanying consolidated balance sheets of Industrial Services of America, Inc. and Subsidiaries as of December 31, 2006 and 2005 and the related consolidated statements of operations, shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Industrial Services of America, Inc. and Subsidiaries as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with U. S. generally accepted accounting principles. Also, in our opinion, the related consolidated financial statements schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

Mountjoy & Bressler, LLP

Louisville, Kentucky

March 19, 2007

1.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Industrial Services of America, Inc. and Subsidiaries

Louisville, Kentucky

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We have audited the accompanying consolidated statements of operations, shareholders' equity and cash flows of Industrial Services of America, Inc. and Subsidiaries for the year ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, Industrial Services of America, Inc. and Subsidiaries' results of its operations and its cash flows for the year ended December 31, 2004, in conformity with U. S. generally accepted accounting principles. Also, in our opinion, the related consolidated financial statements schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

Crowe Chizek and Company, LLC

Louisville, Kentucky

January 28, 2005, except for Notes 3 and 6,

as to which the date is March 25, 2005

2.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
December 31, 2006 and 2005

2006

2005

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ASSETS

Current assets

| | | |
|--|---------------|----------------|
| Cash | \$ 1,331,807 | \$ 1,721,301 |
| Accounts receivable - trade (after allowance for doubtful accounts of \$100,000 in 2006 and \$50,000 in 2005) (Note 1) | 5,026,441 | 4,502,845 |
| Net investment in sales-type leases (Note 5) | 50,586 | 65,797 |
| Inventories (Note 1) | 3,428,226 | 2,488,609 |
| Deferred income taxes (Note 4) | 106,725 | 78,385 |
| Other | <u>88,113</u> | <u>120,012</u> |
| Total current assets | 10,031,898 | 8,976,949 |

| | | |
|-------------------------------------|-----------|-----------|
| Net property and equipment (Note 1) | 8,152,606 | 7,604,712 |
|-------------------------------------|-----------|-----------|

Other assets

| | | |
|--|------------------|------------------|
| Net investment in sales-type leases (Note 5) | 186,215 | 236,801 |
| Notes receivable - related party (Note 6) | 238,566 | 264,390 |
| Goodwill (Note 1) | 560,005 | 560,005 |
| Other assets | <u>162,527</u> | <u>241,615</u> |
| | <u>1,147,313</u> | <u>1,302,811</u> |
| | \$ 19,331,817 | \$ 17,884,472 |

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities

| | | |
|--|----------------|------------------|
| Current maturities of long term debt (Note 3) | \$ 149,431 | - |
| Current maturities of capital lease obligations (Note 8) | 228,533 | \$ 118,945 |
| Accounts payable | 4,545,057 | 8,282,281 |
| Income tax payable | 1,185,717 | 109,129 |
| Other current liabilities | <u>399,062</u> | <u>1,357,903</u> |
| Total current liabilities | 6,507,800 | 9,868,258 |

Long-term liabilities

| | | |
|------------------------------------|----------------|----------------|
| Long-term debt (Note 3) | 2,790,460 | - |
| Capital lease obligations (Note 8) | 67,853 | 152,889 |
| Deferred income taxes (Note 4) | <u>219,399</u> | <u>413,570</u> |
| | 3,077,712 | 566,459 |

Commitments (Note 8)

Shareholders' equity

| | | |
|---|------------------|------------------|
| Common stock, \$.005 par value: 10,000,000 shares authorized, 4,295,000 and 4,255,000 shares issued in 2006 and 2005, 3,640,899 and 3,566,408 shares outstanding in 2006 and 2005, respectively | 21,475 | 21,275 |
| Additional paid-in capital | 3,194,816 | 3,113,819 |
| Retained earnings | 7,234,990 | 5,046,411 |
| Treasury stock at cost, 654,101 and 688,592 shares in 2006 and 2005 | <u>(704,976)</u> | <u>(731,750)</u> |
| | <u>9,746,305</u> | <u>7,449,755</u> |
| | \$ 19,331,817 | \$ 17,884,472 |

See accompanying notes to consolidated financial statements.

3.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
Years ended December 31, 2006, 2005 and 2004

2006

2005

2004

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| | | | |
|---|---------------------|---------------------|---------------------|
| Revenue from services | \$ 15,387,241 | \$ 84,451,367 | \$ 93,275,079 |
| Revenue from product sales | <u>46,694,807</u> | <u>32,930,492</u> | <u>46,312,997</u> |
| Total Revenue | 62,082,048 | 117,381,859 | 139,588,076 |
| Cost of goods sold for services | 13,984,314 | 80,600,770 | 89,443,927 |
| Cost of goods sold for product sales | 40,284,368 | 29,175,791 | 41,942,233 |
| Reduction of cost of goods sold | <u>(1,272,241)</u> | <u>-</u> | <u>-</u> |
| Total Cost of goods sold | 52,996,441 | 109,776,561 | 131,386,160 |
| Selling, general and administrative | <u>5,609,959</u> | <u>5,816,605</u> | <u>5,564,023</u> |
| Income before other income (expense) | 3,475,648 | 1,788,693 | 2,637,893 |
| Other income (expense) | | | |
| Interest expense | (212,722) | (74,016) | (191,586) |
| Interest income | 195,662 | 126,578 | 56,783 |
| Gain (loss) on sale of assets | 22,990 | (2,649) | (15,727) |
| Other income (expense), net | <u>32,930</u> | <u>3,424</u> | <u>21,832</u> |
| | <u>38,860</u> | <u>53,337</u> | <u>(128,698)</u> |
| Income before income taxes | 3,514,508 | 1,842,030 | 2,509,195 |
| Income tax provision (Note 4) | <u>1,325,929</u> | <u>740,433</u> | <u>1,012,001</u> |
| Net income | <u>\$ 2,188,579</u> | <u>\$ 1,101,597</u> | <u>\$ 1,497,194</u> |
| Basic earnings per share | \$ <u>.61</u> | \$ <u>.31</u> | \$ <u>.43</u> |
| Diluted earnings per share | \$ <u>.61</u> | \$ <u>.31</u> | \$ <u>.42</u> |

See accompanying notes to consolidated financial statements.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
Years ended December 31, 2006, 2005 and 2004

| | <u>Common Stock</u> | | Additional | Retained | <u>Treasury Stock</u> | | <u>Total</u> |
|--|---------------------|------------------|----------------------------|---------------------|-----------------------|---------------------|---------------------|
| | <u>Shares</u> | <u>Amount</u> | <u>Paid-in Capital</u> | <u>Earnings</u> | <u>Shares</u> | <u>Cost</u> | |
| Balance as of January 1, 2004 | 3,935,000 | \$ 19,675 | \$ 1,950,221 | \$ 2,801,167 | (729,200) | \$ (753,897) | \$ 4,017,166 |
| Exercise of stock options and related tax benefits | 320,000 | 1,600 | 647,985 | - | - | - | 649,585 |
| Treasury stock distribution to employees | - | - | 58,685 | - | 49,668 | 50,936 | 109,621 |
| Cash dividend | - | - | - | (353,547) | - | - | (353,547) |
| Net income | <u>-</u> | <u>-</u> | <u>-</u> | <u>1,497,194</u> | <u>-</u> | <u>-</u> | <u>1,497,194</u> |
| Balance as of December 31, 2004 | 4,255,000 | 21,275 | 2,656,891 | 3,944,814 | (679,532) | (702,961) | 5,920,019 |
| Treasury stock distribution to employees | - | - | 5,551 | - | 940 | 973 | 6,524 |
| Repurchase of common stock | - | - | - | - | (10,000) | (29,762) | (29,762) |
| Tax benefits related to common stock options | - | - | 451,377 | - | - | - | 451,377 |
| Net income | <u>-</u> | <u>-</u> | <u>-</u> | <u>1,101,597</u> | <u>-</u> | <u>-</u> | <u>1,101,597</u> |
| Balance as of December 31, 2005 | 4,255,000 | 21,275 | 3,113,819 | 5,046,411 | (688,592) | (731,750) | 7,449,755 |
| Treasury stock purchase | - | - | - | - | (5,509) | (16,338) | (16,338) |
| Exercise of stock options and related tax benefits | 40,000 | 200 | 80,997 | - | 40,000 | 43,112 | 124,309 |
| Net income | <u>-</u> | <u>-</u> | <u>-</u> | <u>2,188,579</u> | <u>-</u> | <u>-</u> | <u>2,188,579</u> |
| Balance as of December 31, 2006 | <u>4,295,000</u> | <u>\$ 21,475</u> | <u>\$ 3,194,816</u> | <u>\$ 7,234,990</u> | <u>(654,101)</u> | <u>\$ (704,976)</u> | <u>\$ 9,746,305</u> |

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years ended December 31, 2006, 2005 and 2004

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|------------------|--------------------|--------------------|
| Cash flows from operating activities | | | |
| Net income | \$ 2,188,579 | \$ 1,101,597 | \$ 1,497,194 |
| Adjustments to reconcile net income to net cash from operating activities | | | |
| Depreciation and amortization | 1,745,905 | 1,709,668 | 1,538,161 |
| Stock distribution to employees | - | 6,524 | 109,621 |
| Deferred income taxes | (222,511) | (213,538) | 335,023 |
| Tax benefit of stock options exercised | - | 451,377 | 213,444 |
| Provision for doubtful accounts | 50,000 | (25,000) | - |
| (Gain) loss on sale of property and equipment | (22,990) | 2,649 | 15,727 |
| Change in assets and liabilities | | | |
| Receivables | (573,596) | 4,099,483 | 472,524 |
| Net investment in sales-type leases | 65,797 | (94,360) | 79,754 |
| Inventories | (939,617) | (336,235) | (445,279) |
| Other assets | 110,987 | 102,797 | (167,573) |
| Accounts payable | (3,737,224) | (3,800,395) | 1,580,173 |
| Other current liabilities | <u>117,747</u> | <u>854,163</u> | <u>221,581</u> |
| Net cash from operating activities | (1,216,923) | 3,858,730 | 5,450,350 |
| Cash flows from investing activities | | | |
| Proceeds from sale of property and equipment | 81,700 | 101,797 | 3,188 |
| Purchases of property and equipment | (2,166,331) | (1,817,885) | (1,845,073) |
| Payments from/(advances to) related party | <u>25,824</u> | <u>37,770</u> | <u>(302,160)</u> |
| Net cash from investing activities | (2,058,807) | (1,678,318) | (2,144,045) |
| Cash flows from financing activities | | | |
| Payments on capital lease obligation | (161,626) | (559,039) | (159,073) |
| Proceeds from long-term debt | 10,710,875 | - | - |
| Payments on long-term debt | (7,770,984) | (1,000,000) | (2,762,908) |
| Proceeds from exercise of common stock options | 124,309 | - | 436,141 |
| Payment of cash dividend | - | - | (353,547) |
| Purchases of common stock | <u>(16,338)</u> | <u>(29,762)</u> | <u>-</u> |
| Net cash from financing activities | <u>2,886,236</u> | <u>(1,588,801)</u> | <u>(2,839,387)</u> |

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| | | | |
|--|----------------------------|----------------------------|----------------------------|
| Net change in cash | (389,494) | 591,611 | 466,918 |
| Cash at beginning of year | <u>1,721,301</u> | <u>1,129,690</u> | <u>662,772</u> |
| Cash at end of year | <u>\$ 1,331,807</u> | <u>\$ 1,721,301</u> | <u>\$ 1,129,690</u> |
| Supplemental disclosure of cash flow information | | | |
| Cash paid for interest | \$ 212,722 | \$ 74,016 | \$ 191,586 |
| Cash paid for taxes | 604,652 | 173,140 | 710,384 |
| Supplemental disclosure of noncash investing and financing activities: | | | |
| Equipment purchased under capital leases | 186,178 | - | - |

6.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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Nature of Business: The recycling division of Industrial Services of America, Inc. and its subsidiaries (ISA) purchases and sells ferrous and nonferrous materials and fiber scrap on a daily basis at our two wholly owned subsidiaries, ISA Recycling, LLC (located in Louisville, Kentucky) and ISA Indiana, Inc. (serving southern Indiana). ISA also provides products and services to meet the waste management needs of its customers related to ferrous, non-ferrous and corrugated scrap recycling, management services and waste equipment sales and rental. Our management services division represents contracts with retail, commercial and industrial businesses to handle their waste disposal needs, primarily by subcontracting with commercial waste hauling and disposal companies. Our customers and subcontractors are located throughout the United States, Canada and Mexico. ISA's waste equipment sales and services division (WESSCO) installs or repairs equipment and rental equipment on a same day basis. Each of our segments bills separately for its products or services. Generally, services and products are not bundled for sale to individual customers. The products or services have value to the customer on a standalone basis.

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Revenue Recognition: ISA records revenue for its recycling and equipment sales divisions upon delivery of the related materials and equipment to the customer. We provide installation and training on all equipment and we charge these costs to the customer, recording revenue in the period we provide the service. We are the middleman in the sale of the equipment and not a manufacturer. Any warranty is the responsibility of the manufacturer and therefore we make no estimates for warranty obligations. Allowances for equipment returns are made on a case-by-case basis. Historically, returns of equipment have not been material.

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Our management services division provides our customers evaluation, management, monitoring, auditing and cost reduction of our customers' non-hazardous solid waste removal activities. We recognize revenue related to the management aspects of these services when we deliver the services. We record revenue related to this activity on a gross basis because we are ultimately responsible for service delivery, have discretion over the selection of the specific service provided and the amounts to be charged, and are directly obligated to the subcontractor for the services provided. We are an independent contractor. If we discover that third party service providers have not performed, either by auditing of the service provider invoices or communications from our customers, we then resolve the service delivery dispute directly with the third party service supplier.

(Continued)

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
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December 31, 2006, 2005 and 2004

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In our management services division, the customer contacts us for service. We determine the type of waste removal service required to meet the customer's needs, and we use our discretion to choose from a selection of approved third party service suppliers. Upon our authorization, the third party service supplier uses its own trucking to remove waste materials from the customer's location. We pay the third party service suppliers on several different payment terms after we have received payment from the customers who are billed monthly. We recognize revenue after assessing the satisfactory performance of the service by the third party service supplier. Assessment includes our review of landfill weight tickets provided by the third party service supplier documenting completion of the contracted service.

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We record sales-type leases at the net present value of future minimum lease payments. Interest income related to the lease is recognized over the life of the lease. At the inception of the lease, any difference between the net present value of future cash flows and the basis of the leased asset (carrying value plus initial direct costs, less present value of any residual) is recorded as a gain or loss.

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Accounts Receivable and Allowance for Doubtful Accounts: Accounts receivable consist primarily of amounts due from customers from product and brokered sales. The allowance for doubtful accounts totaled \$100,000 and \$50,000 at December 31, 2006 and 2005, respectively. Our determination of the allowance for doubtful accounts includes a number of factors, including the age of the balance, past experience with the customer account, changes in collection patterns and general industry conditions. Interest is not normally charged on receivables. Potential credit losses from our significant customers could adversely affect our results of operations or financial condition. While we believe our allowance for doubtful accounts is adequate, changes in economic conditions or any weakness in the steel and metals industry could adversely impact our future earnings. We charge off losses to the allowance when we deem further collection efforts will not provide additional recoveries.

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Major Customer: We used to derive a significant portion of our revenues from one primary customer, The Home Depot, accounting for approximately 56% and 51% of 2005 and 2004 total revenues, respectively, and approximately 24% and 23% of 2005 and 2004 total gross profit, respectively. The revenue from this former customer represented approximately 77% and 76% of CWS revenues in 2005 and 2004, respectively. At December 31, 2005, amounts due from this former customer were \$293,936. We currently have no significant customer concentration.

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Principles of Consolidation: The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, ISA Indiana, Inc. and ISA Recycling, LLC. Upon consolidation, all intercompany accounts, transactions and profits have been eliminated.

(Continued)

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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Common Control: The Company conducts significant levels of business (see Note 6) with K&R, LLC (K&R), which is owned by the Company's principal shareholder. Because these entities are under common control, operating results or the financial position of the Company may be materially different from those that would have been obtained if the entities were autonomous.

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Estimates: In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management must make estimates and assumptions. These estimates and assumptions affect the amounts reported for assets, liabilities, revenues and expenses, as well as affecting the disclosures provided. Future results could differ from the current estimates.

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Inventories: Our inventories primarily consist of ferrous and non-ferrous scrap metals and are valued at the lower of average purchased cost or market. Quantities of inventories are determined based on our inventory systems and are subject to periodic physical verification using estimation techniques including observation, weighing and other industry methods. We would recognize inventory impairment when the market value, based upon current market pricing, falls below recorded value or when the estimated volume is less than the recorded volume of the inventory. We would record the loss in cost of goods sold in the period during which we identified the loss.

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Some commodities are in saleable condition at acquisition. We purchase these commodities in small amounts until we have a truckload of material available for shipment. Some commodities are not in saleable condition at acquisition. These commodities must be torched, sheared or baled. We do not have work-in-process inventory that needs to be manufactured to become finished goods. We include processing costs in inventory for all commodities by gross ton. Processing costs in ferrous inventory totaled \$387,751 at December 31, 2006 and \$242,295 at December 31, 2005. Processing costs in non-ferrous inventory totaled \$86,101 at December 31, 2006 and \$71,595 at December 31, 2005. Ferrous inventory of \$1,667,937 at December 31, 2006 was comprised of \$382,445 in raw materials and \$1,285,492 of finished goods. Ferrous inventory of \$1,380,050 at December 31, 2005 was comprised of \$402,041 in raw materials and \$978,009 of finished goods. Non-ferrous inventory of \$1,678,655 at December 31, 2006 was comprised of \$451,289 in raw materials and \$1,227,366 of finished goods. Non-ferrous inventory of \$961,085 at December 31, 2005 was comprised of \$196,508 in raw materials and \$764,577 of finished goods. We charged \$2,353,435 in general and administrative processing costs to COS for the year ended December 31, 2006 and \$2,015,733 for the year ended December 31, 2005.

(Continued)

INDUSTRIAL SERVICES OF AMERICA, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Inventory also includes all types of industrial waste handling equipment and machinery held for resale such as compactors, balers, and containers. Other inventory includes cardboard and baling wire. Inventories as of December 31, 2006 and 2005 consist of the following:

| | <u>2006</u> | <u>2005</u> |
|---------------------------|---------------------|---------------------|
| Ferrous materials | \$ 1,667,937 | \$ 1,380,050 |
| Non-Ferrous materials | 1,678,655 | 961,085 |
| Waste Equipment Machinery | 56,200 | 120,922 |
| Other | <u>25,434</u> | <u>26,552</u> |
| | <u>\$ 3,428,226</u> | <u>\$ 2,488,609</u> |

Property and Equipment: Property and equipment are stated at cost and depreciated on a straight line basis over the estimated useful lives of the related property. Assets under capital lease obligations are amortized over the term of the capital lease.

Property and equipment as of December 31, 2006 and 2005 consist of the following:

| | <u>Life</u> | <u>2006</u> | <u>2005</u> |
|--|-------------|---------------------|---------------------|
| Land | | \$ 1,581,550 | \$ 1,581,550 |
| Equipment and vehicles | 1-10 years | 9,759,509 | 8,535,479 |
| Office equipment | 1-7 years | 1,600,034 | 1,521,783 |
| Rental equipment | 3-5 years | 4,238,555 | 3,376,443 |
| Building and leasehold improvements | 5-40 years | <u>2,329,886</u> | <u>2,292,331</u> |
| | | 19,509,534 | 17,307,586 |
| Less accumulated depreciation and amortization | | <u>11,356,928</u> | <u>9,702,874</u> |
| | | <u>\$ 8,152,606</u> | <u>\$ 7,604,712</u> |

Depreciation expense for the years ended December 31, 2006, 2005 and 2004 was \$1,745,905, \$1,709,668 and \$1,538,161. Of the \$1,745,905 depreciation expense recognized in 2006, \$1,325,035 was recorded in cost of sales, and \$420,870 was recorded in general and administrative expense.

(Continued)

10.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
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NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

A typical term of our rental equipment leases is five years. The revenue stream is based on monthly usage and recognized in the month of usage. We record purchased rental equipment, including all installation and freight charges, as a fixed asset. We are typically responsible for all repairs and maintenance expenses on rental equipment. Based on existing agreements, future operating lease revenue from rental equipment for each of the next five years is estimated to be:

| | |
|------|--------------------|
| 2007 | \$1,586,285 |
| 2008 | 1,350,700 |
| 2009 | 1,200,620 |
| 2010 | 786,468 |
| 2011 | <u>293,990</u> |
| | <u>\$5,218,063</u> |

Goodwill and Other Intangible Assets: Goodwill and certain intangible assets are no longer amortized but are assessed at least annually for impairment with any such impairment recognized in the period identified. We perform our annual goodwill impairment test internally at December 31 and at the level of the recycling reporting unit to which all the goodwill is related. We determine whether to impair goodwill by comparing the fair value of the recycling reporting unit as a whole (the present value of expected cash flows) to its carrying value including goodwill. Since the recycling reporting unit's fair value exceeds its carrying value, no further computations are required.

Income Taxes: Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Statement of Cash Flows: The statement of cash flows has been prepared using a definition of cash that includes deposits with original maturities of three months or less.

(Continued)

11.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings Per Share: Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding during the year. Diluted earnings per share is computed by dividing net income by the weighted average number of common shares outstanding plus the dilutive effect of stock options.

Stock Option Plans: During the year ended December 31, 2004 we granted options to purchase shares of our common stock to several of our officers and outside directors. We applied APB Opinion No. 25 in accounting for our employees' stock option agreements. There was no compensation charged to operations in 2006, 2005, and 2004 related to these options.

We have an employee stock option plan under which we may grant options for up to 400,000 shares of common stock, which are reserved by the board of directors for issuance of stock options. The exercise price of each option is equal to the market price of our stock on the date of grant. The maximum term of the option is five years.

On January 1, 2006, we adopted SFAS No. 123R (Revised 2004), Share-Based Payment, using the modified prospective method. The impact of adopting SFAS 123R on our consolidated results of operations depends on the level of future option grants and the fair value of the options granted at such future dates, as well as the vesting periods provided by such awards. Existing outstanding options did not result in additional compensation expense upon adoption of SFAS 123R since all outstanding options were fully vested.

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|---------------------|---------------------|---------------------|
| <u>Net income (loss)</u> | | | |
| Net income, as reported | \$ <u>2,188,579</u> | \$ <u>1,101,597</u> | \$ <u>1,497,194</u> |
| <u>Basic earnings (loss) per share</u> | | | |
| As reported | \$ <u>.61</u> | \$ <u>.31</u> | \$ <u>.43</u> |
| <u>Diluted earnings (loss) per share</u> | | | |
| As reported | \$ <u>.61</u> | \$ <u>.31</u> | \$ <u>.42</u> |

(Continued)

INDUSTRIAL SERVICES OF AMERICA, INC.
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Following is a summary of stock option activity and number of shares reserved for outstanding options for the years ended December 31, 2006, 2005 and 2004:

| | Number of <u>Shares</u> | Weighted Average Exercise Price <u>Per Share</u> | Exercise Price Per <u>Share</u> | Maximum Remaining Term of Options <u>Granted</u> | Weighted Average Grant Date Fair Value <u>of Options</u> |
|--|----------------------------|---|---------------------------------------|--|--|
| Balance as of January 1, 2004 | 591,000 | \$1.75 | \$1.25 to \$3.00 | 1 to 5 years | \$1.12 |
| Exercised | (320,000) | \$1.41 | \$1.41 | - | - |
| Expired | <u>(231,000)</u> | \$2.31 | \$1.25 to \$3.00 | - | - |
| Balance as of December 31, 2004 | 40,000 | \$1.25 | \$1.25 | 1 to 3 years | \$1.21 |
| Expired | <u>(20,000)</u> | \$1.25 | \$1.25 | - | - |
| Balance as of December 31, 2005 | 20,000 | \$1.25 | \$1.25 | 1 to 3 Years | \$1.21 |
| Exercised | <u>(20,000)</u> | \$1.25 | \$1.25 | - | - |
| Balance as of December 31, 2006 | <u>-</u> | - | - | - | - |

(Continued)

13.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

SFAS No. 123 (Revised 2005), Share-Based Payment, applies to awards granted or modified by ISA after July 1, 2005. Compensation cost is also to be recorded for prior option grants that vest after that date. The effect of adopting SFAS 123R on ISA's consolidated results of operations depends on the level of future option grants and the fair value of the options granted at such future dates, as well as the vesting periods provided by such awards and, therefore, cannot currently be estimated. There is no significant effect on ISA's consolidated financial position since total stockholders' equity is not impacted.

Effective as of May 5, 2006, we entered into an agreement with Andrew M. Lassak to settle Mr. Lassak's claims against us in Lassak v. Industrial Services of America, Inc., et al, No. 04-423-CA (Fla. 19th Cir. Ct. filed June 2, 2004). Lassak's demands and claims included rights to purchase 240,500 shares of our common stock for \$1.25 per share, rights to purchase 149,500 shares of our common stock for \$3.00 per share, and demand and piggyback registration rights as well as cashless exercise rights with respect to such options. Since the inception of the suit, we have disputed Lassak's claims and have denied any liability for Lassak's claims and demands. Pursuant to the settlement agreement, we allowed Lassak to exercise a reduced number of the options he was seeking - 40,000 at an exercise price of \$1.25 per share. Lassak tendered to us the full exercise price for the 40,000 options and we filed a registration statement for the underlying shares with the Securities and Exchange Commission on May 24, 2006. The registration was declared effective by the Securities and Exchange Commission on June 12, 2006. We then delivered 40,000 registered shares to Lassak, thereby satisfying all our requirements under the settlement agreement and effectively concluding this matter. The estimated fair value of these options is approximately \$270,000. Additional expense of \$34,309 associated with the value of the options was recognized in the third quarter of 2006 and the remaining \$235,691 was recognized in prior years 1998-2001.

Fair Values of Financial Instruments: We estimate the fair value of our financial instruments using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, prepayments and other factors. Changes in assumptions or market conditions could significantly affect these estimates. As of December 31, 2006 and 2005, the estimated fair value of our financial instruments approximated book value. The fair value of our debt approximates its carrying value because the majority of our debt bears a floating rate of interest based on the prime rate. There is no readily available market by which to determine fair market value of our fixed term debt; however, based on existing interest rates and prevailing rates as of each year end, we have determined that the fair value of our fixed rate debt approximates book value.

(Continued)

14.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impact of Recently Issued Accounting Standards:

SFAS No. 154, Accounting Changes and Error Corrections, replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 was issued May 2005 and is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We do not expect this standard to significantly impact our financial statements.

SFAS No. 157, Fair Value Measurements, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). SFAS No. 157 also stipulates that, as a market-based measurement, fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability, and establishes a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, although earlier application is encouraged. We do not expect this standard to significantly impact our financial statements.

Interpretation No. 48, Accounting for Uncertainty in Income Taxes--an interpretation of FASB Statement No. 109 (issued June 2006), clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this standard on January 1, 2007 did not have an impact on our consolidated financial statements.

(Continued)

15.

NOTE 2 - NOTE PAYABLE TO BANK

On December 22, 2006, ISA executed a new revolving credit facility with BB&T increasing the borrowing line from \$5.0 million to \$10.0 million to provide ISA with working capital to support the current needs of our business. This revolving credit facility has a three year term expiring December 22, 2009, and provides for advances of up to eighty percent (80%) of ISA's eligible accounts receivable and up to the forty percent (40%) of eligible inventory, and up to one hundred (100%) of ISA's net book value of eligible equipment less an outstanding indebtedness on the equipment. The revolving credit facility bears interest at the one month Libor rate, as published in the Wall Street Journal, plus two and twenty-five one-hundredths percent (2.25%) per annum which was 7.57% as of December 31, 2006, and is secured by all ISA assets (except rental fleet equipment). The revolving credit facility contains certain restrictive and financial covenants. At December 31, 2006, ISA was in compliance with all restrictive covenants.

NOTE 3 - LONG-TERM DEBT

Long-term debt as of December 31, 2006 and 2005 consists of the following:

| | <u>2006</u> | <u>2005</u> |
|--|--------------------|-------------|
| Note payable to a bank secured by our rental fleet equipment with a fixed interest rate of 6.83% and monthly payments of \$23,047. The maturity date under this agreement is June 2011 with a ten-year amortization schedule. | \$ 1,929,016 | \$ - |
| Revolving credit facility with a bank secured by all assets except for rental fleet equipment with a variable interest rate of Libor plus 2.25% and no required monthly principal payments. The maturity date under this agreement is December 2009. | <u>1,010,875</u> | <u>-</u> |
| | 2,939,891 | - |
| Less current maturities | <u>149,431</u> | <u>-</u> |
| | <u>\$2,790,460</u> | <u>\$ -</u> |

The annual maturities of long-term debt as of December 31, 2004 are as follows:

| | |
|---------------------|---------------------|
| 2007 | \$ 149,431 |
| 2008 | 159,962 |
| 2009 | 1,182,111 |
| 2010 | 183,305 |
| 2011 and thereafter | <u>1,265,082</u> |
| Total | <u>\$ 2,939,891</u> |

(Continued)

16.

December 31, 2006, 2005 and 2004

NOTE 4 -- INCOME TAXES

The income tax provision (benefit) consists of the following for the years ended December 31, 2006, 2005 and 2004:

| | | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---------|----------|---------------------|-------------------|---------------------|
| Federal | | | | |
| | Current | \$ 1,178,483 | \$ 780,181 | \$ 448,275 |
| | Deferred | <u>(174,958)</u> | <u>(203,543)</u> | <u>343,916</u> |
| | | 1,003,525 | 576,638 | 792,191 |
| State | | | | |
| | Current | 369,957 | 173,790 | 228,703 |
| | Deferred | <u>(47,553)</u> | <u>(9,995)</u> | <u>(8,893)</u> |
| | | <u>322,404</u> | <u>163,795</u> | <u>219,810</u> |
| | | <u>\$ 1,325,929</u> | <u>\$ 740,433</u> | <u>\$ 1,012,001</u> |

A reconciliation of income taxes at the statutory rate to the reported provision is as follows:

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|--|--------------------|-------------------|---------------------|
| Federal income tax at statutory rate | \$1,194,933 | \$ 629,083 | \$ 853,127 |
| State and local income taxes, net of federal income tax effect | 212,787 | 106,257 | 145,074 |
| Permanent differences | (43,702) | - | - |
| Other differences, net | <u>(38,089)</u> | <u>5,093</u> | <u>13,800</u> |
| | <u>\$1,325,929</u> | <u>\$ 740,433</u> | <u>\$ 1,012,001</u> |

The permanent differences of \$(43,702) and the other differences, net of \$(38,089) are due to a decreased taxable base of the common stock awarded to Andrew J. Lassak in the second quarter of 2006. This decrease was mutually agreed upon in the fourth quarter of 2006.

(Continued)

17.

NOTE 4 - INCOME TAXES (Continued)

Significant components of the Company's deferred tax liabilities and assets as of December 31, 2006 and 2005 are as follows:

| | <u>2006</u> | <u>2005</u> |
|------------------------------------|---------------------|---------------------|
| Deferred tax liabilities | | |
| Tax depreciation in excess of book | \$ 278,929 | \$ 529,530 |
| Tax amortization in excess of book | <u>114,666</u> | <u>89,598</u> |
| Gross deferred tax liabilities | 393,595 | 619,128 |
| Deferred tax assets | | |
| Property taxes | 39,495 | 44,025 |
| Allowance for doubtful accounts | 43,000 | 24,206 |
| Book amortization in excess of tax | 174,196 | 205,558 |
| Inventory capitalization | 13,887 | 10,154 |
| Other | <u>10,343</u> | <u>-</u> |
| Gross deferred tax assets | <u>280,921</u> | <u>283,943</u> |
| Net deferred tax liabilities | <u>\$ (112,674)</u> | <u>\$ (335,185)</u> |

NOTE 5 - SALES-TYPE LEASES

The Company is the lessor of equipment under sales-type lease agreements having terms of three to five years, with the lessees having the option to acquire the equipment at the termination of the leases. All costs associated with this equipment are the responsibility of the lessees.

Future lease payments receivable under sales-type leases at December 31, 2006 are as follows:

| | |
|-------------------------------------|-------------------|
| 2007 | \$ 94,020 |
| 2008 | 84,920 |
| 2009 | 66,720 |
| 2010 | <u>50,040</u> |
| Minimum lease payments receivable | 295,700 |
| Less unearned income | <u>(58,899)</u> |
| Net investment in sales-type leases | 236,801 |
| Less current portion | <u>(50,586)</u> |
| | <u>\$ 186,215</u> |

(Continued)

18.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
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NOTE 6 - RELATED PARTY TRANSACTIONS

The Company enters into various transactions with related parties including the Company's principal shareholder and an affiliated company owned by the Company's principal shareholder (K&R). A summary of these transactions is as follows:

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|-------------------|-------------------|-------------------|
| <u>Balance sheet accounts:</u> | | | |
| Accounts receivable | \$ _____ - | \$ _____ - | \$ _____ - |
| Notes receivable | \$ <u>238,566</u> | \$ <u>264,390</u> | \$ <u>302,160</u> |
| Deposits (included in other long-term assets) | \$ <u>62,106</u> | \$ <u>62,106</u> | \$ <u>62,106</u> |
| <u>Income statement activity:</u> | | | |
| Rent expense | \$ <u>505,272</u> | \$ <u>505,272</u> | \$ <u>505,272</u> |
| Consulting fees | \$ <u>240,000</u> | \$ <u>240,000</u> | \$ <u>240,000</u> |

ISA leases its corporate offices, processing property and buildings in Louisville, Kentucky for \$42,106 per month from K&R pursuant to the K&R Lease. Deposits include one month of rent in advance in the amount of \$42,106. In 2004, we paid for repairs totaling \$302,160 that we made to the buildings and property that we lease from K&R, located at 7100 Grade Lane, Louisville, Kentucky. K&R executed an unsecured promissory note, dated March 25, 2005, but effective December 31, 2004, to us for the principal sum of \$302,160. K&R makes payments on the promissory note of principal and interest in ninety-six (96) monthly installments of \$3,897.66. Failure of K&R to make any payment when due under this note within fifteen (15) days of its due date shall constitute a default. After the fifteen day period, the note shall bear interest at a rate equal to fifteen percent (15%) per annum and we have the right to exercise our remedies to collect full payment of the note.

In an addendum to the K&R lease as of January 1, 2005, the rent was increased \$4,000 as a result of the improvements made to the property in 2004. For years 2005 and 2006, the payments to K&R by the Company of \$4,000 for additional rent and the payment from K&R to the Company of \$3,897.66 for the promissory note were offset.

(Continued)

19.

NOTE 6 - RELATED PARTY TRANSACTIONS (Continued)

The Company entered into an agreement with K&R for consulting services related to the scrap metal and paper recycling operations and related equipment sales and services. The agreement remains in effect until December 31, 2007, with automatic renewals thereafter unless one party provides written notice to the other party of its intent not to renew at least six months in advance of the next renewal date. The agreement requires that we make annual payments to K&R of \$240,000 in equal monthly installments of \$20,000. Deposits include one month of consulting services in advance in the amount of \$20,000. ISA's Chairman is compensated through these consulting fees .

NOTE 7 - EMPLOYEE RETIREMENT PLAN

The Company maintains a defined contribution retirement plan under Section 401(k) of the Internal Revenue Code which covers substantially all employees. Eligible employees may contribute a maximum of 15% of their annual salary. Under the plan, the Company matches 25% of each employee's voluntary contribution up to 6% of their gross salary. The expense under the plan for 2006, 2005 and 2004 was \$33,438, \$31,996 and \$28,950, respectively.

NOTE 8 - LEASE COMMITMENTS

Operating Leases:

The Company leases its Louisville, Kentucky facility from a related party (see Note 6) under an operating lease expiring December 2007. The rent was adjusted in January 2003 per the agreement to monthly payments of \$42,106 through December 2007. In addition, the Company is also responsible for real estate taxes, insurance, utilities and maintenance expense.

The Company leases a facility in Dallas, Texas for management services operations. The agreement provided that monthly payments of \$2,457 were paid through September 2005. The lease was renewed effective October 1, 2005 for a period of two years with monthly payments of \$2,525. The Company also leases other machinery and equipment under operating leases which expire through February 2009.

We lease a facility in Lexington, Kentucky for \$4,500 per month; the lease terminates December 31, 2012. We have subleased this property for a term commencing March 1, 2007 and ending December 31, 2012 for \$4,500 per month. If for any reason the sublessee defaults, we remain liable for the remainder of the lease payments through December 31, 2012.

On February 6, 2007, we leased 7.7 acres of real property, including a 38,000 square foot warehouse and a 400 square foot office, in Pineville, Louisiana for \$5,250 per month for twenty-four months beginning March 1, 2007 and ending February 28, 2009, with an option to purchase the property for a purchase price of \$575,000.

(Continued)

20.

NOTE 8 -- LEASE COMMITMENTS (Continued)

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Future minimum lease payments for operating leases as of December 31, 2006 are as follows:

| | |
|-------------------------------|-------------------|
| 2007 | \$ 612,246 |
| 2008 | 80,554 |
| 2009 | 42,243 |
| 2010 | <u>3,375</u> |
| Future minimum lease payments | <u>\$ 738,418</u> |

Total rent expense for the years ended December 31, 2006, 2005 and 2004 was \$784,954, \$809,270 and \$773,139, respectively.

Capital Leases:

The Company leases various pieces of equipment which qualify as capital leases. These lease arrangements require monthly lease payments expiring at various dates through November 2009.

The following is a summary of assets held under capital leases which are included in property and equipment:

| | <u>2006</u> | <u>2005</u> |
|-------------------------------|-------------------|-------------------|
| Equipment | \$ 757,513 | \$ 571,335 |
| Less accumulated depreciation | <u>168,904</u> | <u>159,525</u> |
| | <u>\$ 588,609</u> | <u>\$ 411,810</u> |

The following is a schedule of future annual minimum lease payments under the capitalized lease arrangements, together with the present value of net minimum lease payments at December 31, 2006.

| | |
|---|------------------|
| 2007 | \$ 233,992 |
| 2008 | 60,786 |
| 2009 | <u>7,475</u> |
| Total future minimum lease payments | 302,253 |
| Less amount representing interest | <u>(5,867)</u> |
| Present value of net minimum lease payments | 296,386 |
| Less current portion | <u>(228,533)</u> |
| Capital Lease Obligations | <u>\$ 67,853</u> |

(Continued)

21.

NOTE 9 - PER SHARE DATA

The computation for basic and diluted earnings per share is as follows:

| | <u>2006</u> | <u>2005</u> | <u>2004</u> |
|---|------------------|------------------|------------------|
| Basic earnings per share | | | |
| Net income | \$ 2,188,579 | \$ 1,101,597 | \$ 1,497,194 |
| Weighted average shares outstanding | <u>3,602,872</u> | <u>3,575,202</u> | <u>3,473,887</u> |
| Basic earnings per share | <u>\$.61</u> | <u>\$.31</u> | <u>\$.43</u> |
| Diluted earnings per share | | | |
| Net income | \$ 2,188,579 | \$ 1,101,597 | \$ 1,497,194 |
| Weighted average shares outstanding | 3,602,872 | 3,575,202 | 3,473,887 |
| Add dilutive effect of assumed exercising of stock options | <u>10,218</u> | <u>18,608</u> | <u>118,912</u> |
| Diluted average shares outstanding | <u>3,613,090</u> | <u>3,593,810</u> | <u>3,592,799</u> |
| Diluted earnings per share | <u>\$.61</u> | <u>\$.31</u> | <u>\$.42</u> |

NOTE 10 - SEGMENT INFORMATION

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The Company's operations include three primary segments: ISA Recycling, Computerized Waste Systems (CWS), and Waste Equipment Sales & Service (WESSCO). ISA Recycling provides products and services to meet the needs of its customers related to ferrous, non-ferrous and fiber recycling at two locations in the Midwest. CWS provides waste disposal services including contract negotiations with service providers, centralized billing, invoice auditing, and centralized dispatching. WESSCO sells, leases, and services waste handling and recycling equipment.

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The Company's three reportable segments are determined by the products and services that each offers. The recycling segment generates its revenues based on buying and selling of ferrous, non-ferrous and fiber scrap; CWS's revenues consist of charges to customers for waste disposal services; and WESSCO sales and lease income comprise the primary source of revenue for this segment. The components of the column labeled "other" are selling, general and administrative expenses that are not directly related to the three primary segments.

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The accounting policies of the three segments are the same as those described in the summary of significant accounting policies (Note 1). We evaluate segment performance based on gross profit or loss and the evaluation process for each segment includes only direct expenses and selling, general and administrative costs, omitting any other income and expense and income taxes.

(Continued)

22.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

NOTE 10 - SEGMENT INFORMATION (Continued)

Segment

ISA Recycling

CWS

WESSCO

Other

Totals

2006

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| | | | | | | | | |
|--------------------|---------------|----|---|----|---|----|---|---------------|
| Recycling revenues | \$ 44,967,023 | \$ | - | \$ | - | \$ | - | \$ 44,967,023 |
|--------------------|---------------|----|---|----|---|----|---|---------------|

Equipment sales, services

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| | | | | | |
|----------------------|---|---|-----------|---|-----------|
| and leasing revenues | - | - | 1,727,784 | - | 1,727,784 |
|----------------------|---|---|-----------|---|-----------|

Edgar Filing: INDUSTRIAL SERVICES OF AMERICA INC /FL - Form 10-K

| | | | | | |
|-----------------|---|------------|---|---|------------|
| Management fees | - | 15,387,241 | - | - | 15,387,241 |
|-----------------|---|------------|---|---|------------|

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| | | | | | |
|--------------------|--------------|--------------|-----------|---|--------------|
| Cost of goods sold | (39,448,957) | (12,712,073) | (835,411) | - | (52,996,441) |
|--------------------|--------------|--------------|-----------|---|--------------|

Selling, general and

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| | | | | | |
|-------------------------|--------------------|--------------------|------------------|--------------------|--------------------|
| administrative expenses | <u>(1,431,251)</u> | <u>(1,479,302)</u> | <u>(542,433)</u> | <u>(2,156,973)</u> | <u>(5,609,959)</u> |
|-------------------------|--------------------|--------------------|------------------|--------------------|--------------------|

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| | | | | | |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|
| Segment profit (loss) | <u>\$ 4,086,815</u> | <u>\$ 1,195,866</u> | <u>\$ 349,940</u> | <u>\$ (2,156,973)</u> | <u>\$ 3,475,648</u> |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|

Segment

ISA Recycling

CWS

WESSCO

Other

Totals

2006

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| | | | | | | | | | | |
|------|----|---------|----|--------|----|---|----|-----------|----|-----------|
| Cash | \$ | 136,803 | \$ | 16,254 | \$ | - | \$ | 1,178,750 | \$ | 1,331,807 |
|------|----|---------|----|--------|----|---|----|-----------|----|-----------|

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| | | | | | |
|---------------------|-----------|-----------|---|--------|-----------|
| Accounts receivable | 3,903,681 | 1,089,080 | - | 33,680 | 5,026,441 |
|---------------------|-----------|-----------|---|--------|-----------|

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| | | | | | |
|-------------|-----------|---|--------|---|-----------|
| Inventories | 3,357,832 | - | 70,394 | - | 3,428,226 |
|-------------|-----------|---|--------|---|-----------|

Net property and

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| | | | | | |
|-----------|-----------|---------|-----------|-----------|-----------|
| equipment | 3,971,773 | 156,756 | 1,997,911 | 2,026,166 | 8,152,606 |
|-----------|-----------|---------|-----------|-----------|-----------|

Edgar Filing: INDUSTRIAL SERVICES OF AMERICA INC /FL - Form 10-K

| | | | | | |
|----------|---------|---|---|---|---------|
| Goodwill | 560,005 | - | - | - | 560,005 |
|----------|---------|---|---|---|---------|

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| | | | | | |
|--------------|---------------|---------------|---------------|----------------|----------------|
| Other assets | <u>96.848</u> | <u>10.637</u> | <u>75.397</u> | <u>649.850</u> | <u>832.732</u> |
|--------------|---------------|---------------|---------------|----------------|----------------|

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| | | | | | |
|----------------|----------------------|---------------------|---------------------|---------------------|----------------------|
| Segment assets | <u>\$ 12,026,942</u> | <u>\$ 1,272,727</u> | <u>\$ 2,143,702</u> | <u>\$ 3,888,446</u> | <u>\$ 19,331,817</u> |
|----------------|----------------------|---------------------|---------------------|---------------------|----------------------|

ISA Recycling

CWS

WESSCO

Other

Totals

2005

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| | | | | | |
|--------------------|---------------|------|------|------|---------------|
| Recycling revenues | \$ 29,952,938 | \$ - | \$ - | \$ - | \$ 29,952,938 |
|--------------------|---------------|------|------|------|---------------|

Equipment sales, services

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| | | | | | |
|----------------------|---|---|-----------|---|-----------|
| and leasing revenues | - | - | 2,977,554 | - | 2,977,554 |
|----------------------|---|---|-----------|---|-----------|

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| | | | | | |
|-----------------|---|------------|---|---|------------|
| Management fees | - | 84,451,367 | - | - | 84,451,367 |
|-----------------|---|------------|---|---|------------|

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| | | | | | |
|--------------------|--------------|--------------|-------------|---|---------------|
| Cost of goods sold | (27,271,712) | (80,600,770) | (1,904,079) | - | (109,776,561) |
|--------------------|--------------|--------------|-------------|---|---------------|

Selling, general and

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| | | | | | |
|-------------------------|------------------|--------------------|------------------|--------------------|-------------|
| administrative expenses | <u>(987,930)</u> | <u>(2,051,475)</u> | <u>(612,180)</u> | <u>(2,165,020)</u> | (5,816,605) |
|-------------------------|------------------|--------------------|------------------|--------------------|-------------|

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| | | | | | |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|
| Segment profit (loss) | <u>\$ 1,693,296</u> | <u>\$ 1,799,122</u> | <u>\$ 461,295</u> | <u>\$ (2,165,020)</u> | <u>\$ 1,788,693</u> |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|

(Continued)

23.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

Segment

ISA Recycling

CWS

WESSCO

Other

Totals

2005

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| | | | | | | | | | | |
|------|----|---------|----|---------|----|-----|----|-----------|----|-----------|
| Cash | \$ | 332,351 | \$ | 111,738 | \$ | 500 | \$ | 1,276,712 | \$ | 1,721,301 |
|------|----|---------|----|---------|----|-----|----|-----------|----|-----------|

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| | | | | | |
|---------------------|-----------|-----------|--------|--------|-----------|
| Accounts receivable | 2,596,053 | 1,793,547 | 85,431 | 27,814 | 4,502,845 |
|---------------------|-----------|-----------|--------|--------|-----------|

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| | | | | | |
|-------------|-----------|---|---------|---|-----------|
| Inventories | 2,352,375 | - | 136,234 | - | 2,488,609 |
|-------------|-----------|---|---------|---|-----------|

Net property and

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| | | | | | |
|-----------|-----------|---------|-----------|-----------|-----------|
| equipment | 3,282,130 | 310,769 | 1,788,285 | 2,223,528 | 7,604,712 |
|-----------|-----------|---------|-----------|-----------|-----------|

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| | | | | | |
|----------|---------|---|---|---|---------|
| Goodwill | 560,005 | - | - | - | 560,005 |
|----------|---------|---|---|---|---------|

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| | | | | | |
|--------------|----------------|---------------|---------------|----------------|------------------|
| Other assets | <u>132,346</u> | <u>25,845</u> | <u>85,164</u> | <u>763,645</u> | <u>1,007,000</u> |
|--------------|----------------|---------------|---------------|----------------|------------------|

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| | | | | | |
|----------------|---------------------|---------------------|---------------------|---------------------|----------------------|
| Segment assets | <u>\$ 9,255,260</u> | <u>\$ 2,241,899</u> | <u>\$ 2,095,614</u> | <u>\$ 4,291,699</u> | <u>\$ 17,884,472</u> |
|----------------|---------------------|---------------------|---------------------|---------------------|----------------------|

Segment

ISA Recycling

CWS

WESSCO

Other

Totals

2004

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| | | | | | | | | |
|--------------------|---------------|----|---|----|---|----|---|---------------|
| Recycling revenues | \$ 43,262,813 | \$ | - | \$ | - | \$ | - | \$ 43,262,813 |
|--------------------|---------------|----|---|----|---|----|---|---------------|

Equipment sales, services

Edgar Filing: INDUSTRIAL SERVICES OF AMERICA INC /FL - Form 10-K

| | | | | | |
|----------------------|---|---|-----------|---|-----------|
| and leasing revenues | - | - | 3,050,184 | - | 3,050,184 |
|----------------------|---|---|-----------|---|-----------|

Edgar Filing: INDUSTRIAL SERVICES OF AMERICA INC /FL - Form 10-K

| | | | | | |
|-----------------|---|------------|---|---|------------|
| Management fees | - | 93,275,079 | - | - | 93,275,079 |
|-----------------|---|------------|---|---|------------|

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| | | | | | |
|--------------------|--------------|--------------|-------------|---|---------------|
| Cost of goods sold | (40,129,036) | (89,443,927) | (1,813,197) | - | (131,386,160) |
|--------------------|--------------|--------------|-------------|---|---------------|

Selling, general and

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| | | | | | |
|-------------------------|------------------|--------------------|------------------|--------------------|--------------------|
| administrative expenses | <u>(846,631)</u> | <u>(1,862,000)</u> | <u>(588,882)</u> | <u>(2,266,510)</u> | <u>(5,564,023)</u> |
|-------------------------|------------------|--------------------|------------------|--------------------|--------------------|

Edgar Filing: INDUSTRIAL SERVICES OF AMERICA INC /FL - Form 10-K

| | | | | | |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|
| Segment profit (loss) | <u>\$ 2,287,146</u> | <u>\$ 1,969,152</u> | <u>\$ 648,105</u> | <u>\$ (2,266,510)</u> | <u>\$ 2,637,893</u> |
|-----------------------|---------------------|---------------------|-------------------|-----------------------|---------------------|

(Continued)

24.

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

NOTE 11-- CONTINGENCY/LITIGATION SETTLEMENT

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On June 2, 2004, Andrew M. Lassak filed a Complaint against us in the City of Stuart, Martin County, Florida. In the complaint, Lassak alleged that we breached our contracts with him by failing and refusing to release and register 390,000 shares of stock. He claims he was entitled to "piggyback" registration rights relating to the Form S-3 Registration Statement that we filed for the benefit of Falkner as well as "demand" registration rights. He sought specific performance of the contracts and damages that occurred by ISA not releasing and registering the underlying shares relating to his options sooner.

On August 6, 2004 we filed a Motion to Dismiss or in the Alternative Motion for More Definite Statement. At a hearing before the Court on September 20, 2004, the judge granted our Motion without prejudice, allowing Lassak to amend the Complaint. Lassak filed an Amended Complaint on December 27, 2004, which restated his previous claims and made a number of new claims including claims of federal and state securities fraud. The Amended Complaint also named Harry Kletter individually as a defendant. In June 2005, Lassak filed a Second Amended Complaint which is substantially similar to the first Amended Complaint. We filed an Answer and Affirmative Defenses to the Second Amended Complaint as well as a Motion to Dismiss on behalf of Harry Kletter that remains pending.

Effective as of May 5, 2006, we entered into an agreement with Mr. Lassak to settle Mr. Lassak's claims against us in *Lassak v. Industrial Services of America, Inc., et al*, No. 04-423-CA (Fla. 19th Cir. Ct. filed June 2, 2004). Lassak's demands and claims included rights to purchase 240,500 shares of our common stock for \$1.25 per share, rights to purchase 149,500 shares of our common stock for \$3.00 per share, and demand and piggyback registration rights as well as cashless exercise rights with respect to such options. Since the inception of the suit, we have disputed Lassak's claims and have denied any liability for Lassak's claims and demands. Pursuant to the settlement agreement, we allowed Lassak to exercise a reduced number of the options he was seeking -- 40,000 at an exercise price of \$1.25 per share. Lassak tendered to us the full exercise price for the 40,000 options and we filed a registration statement for the underlying shares with the Securities and Exchange Commission on May 24, 2006. The registration was declared effective by the Securities and Exchange Commission on June 12, 2006. We then delivered 40,000 registered shares to Lassak, thereby satisfying all our requirements under the settlement agreement and effectively concluding this matter. The estimated fair value of these options is approximately \$270,000. We recognized additional expense of \$34,309 associated with the value of the options in the third quarter of 2006 and we had recognized the remaining \$235,691 in prior years 1998-2001.

(Continued)

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006, 2005 and 2004

NOTE 12 -- SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

1st

2nd

3rd

4th

Year

2006

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| | | | | | |
|---------|--------------|--------------|---------------|--------------|---------------|
| Revenue | \$14,484,020 | \$17,702,634 | \$ 15,331,235 | \$14,564,159 | \$ 62,082,048 |
|---------|--------------|--------------|---------------|--------------|---------------|

Income before other

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| | | | | | |
|------------------|---------|-----------|---------|-----------|-----------|
| income (expense) | 688,693 | 1,007,525 | 511,167 | 1,268,263 | 3,475,648 |
|------------------|---------|-----------|---------|-----------|-----------|

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| | | | | | |
|------------|---------|---------|---------|---------|-----------|
| Net income | 416,526 | 602,757 | 439,568 | 729,728 | 2,188,579 |
|------------|---------|---------|---------|---------|-----------|

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| | | | | | |
|--------------------------|------|------|------|------|------|
| Basic earnings per share | 0.12 | 0.17 | 0.12 | 0.20 | 0.61 |
|--------------------------|------|------|------|------|------|

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| | | | | | |
|----------------------------|------|------|------|------|------|
| Diluted earnings per share | 0.12 | 0.17 | 0.12 | 0.20 | 0.61 |
|----------------------------|------|------|------|------|------|

1st 2nd 3rd 4th Year

2005

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| | | | | | |
|---------|--------------|--------------|---------------|--------------|---------------|
| Revenue | \$29,674,470 | \$33,399,907 | \$ 34,579,729 | \$19,727,753 | \$117,381,859 |
|---------|--------------|--------------|---------------|--------------|---------------|

Income before other

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| | | | | | |
|------------------|---------|--------|---------|---------|-----------|
| income (expense) | 257,610 | 52,887 | 546,168 | 632,028 | 1,788,693 |
|------------------|---------|--------|---------|---------|-----------|

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| | | | | | |
|------------|---------|---------|---------|---------|-----------|
| Net income | 149,088 | 211,679 | 325,294 | 415,536 | 1,101,597 |
|------------|---------|---------|---------|---------|-----------|

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| | | | | | |
|--------------------------|------|------|------|------|------|
| Basic earnings per share | 0.04 | 0.06 | 0.09 | 0.12 | 0.31 |
|--------------------------|------|------|------|------|------|

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| | | | | | |
|----------------------------|------|------|------|------|------|
| Diluted earnings per share | 0.04 | 0.06 | 0.09 | 0.12 | 0.31 |
|----------------------------|------|------|------|------|------|

1st

2nd

3rd

4th

Year

2004

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| | | | | | |
|---------|--------------|--------------|---------------|--------------|---------------|
| Revenue | \$34,764,205 | \$34,054,273 | \$ 38,223,906 | \$32,545,692 | \$139,588,076 |
|---------|--------------|--------------|---------------|--------------|---------------|

Income before other

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| | | | | | |
|------------------|---------|---------|---------|---------|-----------|
| income (expense) | 803,300 | 613,084 | 798,076 | 423,433 | 2,637,893 |
|------------------|---------|---------|---------|---------|-----------|

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| | | | | | |
|------------|---------|----------|---------|---------|-----------|
| Net income | 449,284 | 363,693* | 429,584 | 254,633 | 1,497,194 |
|------------|---------|----------|---------|---------|-----------|

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| | | | | | |
|--------------------------|------|-------|------|------|------|
| Basic earnings per share | 0.14 | 0.10* | 0.12 | 0.07 | 0.43 |
|--------------------------|------|-------|------|------|------|

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| | | | | | |
|----------------------------|------|-------|------|------|------|
| Diluted earnings per share | 0.13 | 0.10* | 0.12 | 0.07 | 0.42 |
|----------------------------|------|-------|------|------|------|

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* In the second quarter 2004, the net income amount of \$363,693 (with basic and diluted earnings per share of \$0.10) shown above is \$127,300 less (with basic and diluted earnings per share of \$0.04) than the net income amount of \$490,933 (with basic and diluted earnings per share of \$0.14) previously reported in the second quarter report on Form 10-Q.

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In the second quarter of 2004, a permanent tax benefit related to the exercise of non-employee options was inadvertently recorded as a reduction to income tax expense. After further review, we have determined that the tax benefit should instead be reported as an increase to additional paid in capital.

SUPPLEMENTARY INFORMATION

INDUSTRIAL SERVICES OF AMERICA, INC.
AND SUBSIDIARIES
SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
Years ended December 31, 2006, 2005 and 2004

| | |
|------------|------------|
| Balance at | Additions |
| | Charged to |

Beginning

Costs and

Balance at

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of Period Expenses Deductions * End of Period

Description

Allowance for doubtful

accounts 2006 (deducted)

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from accounts receivable) \$ 50,000 \$ 50,000 \$ - \$ 100,000

Allowance for doubtful

accounts 2005 (deducted)

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from accounts receivable) \$ 75,000 \$ - \$ (25,000) \$ 50,000

Allowance for doubtful

accounts 2004 (deducted)

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| | | | | |
|---------------------------|------------------|------------------|--------------------|------------------|
| from accounts receivable) | <u>\$ 60.000</u> | <u>\$ 37.937</u> | <u>\$ (22.937)</u> | <u>\$ 75.000</u> |
|---------------------------|------------------|------------------|--------------------|------------------|

* uncollected amounts written off, net of recoveries

