

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

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2010

or

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

Commission File No. 001-33407

**ISORAY, INC.**

(Exact name of registrant as specified in its charter)

Minnesota  
(State or other jurisdiction of incorporation or  
organization)

41-1458152  
(I.R.S. Employer  
Identification No.)

350 Hills St., Suite 106, Richland, Washington  
(Address of principal executive offices)

99354  
(Zip Code)

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

Indicate by check mark whether the registrant: (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 the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).  
Yes  No

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

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

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

Class  
Common stock, \$0.001 par value

Outstanding as of May 6, 2010  
23,048,754

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**ISORAY, INC.**

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PART I – FINANCIAL INFORMATION

IsoRay, Inc. and Subsidiaries  
Consolidated Balance Sheets

	(Unaudited) March 31, 2010	June 30, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 2,425,844	\$ 2,990,744
Short-term investments	-	1,679,820
Accounts receivable, net of allowance for doubtful accounts of \$69,057 and \$86,931, respectively	872,561	746,568
Inventory	695,069	789,246
Prepaid expenses and other current assets	159,961	151,077
<b>Total current assets</b>	<b>4,153,435</b>	<b>6,357,455</b>
Fixed assets, net of accumulated depreciation and amortization	4,194,194	4,891,484
Deferred financing costs, net of accumulated amortization	13,830	28,186
Restricted cash	180,031	178,615
Other assets, net of accumulated amortization	266,788	285,826
<b>Total assets</b>	<b>\$ 8,808,278</b>	<b>\$ 11,741,566</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 700,949	\$ 698,882
Accrued payroll and related taxes	231,759	188,703
Notes payable, due within one year	48,340	161,437
<b>Total current liabilities</b>	<b>981,048</b>	<b>1,049,022</b>
Notes payable, due after one year	143,305	176,023
Asset retirement obligation	591,971	553,471
<b>Total liabilities</b>	<b>1,716,324</b>	<b>1,778,516</b>
Shareholders' equity:		
Preferred stock, \$.001 par value; 6,000,000 shares authorized:		
Series A: 1,000,000 shares allocated; no shares issued and outstanding	-	-
Series B: 5,000,000 shares allocated; 59,065 shares issued and outstanding	59	59
Common stock, \$.001 par value; 194,000,000 shares authorized; 22,945,421 and 22,942,088 shares issued and outstanding, respectively	22,945	22,942
Treasury stock, at cost, 13,200 shares	(8,390)	(8,390)
Additional paid-in capital	47,898,972	47,818,203
Accumulated deficit	(40,821,632)	(37,869,764)
<b>Total shareholders' equity</b>	<b>7,091,954</b>	<b>9,963,050</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 8,808,278</b>	<b>\$ 11,741,566</b>

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

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

	<u>Three months ended March 31,</u>		<u>Nine months ended March 31,</u>	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
Product sales	\$ 1,203,216	\$ 1,366,289	\$ 3,950,650	\$ 4,212,574
Cost of product sales	<u>1,150,730</u>	<u>1,351,044</u>	<u>3,411,012</u>	<u>4,523,705</u>
Gross income / (loss)	<u>52,486</u>	<u>15,245</u>	<u>539,638</u>	<u>(311,131)</u>
Operating expenses:				
Research and development expenses	98,964	301,907	226,924	826,513
Sales and marketing expenses	447,693	529,349	1,494,572	1,880,823
General and administrative expenses	<u>596,224</u>	<u>666,637</u>	<u>1,748,664</u>	<u>2,205,616</u>
Total operating expenses	<u>1,142,881</u>	<u>1,497,893</u>	<u>3,470,160</u>	<u>4,912,952</u>
Operating loss	<u>(1,090,395)</u>	<u>(1,482,648)</u>	<u>(2,930,522)</u>	<u>(5,224,083)</u>
Non-operating income (expense):				
Interest income	1,547	18,722	10,358	101,070
Gain on fair value of short-term investments	-	-	-	274,000
Financing and interest expense	<u>(6,445)</u>	<u>(16,278)</u>	<u>(31,704)</u>	<u>(57,894)</u>
Non-operating income (expense), net	<u>(4,898)</u>	<u>2,444</u>	<u>(21,346)</u>	<u>317,176</u>
Net loss	(1,095,293)	(1,480,204)	(2,951,868)	(4,906,907)
Preferred stock dividends	<u>-</u>	<u>-</u>	<u>(36,679)</u>	<u>-</u>
Net loss applicable to common shareholders	<u>\$ (1,095,293)</u>	<u>\$ (1,480,204)</u>	<u>\$ (2,988,547)</u>	<u>\$ (4,906,907)</u>
Basic and diluted loss per share	<u>\$ (0.05)</u>	<u>\$ (0.06)</u>	<u>\$ (0.13)</u>	<u>\$ (0.21)</u>
Weighted average shares used in computing net loss per share:				
Basic and diluted	<u>22,942,458</u>	<u>22,942,088</u>	<u>22,942,458</u>	<u>22,942,088</u>

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

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

	<b>Nine months ended March 31,</b>	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (2,951,868)	\$ (4,906,907)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization of fixed assets	719,032	905,678
Impairment of IBt license (see Note 4)	-	425,434
Write-off of certain foreign patents and trademarks		84,671
Amortization of deferred financing costs and other assets	36,368	60,448
Gain on fair value of short-term investments		(274,000)
Realized (gains) / losses on short-term investments		-
Accretion of asset retirement obligation	38,500	35,198
Share-based compensation	115,285	255,450
Changes in operating assets and liabilities:		
Accounts receivable, net	(125,993)	152,399
Inventory	94,177	78,162
Prepaid expenses and other current assets	(11,858)	94,068
Accounts payable and accrued expenses	22,067	132,403
Accrued payroll and related taxes	43,056	(75,616)
Net cash used by operating activities	<u>(2,021,234)</u>	<u>(3,032,612)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of fixed assets	(21,742)	(41,961)
Additions to licenses and other assets	-	(22,245)
Change in restricted cash	(1,416)	(2,243)
Purchases of short-term investments	-	(479,820)
Proceeds from the sale or maturity of short-term investments	1,679,820	4,000,000
Net cash provided by investing activities	<u>1,656,662</u>	<u>3,453,731</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Principal payments on notes payable	(145,815)	(49,185)
Principal payments on capital lease obligations	-	(23,312)
Preferred dividends paid	(36,679)	-
Proceeds from cash sales of common stock, pursuant to exercise of options	2,166	-
Repurchase of Company common stock	-	(4,735)
Net cash used by financing activities	<u>(180,328)</u>	<u>(77,232)</u>
Net increase (decrease) in cash and cash equivalents	(544,900)	343,887
Cash and cash equivalents, beginning of period	2,990,744	4,820,033
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<u><u>\$ 2,445,844</u></u>	<u><u>\$ 5,163,920</u></u>

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

**IsoRay, Inc. and Subsidiaries**  
**Notes to the Consolidated Unaudited Financial Statements**  
**For the three and nine-month periods ended March 31, 2010 and 2009**

**1. Basis of Presentation**

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

The accompanying interim consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles, consistent in all material respects with those applied in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2009. The financial information is unaudited but reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of the Company's management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2009.

Certain amounts in the prior-year financial statements have been reclassified to conform to the current year presentation.

**2. New Accounting Pronouncements**

On July 1, 2009, the Company adopted new accounting provisions which establishes the FASB Accounting Standards Codification™ (the Codification) as the single official source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles (GAAP) other than rules and interpretive releases issued by the Securities and Exchange Commission. The Codification reorganized the literature and changed the naming mechanism by which topics are referenced. The Codification became effective for interim and annual periods ending after September 15, 2009. The Company's accounting policies and amounts presented in the financial statements were not impacted by this change.

On July 1, 2009, the Company adopted new accounting provisions which were delayed from the effective date of fair value accounting for one year for certain nonfinancial assets and nonfinancial liabilities, excluding those that are recognized or disclosed in financial statements at fair value on a recurring basis (that is, at least annually). For purposes of applying the new provisions, nonfinancial assets and nonfinancial liabilities include all assets and liabilities other than those meeting the definition of a financial asset or a financial liability. The Company had previously adopted new standards for fair value accounting on July 1, 2008. The adoption of these new provisions did not have a material effect on the Company but will affect future calculations of asset retirement obligations and long-lived asset impairment.

On July 1, 2009, the Company adopted new accounting provisions for business combinations and for non-controlling interests. The new business combination provisions require an acquirer to measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. In addition, the new provisions require that a non-controlling interest in a subsidiary be reported as equity in the consolidated financial statements. The calculation of earnings per share will continue to be based on income amounts attributable to the parent. The adoption of these statements did not have a material effect on the Company's financial statements.

### 3. Loss per Share

Basic earnings per share is calculated by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding, and does not include the impact of any potentially dilutive common stock equivalents. Common stock equivalents, including warrants and options to purchase the Company's common stock, are excluded from the calculations when their effect is anti-dilutive. At March 31, 2010 and 2009, the calculation of diluted weighted average shares does not include preferred stock, common stock warrants, or options that are potentially convertible into common stock as those would be anti-dilutive due to the Company's net loss position.

Securities not considered in the calculation of diluted weighted average shares, but that could be dilutive in the future as of March 31, 2010 and 2009 were as follows:

	March 31,	
	2010	2009
Preferred stock	59,065	59,065
Common stock warrants	3,216,644	3,216,644
Common stock options	2,317,237	2,430,839
Total potentially dilutive securities	<u>5,592,946</u>	<u>5,706,548</u>

### 4. Impairment of IBt License

In December 2008, the Company reevaluated its license agreement with International Brachytherapy SA (IBt) in connection with an overall review of its present cost structure and projected market and manufacturing strategies. Management determined through this review that it does not currently intend to utilize the IBt license as part of its market strategy due to the cost of revamping its manufacturing process to incorporate the technology and as there can be no assurance that physicians would accept this new technology without extensive education and marketing costs. However, the Company does not intend to cancel the license agreement at this time; therefore, the license was reviewed in terms of an "abandoned asset" for purposes of ASC 360. As there are no anticipated future revenues from the license and the Company cannot sell or transfer the license, it was determined that the entire value was impaired. Therefore, the Company recorded an impairment charge of \$425,434 that is included in cost of product sales for the nine months ended March 31, 2009.

### 5. Short-Term Investments

The Company's short-term investments are classified as available-for-sale and recorded at fair market value. The Company's short-term investments consisted entirely of certificates of deposit at various banks. As of March 31, 2010 the Company had no short-term investments and as of June 30, 2009, the Company had \$1,679,820 in short-term investments. The Company's short-term investments are accounted for and reported at fair value using level 1 inputs.

## 6. Inventory

Inventory consisted of the following at March 31, 2010 and June 30, 2009:

	March 31, 2010	June 30, 2009
Raw materials	\$ 559,946	\$ 609,932
Work in process	135,123	155,827
Finished goods	—	23,487
	<u>\$ 695,069</u>	<u>\$ 789,246</u>

## 7. Share-Based Compensation

The following table presents the share-based compensation expense recognized in the statement of operations during the three and nine months ended March 31, 2010 and 2009:

	Three months ended March 31,		Nine months ended March 31,	
	2010	2009	2010	2009
Cost of product sales	\$ 5,506	\$ 3,100	\$ 16,778	\$ 17,010
Research and development expenses	1,840	4,001	2,176	23,490
Sales and marketing expenses	19,599	18,869	70,684	123,852
General and administrative expenses	7,863	29,698	25,647	91,098
Total share-based compensation	<u>\$ 34,808</u>	<u>\$ 55,668</u>	<u>\$ 115,285</u>	<u>\$ 255,450</u>

As of March 31, 2010, total unrecognized compensation expense related to share-based options was \$92,251 and the related weighted-average period over which it is expected to be recognized is approximately 1.09 years.

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

A summary of stock options within the Company's share-based compensation plans as of March 31, 2010 was as follows:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at March 31, 2010	<u>2,317,237</u>	<u>\$ 1.91</u>	<u>7.08</u>	<u>\$ 976,633</u>
Vested and expected to vest at March 31, 2010	<u>2,235,647</u>	<u>\$ 1.97</u>	<u>7.02</u>	<u>\$ 893,448</u>
Vested and exercisable at March 31, 2010	<u>1,854,603</u>	<u>\$ 2.29</u>	<u>6.72</u>	<u>\$ 536,375</u>

The aggregate intrinsic value of options exercised during the nine months ended March 31, 2010 and 2009 was \$2,233 and \$0, respectively. The Company's current policy is to issue new shares to satisfy option exercises.

The weighted average fair value of stock option awards granted and the key assumptions used in the Black-Scholes valuation model to calculate the fair value are as follows:

	Three months ended March 31,		Nine months ended March 31,	
	2010(a)	2009(b)	2010(c)	2009(d)
Weighted average fair value of options granted	\$ 0.56	\$ –	\$ 0.68	\$ 0.37
Key assumptions used in determining fair value:				
Weighted average risk-free interest rate	1.93%	–%	2.55%	2.63%
Weighted average life of the option (in years)	3.75	–	4.75	5.68
Weighted average historical stock price volatility	101.84%	–%	134.89%	191.04%
Expected dividend yield	0.00%	–%	0.00%	0.00%

- (a) During the three months ended March 31, 2010, the Company granted 30,000 stock options.  
(b) During the three months ended March 31, 2009, the Company did not grant any stock options.  
(c) During the nine months ended March 31, 2010, the Company granted 40,000 stock options.  
(d) During the nine months ended March 31, 2009, the Company granted 95,000 stock options.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Although the Company is using the Black-Scholes option valuation model, management believes that because changes in the subjective input assumptions can materially affect the fair value estimate, this valuation model does not necessarily provide a reliable single measure of the fair value of its stock options. The risk-free interest rate is based on the U.S. treasury security rate with an equivalent term in effect as of the date of grant. The expected option lives, volatility, and forfeiture assumptions are based on historical data of the Company.

## 8. Commitments and Contingencies

### Patent and Know-How Royalty License Agreement

The Company is the holder of an exclusive license to use certain "know-how" developed by one of the founders of a predecessor to the Company and licensed to the Company by the Lawrence Family Trust, a Company shareholder. The terms of this license agreement require the payment of a royalty based on the Net Factory Sales Price, as defined in the agreement, of licensed product sales. Because the licensor's patent application was ultimately abandoned, only a 1% "know-how" royalty based on Net Factory Sales Price, as defined in the agreement, remains applicable. To date, management believes that there have been no product sales incorporating the "know-how" and therefore no royalty is due pursuant to the terms of the agreement. Management believes that ultimately no royalties should be paid under this agreement as there is no intent to use this "know-how" in the future.

The licensor of the "know-how" has disputed management's contention that it is not using this "know-how". On September 25, 2007 and again on October 31, 2007, the Company participated in nonbinding mediation regarding this matter; however, no settlement was reached with the Lawrence Family Trust. After additional settlement discussions, which ended in April 2008, the parties failed to reach a settlement. The parties may demand binding arbitration at any time.

**9. Preferred Dividends**

On December 11, 2009, the Board of Directors declared a dividend on the Series B Preferred Stock of all currently payable and accrued outstanding and cumulative dividends through December 31, 2009. Dividends on the Series B Preferred Stock were last paid on February 15, 2007 for dividends outstanding and cumulative through December 31, 2006. The dividends outstanding and cumulative through December 31, 2009 of \$36,679 were paid as of that date.

**10. Subsequent Event**

Management executed a sales agreement with C.K.Cooper & Company, Inc on April 22, 2010 to sell shares as the Company's sales agent at market prices. The sales agreement expires on June 30, 2010. If the shares are sold, the shares will be issued pursuant to the Form S-3 (File No. 333-162694) which became effective on November 13, 2009 and the prospectus supplement dated April 23, 2010. Sales cannot exceed \$4 million under the prospectus supplement and must be sold "at the market" price of the common stock as of the day the sales are made.

## ITEM 2 – MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### **Caution Regarding Forward-Looking Information**

*In addition to historical information, this Form 10-Q contains certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). This statement is included for the express purpose of availing IsoRay, Inc. of the protections of the safe harbor provisions of the PSLRA.*

*All statements contained in this Form 10-Q, other than statements of historical facts, that address future activities, events or developments are forward-looking statements, including, but not limited to, statements containing the words "believe," "expect," "anticipate," "intends," "estimate," "forecast," "project," and similar expressions. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, including any statements of the plans, strategies and objectives of management for future operations; any statements concerning proposed new products, services, developments or industry rankings; any statements regarding future economic conditions or performance; any statements of belief; and any statements of assumptions underlying any of the foregoing. These statements are based on certain assumptions and analyses made by us in light of our experience and our assessment of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate under the circumstances. However, whether actual results will conform to the expectations and predictions of management is subject to a number of risks and uncertainties described under "Risk Factors" beginning on page 17 below and in the "Risk Factors" section of our Form 10-K for the fiscal year ended June 30, 2009 that may cause actual results to differ materially.*

*Consequently, all of the forward-looking statements made in this Form 10-Q are qualified by these cautionary statements and there can be no assurance that the actual results anticipated by management will be realized or, even if substantially realized, that they will have the expected consequences to or effects on our business operations. Readers are cautioned not to place undue reliance on such forward-looking statements as they speak only of the Company's views as of the date the statement was made. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.*

### **Critical Accounting Policies and Estimates**

The discussion and analysis of the Company's financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. On an on-going basis, management evaluates past judgments and estimates, including those related to bad debts, inventories, accrued liabilities, and contingencies. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The accounting policies and related risks described in the Company's annual report on Form 10-K as filed with the Securities and Exchange Commission on September 23, 2009 are those that depend most heavily on these judgments and estimates. As of March 31, 2010, there have been no material changes to any of the critical accounting policies contained therein.

## **Results of Operations**

### **Three months ended March 31, 2010 compared to three months ended March 31, 2009**

**Product sales.** The Company generated revenue of \$1,203,216 during the three months ended March 31, 2010 compared to revenue of \$1,366,289 during the three months ended March 31, 2009. The decrease of \$163,073 or 12% in revenue directly correlates with a reduction in the quantity of seeds sold. While no marketing program has been implemented for the treatment of sites other than prostate, these new treatment sites including lung, head and neck, colorectal and others contributed 5 new cases in the three months ended March 31, 2010 and approximately \$31,000 in additional revenue to the revenue generated by prostate related treatments. Management believes that the overall market for prostate brachytherapy has received increased pressure from other treatment modalities with higher reimbursement rates such as Intensity-Modulated Radiation Therapy (IMRT) and Robotics. While these new treatment sites for the quarter ended March 31, 2010 comprised 3% of Company revenue, management believes these sites present opportunities for growth with market acceptance that is not available at this time in the highly competitive prostate market.

**Cost of product sales.** Cost of product sales was \$1,150,730 for the three months ended March 31, 2010 compared to cost of product sales of \$1,351,044 during the three months ended March 31, 2009. The decrease in cost of \$200,314 or 15% correlates with the reduced sales. The major components of the decrease were personnel costs, materials, preload expenses, occupancy costs and depreciation and amortization expense. Personnel costs, including payroll, benefits, and related taxes, decreased approximately \$31,000 as the number of production personnel decreased for the three months ended March 31, 2010 compared to March 31, 2009. Materials decreased approximately \$66,000 mainly due to decreased rate of consumption of inventory materials as a result of changes in sales in the three months ended March 31, 2010 compared to March 31, 2009. Preload expenses decreased by approximately \$14,000 mainly due to the lower volume of sales and increased in-house loading for the three months ended March 31, 2010 compared to March 31, 2009. Occupancy costs were reduced by approximate \$17,000 for the three months ended March 31, 2010 compared to March 31, 2009 as a result of reduced rent and related utility consumption. Depreciation and amortization was reduced by approximately \$53,000 for the three months ended March 31, 2010 compared to March 31, 2009.

**Gross margin.** Gross margin was \$52,486 for the three month period ended March 31, 2010 as compared to \$15,245 for the three months ended March 31, 2009. This represents an increase in the Company's gross margin of \$37,241 or 244%. The increase in the gross margin is due to the Company's continuing efforts in managing production during decreased periods of sales.

**Research and development expenses.** Research and development expenses for the three month period ended March 31, 2010 were \$98,964 which represents a decrease of \$202,943 or 67% less than the research and development expenses of \$301,907 for the three month period ended March 31, 2009. The decrease in cost is primarily due to lower consulting, personnel expenses and protocol expense. Consulting expenses decreased approximately \$49,000 as the Company completed several projects related to production automation and bringing delivery methods to treat head and neck, lung and colorectal cancer to market. Protocol expenses decreased approximately \$61,000 as the major cost for the monotherapy protocol has been completed. Legal costs were reduced by approximately \$90,000 because in the three months ended March 31, 2009, the Company finalized its on-going strategy regarding foreign patents and trademarks and wrote-off \$84,671 of previously capitalized costs. The Company had pursued patents and trademarks in various foreign countries including Australia, Japan, and China; however, the Company no longer believes that pursuing patents and trademarks in these foreign countries is fundamental to its current business strategy.

**Sales and marketing expenses.** Sales and marketing expenses were \$447,693 for the three months ended March 31, 2010. This represents a decrease of \$81,656 or 15% compared to expenditures in the three months ended March 31, 2009 of \$529,349 for sales and marketing. Personnel expenses, including payroll, benefits, and related taxes, decreased approximately \$46,000 due to a lower sales headcount. Training for physicians was reduced by approximately \$18,000 for the three months ended March 31, 2010 as the training that occurred in the three months ended March 31, 2009 did not occur in the three months ended March 31, 2010.

**General and administrative expenses.** General and administrative expenses for the three months ended March 31, 2010 were \$596,224 compared to general and administrative expenses of \$666,637 for the three months ended March 31, 2009. The decrease of \$70,413 or 11% is mainly due to decreased personnel, and consulting expenses that were partially offset by an increase in other costs. Personnel expenses, including payroll, benefits, related taxes, and share-based compensation decreased approximately \$77,000 due primarily to the resignation of the Company's CFO in October 2009. Public company and consulting expenses were reduced by approximately \$40,000 due primarily to the conversion of the interim CEO to a full-time employee. These reductions were partially offset by an increase in other costs of approximately \$46,000 that include franchise taxes, licenses and permits, credit card discount expense and allowance for bad debt.

**Operating loss.** The Company continues to focus its resources on improving sales while retaining the necessary administrative infrastructure to increase the level of demand for the Company's product. These objectives and resulting costs have resulted in the Company not being profitable and generating operating losses since its inception. In the three months ended March 31, 2010, the Company had an operating loss of \$1,090,395 which is a decrease of \$392,253 or 26% less than the operating loss of \$1,482,648 for the three months ended March 31, 2009.

**Interest income.** Interest income was \$1,547 for the three months ended March 31, 2010. This represents a decrease of \$17,175 or 92% compared to interest income of \$18,722 for the three months ended March 31, 2009. Interest income is mainly derived from excess funds held in money market accounts and invested in short-term investments. The decrease is due to lower interest rates and lower balances in the Company's money market and short-term investment accounts.

**Financing and interest expense.** Financing and interest expense for the three months ended March 31, 2010 was \$6,445 or a decrease of \$9,833 or 60% from financing and interest expense of \$16,278 for the three months ended March 31, 2009. Included in financing expense is interest expense of approximately \$6,000 for each of the three months ended March 31, 2010 and 2009, respectively. The remaining balance of financing expense represents the amortization of deferred financing costs.

#### **Nine months ended March 31, 2010 compared to nine months ended March 31, 2009**

**Product sales.** Sales for the nine months ended March 31, 2010 were \$3,950,650 compared to sales of \$4,212,574 for the nine months ended March 31, 2009. The decrease of \$261,924 or 6% directly correlates with a reduction in the quantity of seeds sold. New treatment sites including lung, head and neck, colorectal and other applications contributed 19 new cases in the nine months ended March 31, 2010 and approximately \$108,000 in additional revenue to the revenue generated by prostate related treatments. Management believes that the overall market for prostate brachytherapy has received increased pressure from other treatment modalities with higher reimbursement rates such as Intensity-Modulated Radiation Therapy (IMRT) and Robotics. While these new treatment sites year to date only comprise 3% of Company revenue, management believes these sites present opportunities for growth with market acceptance that is not available at this time in the highly competitive prostate market.

**Cost of product sales.** Cost of product sales was \$3,411,012 for the nine months ended March 31, 2010 compared to cost of product sales of \$4,523,705 during the nine months ended March 31, 2009. The cost reduction of \$1,112,693 or 25% for the nine months ended March 31, 2010 were the result of both the reduction in sales and continued production efficiency improvements. Depreciation and amortization cost was reduced by approximately \$164,000. Personnel expenses, including payroll, benefits, and related taxes, decreased approximately \$170,000 due to a reduction in the average production headcount levels. Preload expenses decreased approximately \$183,000 due to lower sales volumes and increased in-house loading. Occupancy costs were reduced by approximately \$64,000 as the Company continues to evaluate and reconfigure leased space that has resulted in a reduced facility rent. In addition, the Company continues to monitor its utility consumption and more efficient consumption of utilities in combination with a very mild winter has created a significant savings of approximately \$43,000 in utility costs that is included in occupancy cost for the nine months ended March 31, 2010 as compared to the nine months ended March 31, 2009. Other expenses were reduced by approximately \$435,000, primarily resulting from the impairment charge for the IBt license of approximately \$425,000 that was recorded in the nine months ended March 31, 2009.

**Gross margin / (loss).** Gross margin was \$539,638 for the nine month period ended March 31, 2010. This represents an improvement of \$850,769 compared to a gross loss of \$311,131 during the nine month period ended March 31, 2009. Included in the gross loss of \$311,131 for the nine months ended March 31, 2009 is the one-time IBt license impairment charge of \$425,434. Without this one-time expense, the Company would have recognized a gross margin of \$114,303 for the nine months ended March 31, 2009.

**Research and development expenses.** Research and development expenses for the nine months ended March 31, 2010 were \$226,924 which represents a decrease of \$599,589 or 73% less than the research and development expenses of \$826,513 for the nine months ended March 31, 2009. Consulting expenses decreased approximately \$88,000 as several production projects were completed related to both production automation and delivery methods to treat head and neck, lung, and colorectal cancers. These decreases were partially offset by the transition of a former R&D employee to a consulting role. Legal expenses were reduced by approximately \$125,000 in the nine months ended March 31, 2010 due to the Company finalizing its on-going strategy regarding foreign patents and trademarks and wrote-off \$84,671 of previously capitalized costs and the resulting reduction in continuing activities as a result during the nine months ended March 31, 2009. Personnel expenses, including payroll, benefits, and related taxes, decreased approximately \$72,000 due to lower headcount. Protocol expense was reduced by approximately \$255,000 for the nine month period ended March 31, 2010 as the major cost for the monotherapy protocol has been completed.

**Sales and marketing expenses.** Sales and marketing expenses were \$1,494,572 for the nine months ended March 31, 2010. This represents a decrease of \$386,251 or 21% compared to expenditures in the nine months ended March 31, 2009 of \$1,880,823 for sales and marketing. Personnel expenses, including payroll, benefits, related taxes, and share-based compensation decreased approximately \$209,000 due to a lower sales headcount. Travel expenses also decreased approximately \$85,000 due to the decrease in average headcount

**General and administrative expenses.** General and administrative expenses for the nine months ended March 31, 2010 were \$1,748,664 compared to general and administrative expenses of \$2,205,616 for the nine months ended March 31, 2009. This represents a decrease of \$456,952 or 21%. Personnel costs including payroll, benefits, related taxes, and share-based compensation decreased approximately \$222,000 as a result of the CEO becoming an employee, the resignation of the CFO, an overall reduction in headcount and the related forfeiture of option grants and option grants that have been fully amortized. Public company expenses decreased approximately \$59,000 due to the CEO no longer being paid fees for service on the Board of Directors upon becoming an employee. Legal expenses decreased by approximately \$126,000 in the nine months ended March 31, 2010 as the Company incurred legal fees related to settling a lawsuit with a former employee during the nine months ended March 31, 2009.

**Operating loss.** The Company continues to focus its resources on improving sales while retaining the necessary administrative infrastructure to increase the level of demand for the Company's product. These objectives and resulting costs have resulted in the Company not being profitable and generating operating losses since its inception. In the nine months ended March 31, 2010, the Company had an operating loss of \$2,930,522 which is an improvement of \$2,293,561 or 44% better than the operating loss of \$5,224,083 for the nine months ended March 31, 2009. Included in the operating loss for the nine months ended March 31, 2009 is the one-time IBt license impairment loss of \$425,434. Without this impairment loss, the Company's operating loss would have been \$4,798,649 for the nine months ended March 31, 2009.

**Interest income.** Interest income was \$10,358 for the nine months ended March 31, 2010. This represents a decrease of \$90,712 or 90% compared to interest income of \$101,070 for the nine months ended March 31, 2009. Interest income is mainly derived from excess funds held in money market accounts and invested in short-term investments. The decrease is due to lower interest rates and lower balances in the Company's money market and short-term investment accounts.

**Gain on fair value of short-term investments.** There was no gain on short-term investments for the nine months ended March 31, 2010 as compared to a gain of \$274,000 for the nine months ended March 31, 2009. The gain of \$274,000 for the nine months ended March 31, 2009 was due to the receipt of rights issued by the Company's broker in October 2008. The gain was calculated as the fair value amount of the rights estimated on the date of receipt plus the changes in their fair value offset by additional realized losses on the Company's auction rate securities.

**Financing and interest expense.** Financing and interest expense for the nine months ended March 31, 2010 was \$31,704 or a decrease of \$26,190 or 45% from financing and interest expense of \$57,894 for the nine months ended March 31, 2009. Included in financing expense is interest expense of approximately \$17,000 and \$31,000 for the nine months ended March 31, 2010 and 2009, respectively. The decrease in interest expense is due to the reduction of the principal balances of the Company's overall debt and capital lease balances. The remaining balance of financing expense represents the amortization of deferred financing costs.

**Liquidity and capital resources.** The Company has historically financed its operations through cash investments from shareholders. During the nine months ended March 31, 2010, the Company primarily used existing cash reserves to fund its operations and capital expenditures.

*Cash flows from operating activities*

Cash used in operating activities was \$2.0 million for the nine months ended March 31, 2010 compared to \$3.0 million for the nine months ended March 31, 2009. Cash used by operating activities is net loss adjusted for non-cash items and changes in operating assets and liabilities.

#### *Cash flows from investing activities*

Cash provided by investing activities was approximately \$1.7 million for the nine months March 31, 2010 as compared to cash provided by investing activities of \$3.5 million for the nine months ended March 31, 2009. Cash expenditures for fixed assets were approximately \$22,000 and \$42,000 during the nine months ended March 31, 2010 and 2009, respectively. The Company sold its remaining auction rate securities in January 2009 which generated \$4.0 million of cash proceeds in the nine months ended March 31, 2009. The Company reinvested most of these proceeds in money market funds and certificates of deposit with maturities of less than 3 months which are classified as cash equivalents on the balance sheet.

#### *Cash flows from financing activities*

Cash used in financing activities was approximately \$180,000 and \$77,000 for the nine months ended March 31, 2010 and 2009, respectively. \$146,000 and \$72,000 was used mainly for payments of debt and capital leases in the nine months ended March 31, 2010 and 2009 respectively. Approximately \$108,000 of the \$146,000 in cash that was used for payments of debt and capital leases in the nine months ended March 31, 2010 was to retire the loan facility with Benton-Franklin Council of Governments (BFEDD). Approximately \$37,000 of the remaining cash consumed in financing activities was related to the payment of preferred dividends which was partially offset by the exercise of stock options.

#### *Projected 2010 Liquidity and Capital Resources*

At March 31, 2010, cash and cash equivalents amounted to \$2,425,844 and the Company had no short-term investments, compared to \$2,990,744 of cash and cash equivalents and \$1,679,820 of short-term investments at June 30, 2009.

The Company had approximately \$2.1 million of cash and no short-term investments as of April 30, 2010. The Company's monthly required cash operating expenditures were approximately \$225,000 in the nine months ended March 31, 2010, which represents a 40% decrease of approximately \$150,000 from average monthly cash operating expenditures in fiscal year 2009 of approximately \$375,000. This reduction is primarily the result of improved operating performance in fiscal year 2010. Management believes that less than \$100,000 will be spent on capital expenditures for fiscal year 2010, but there is no assurance that unanticipated needs for capital equipment may not arise.

The Company's loan facility with BFEDD matured during the nine months ended March 31, 2010 and the full amount due of approximately \$108,000 was paid on November 13, 2009 to settle the loan facility. The Company has only one remaining loan facility outstanding with the Hanford Area Economic Investment Fund Committee (HAEIFC), with a principal balance of approximately \$192,000 of which approximately \$48,000 will be due in the next 12 months.

The Company has significantly decreased its protocol studies in the prostate market as management believes the studies conducted to date are adequate. Management is in the process of determining whether the approximately \$225,000 originally budgeted for protocol expenses relating to lung cancer and the ongoing protocols still needed for dual therapy and mono therapy prostate protocols is adequate. For the nine months ended March 31, 2010, approximately \$54,000 has been spent.

Based on the foregoing assumptions, management believes cash, cash equivalents, and short-term investments on hand at March 31, 2010 will not be sufficient to meet our anticipated cash requirements for operations, debt service, and capital expenditure requirements through the next twelve months but will fund operations for approximately 11 months. Management plans to attain breakeven and generate additional cash flows by increasing revenues from both new and existing customers (through our direct sales channels and through our distributors), expanding into other market applications which initially will include head and neck implants, colorectal and lung implants while maintaining the Company's focus on cost control. However, there can be no assurance that the Company will attain profitability or that the Company will be able to attain its revenue targets. Sales in the prostate market have not shown the increases necessary to breakeven during the past two fiscal years and did not improve during the nine months ended March 31, 2010.

Management is now focused on expanding into head and neck, colorectal and lung application segments and our cash and cash equivalents are only sufficient to meet cash requirements for operations, debt service and capital expenditures at our current monthly average expenses for the next eleven months assuming no expansion of our operations. As a result, management believes the Company will need to raise additional capital for protocols, marketing staff, production staff and production equipment as it plans to enter new market applications for the Company's technologies.

Management executed a sales agreement with C.K.Cooper & Company, Inc (CKCC) on April 22, 2010 to sell shares as the Company's sales agent at market prices. The sales agreement expires on June 30, 2010. If the shares are sold, the shares will be issued pursuant to the Form S-3 (File No. 333-162694) which became effective on November 13, 2009 and the prospectus supplement dated April 23, 2010. Sales cannot exceed \$4 million under the prospectus supplement and must be sold "at the market" price of the common stock as of the day the sales are made.

The Company expects to finance its cash needs through the sale of equity securities and possibly strategic collaborations or debt financing or through other sources that may be dilutive to existing shareholders. Funding may not be available to it on acceptable terms, or at all. If the Company is unable to raise additional funds when needed, it may not be able to market its products as planned or continue development and regulatory approval of its future products. If the Company raises additional funds through equity sales, these sales may be dilutive to existing investors.

#### *Long-Term Debt and Capital Lease Agreements*

IsoRay has a single loan facility in place as of March 31, 2010. This loan facility is from the HAEIFC and was originated in June 2006. The loan originally had a total facility of \$1,400,000 which was reduced in September 2007 to the amount of the Company's initial draw of \$418,670. The loan bears interest at nine percent and the principal balance owed as of March 31, 2010 was \$191,645. This loan is secured by receivables, equipment, materials and inventory, and certain life insurance policies and also required personal guarantees.

#### *Other Commitments and Contingencies*

The Company is subject to various local, state, and federal environmental regulations and laws due to the isotopes used to produce the Company's product. As part of normal operations, amounts are expended to ensure that the Company is in compliance with these laws and regulations. While there have been no reportable incidents or compliance issues, the Company believes that if it relocates its current production facilities then certain decommissioning expenses will be incurred. An asset retirement obligation was established in the first quarter of fiscal year 2008 for the Company's obligations at its current production facility. This asset retirement obligation will be for obligations to remove any residual radioactive materials and to remove all leasehold improvements.

The industry that the Company operates in is subject to product liability litigation. Through its production and quality assurance procedures, the Company works to mitigate the risk of any lawsuits concerning its product. The Company also carries product liability insurance to help protect it from this risk.

The Company has no off-balance sheet arrangements.

### **ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a smaller reporting company, the Company is not required to provide Part I, Item 3 disclosure in this Quarterly Report.

### **ITEM 4 – CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the design and operation of our disclosure controls and procedures, as such term is defined under Rules 13a-14(c) and 15d-14(c) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as of March 31, 2010. Based on that evaluation, our principal executive officer and our principal financial officer concluded that the design and operation of our disclosure controls and procedures were effective. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. However, management believes that our system of disclosure controls and procedures is designed to provide a reasonable level of assurance that the objectives of the system will be met.

#### **Changes in Internal Control over Financial Reporting**

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1A – RISK FACTORS**

There have been no material changes for the risk factors disclosed in the “Risk Factors” section of our Annual Report on Form 10-K for the year ended June 30, 2009, except for the addition of the following risk factors:

*The Price Of Our Common Stock May Be Adversely Affected By The Future Issuance And Sale Of Shares Of Our Common Stock Or Other Equity Securities, Including Pursuant To The Sales Agreement, Or By Our Announcement That Such Issuances And Sales May Occur.* We cannot predict the size of future issuances or sales of our common stock or other equity securities, including those made pursuant to the sales agreement with CKCC, future acquisitions or capital raising activities, or the effect, if any, that such issuances or sales may have on the market price of our common stock. In addition, CKCC, as agent for sales under the sales agreement, will not engage in any transactions that stabilize the price of our common stock. The issuance and sale of substantial amounts of common stock or other equity securities, including the issuances and sales pursuant to the sales agreement, or announcement that such issuances and sales may occur, could adversely affect the market price of our common stock.

*Our Reduced Stock Price May Adversely Affect Our Liquidity.* Our common stock has been trading at less than \$1.00 per share periodically in the past. Many market makers are reluctant to make a market in stock with a trading price of less than \$1.00 per share. To the extent that we have fewer market makers for our common stock, our volume and liquidity will likely decline, which could further depress our stock price.

*Failure to Comply with NYSE Amex Listing Standards And Any Resulting Delisting Could Adversely Affect The Market For Our Common Stock.* Our common stock is presently listed on the NYSE Amex. The NYSE Amex will consider delisting a company's securities if, among other things, the company fails to maintain minimum stockholder's equity or the company has sustained losses which are so substantial in relation to its overall operations or its existing financial resources, or its financial condition has become so impaired that it appears questionable, in the opinion of the NYSE Amex, as to whether such issuer will be able to continue operations and/or meet its obligations as they mature. There can be no assurance that we will be able to maintain our listing on the NYSE Amex indefinitely. In the event that our common stock is delisted from the NYSE Amex, trading, if any, in the common stock would be conducted in the over-the-counter market. As a result, our shareholders would likely find it more difficult to dispose of, or to obtain accurate quotations as to the market value of, our common stock.

### **ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

#### *Use of Proceeds from Registered Securities*

On October 27, 2010, we filed a registration statement on Form S-3 to register securities up to \$15 million in value for future issuance in our capital raising activities. The registration statement became effective on November 13, 2010, and we filed a prospectus supplement relating to the Sales Agreement described below on April 23, 2010. The Commission file number assigned to the registration statement is 333-162694.

On April 22, 2010, we entered into a Sales Agreement (the "Agreement") with C. K. Cooper & Company, Inc. ("CKCC"). Pursuant to the terms of the Agreement, the Company may offer and sell (the "Offering") from time to time through CKCC, as the Company's sales agent, up to \$4 million of shares of the Company's common stock, par value \$0.001 per share (the "Shares"). CKCC is not required to sell any specific number or dollar amount of Shares but will use its commercially reasonable efforts, as the Company's agent and subject to the terms of the Agreement, to sell the Shares offered, as instructed by the Company. Sales of the Shares, if any, may be made by means of ordinary brokers' transactions on the NYSE AMEX at market prices and such other sales as agreed to by the Company and CKCC. CKCC will receive from us a commission of 2.0% based on the gross sales price per share for any Shares sold through it as agent under the Agreement. Net proceeds from the sale of the Shares will be used for general corporate purposes. The Company has also agreed to reimburse CKCC for certain expenses incurred in connection with entering into the Agreement and has provided CKCC with customary indemnification rights. The offering of Shares pursuant to the Agreement will terminate upon the earliest of (i) June 30, 2010, (ii) the sale of all Shares subject to the Agreement and (iii) the termination of the Agreement by the Company or CKCC.

CKCC has not yet commenced the Offering as it has not yet been instructed to do so by the Company.

**ITEM 6 – EXHIBITS**

Exhibits:

- 10.58 Consulting and Severance Agreement dated January 12, 2010 between IsoRay, Inc. and Lori Woods
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer
- 32 Section 1350 Certifications

SIGNATURES

Pursuant to the requirements 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.

Dated: May 10, 2010

ISORAY, INC., a Minnesota corporation

By /s/ Dwight Babcock  
Dwight Babcock, Chief Executive Officer  
(Principal Executive Officer)

By /s/ Brien Ragle  
Brien Ragle, Controller  
(Principal Financial and Accounting Officer)

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**CONFIDENTIAL**

**CONSULTING AND SEVERANCE AGREEMENT**

THIS CONSULTING AND SEVERANCE AGREEMENT (the "*Agreement*") is dated as of this 12<sup>th</sup> day of January, 2010 (the "*Effective Date*") by and among ISORAY, INC., a Minnesota corporation ("*IsoRay*") and LORI WOODS ("*Woods*"). (IsoRay together with its subsidiary company IsoRay Medical, Inc., a Delaware corporation ("*Medical*"), its subsidiary company IsoRay International LLC ("*International*"), and all of IsoRay's subsidiaries, including Medical and International, are referred to herein as the "*Company*".)

**RECITALS:**

- A. Woods has been employed by IsoRay pursuant to an executive employment agreement, initially serving as Vice-President of Medical and now as Chief Operating Officer of IsoRay and has served on the Disclosure Committee of the Company.
- B. Woods has decided to voluntarily resign from her employment and service in all capacities with IsoRay and all of its subsidiaries as of the Effective Date but has agreed to serve as a consultant for a six month period ending August 1, 2010.
- C. Woods agrees, subject to the terms and conditions of this Agreement, to make the representations, warranties and covenants contained herein in exchange for the Company making certain payments as described in Article I.
- D. The parties hereto desire to mutually release each other from various obligations and have agreed to enter into this Agreement for such purpose.

**AGREEMENT:**

**ARTICLE I**

**FINANCIAL TERMS; RESIGNATION**

1.1. *Resignation; Payments to Woods.* Effective as of 5 p.m. (PDT) on January 31, 2010 (the "*Resignation Date*"), Woods shall resign from all positions as an employee and as a member of the Disclosure Committee of the Company. Any press release announcing and the Form 8-K describing the event shall refer to her departure as a "resignation" and not as a "termination" by the Company. All accrued expenses incurred in accord with her duties as COO through the Resignation Date shall be paid and a final salary payment also shall be made by the Company at its next scheduled employee pay period for services rendered through the Resignation Date. In addition, the Company shall pay Woods for all accrued vacation time up through the Resignation Date in accordance with its standard practice of providing employees with a check for accrued vacation time on the Resignation Date, including without limitation reduction for withholding taxes and FICA. As severance and consideration for the covenants and promises made to the Company hereunder, for the six (6) month period (the "*Severance Period*") commencing on the Severance Date (as defined below), IsoRay shall pay Woods \$16,500 per month ("*Severance Pay*") by Company check cut on the 15<sup>th</sup> day of each month beginning as of February 15, 2010 and ending on July 15, 2010. The "*Severance Date*" shall be the Resignation Date provided that this Agreement has not been rescinded by Woods pursuant to Section 1.4 below.

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1.2. *No Continuation of Benefits.* The Company shall not continue to provide any welfare plan benefits ("*Severance Benefits*") currently being provided to Woods. Woods acknowledges and agrees that she shall not be entitled to vacation pay during the Severance Period and vacation pay for the period prior to the Resignation Date shall be dealt with solely as set forth in Section 1.1 above.

1.3. *Medical Insurance/COBRA.* Woods shall have the right to purchase personal group medical continuation coverage pursuant to her rights under the COBRA statute and regulations after the Resignation Date.

1.4. *Right to Review.* Woods may rescind this Agreement by giving IsoRay written notice of her desire to rescind within seven (7) days. If Woods does not rescind this Agreement within seven (7) days of signing it, this Agreement will become irrevocable. This Agreement will not be effective until that period has expired. Woods understands the significance and consequences of this Agreement, and acknowledges that it is voluntary and has not been given as a result of any coercion. In the event Woods rescinds this Agreement and IsoRay has theretofore made any Severance Pay, then Woods shall immediately repay IsoRay for the cost of such Severance Pay.

1.5. *Option Exercise Term Extension.* Notwithstanding anything contained in the Company's option plan or the applicable option agreements with Woods to the contrary, the exercise term of the options to purchase 100,000 shares of IsoRay common stock owned by Woods, with a grant date of July 1, 2009 (the "*Vesting Options*"), shall fully vest effective as of the Resignation Date regardless of their original terms of vesting as originally set forth in the applicable option agreement and shall not be reduced as a result of Woods ceasing to be employed by the Company. All options held by Woods as of the Resignation Date other than the Vesting Options shall be cancelled and terminate in accordance with the terms of the Company's various stock option plans pursuant to which said options were granted.

1.6. *Consulting Services.* The parties agree that Woods shall provide consulting services at no additional charge to the Company of up to a maximum of ten (10) hours per month for the six month period ending on August 1, 2010, which services will include assisting the Board of Directors with any transition in management. Services may be rendered out of Woods' home office and are not required on the premises of IsoRay. Woods shall have all airfare, hotel, travel and other reasonable out of pocket expenses reimbursed by IsoRay if IsoRay requires travel to its corporate offices or otherwise.

## ARTICLE II

### REPRESENTATIONS AND WARRANTIES

Woods hereby represents and warrants to the Company as of the date of this Agreement that:

2.1. *Agreement Binding.* Neither the execution, delivery, nor performance of this Agreement by Woods will, with or without the giving of notice or the passage of time, or both, conflict with or result in a default, right to accelerate or loss of rights under, or result in the creation of, any lien, charge or encumbrance or any franchise, mortgage, deed of trust, lease, license, agreement, understanding, law, rule or regulation, or any order, judgment or decree to which Woods is a party or by which Woods may be bound or affected.

2.2. *Full Settlement.* Woods agrees that upon the performance of this Agreement, no further compensation is due or owing to Woods from the Company whether in the form of cash or non-cash compensation with respect to any relationship between the Company and Woods.

2.3. *Return of Property.* As of the Resignation Date, Woods has returned to the Company all Company-owned property, specifically including all keys and card key badges to company buildings or property, all company-owned equipment, and all company documents and papers, including but not limited to trade secrets or confidential company information. The parties acknowledge that Woods shall be provided with access to Company email and documents on the Company's servers as necessary to fulfill her consulting duties as set forth in Section 1.6 above.

## ARTICLE III

### COVENANTS

3.1. (a) *Woods Release.* Woods and her heirs, executors, successors, predecessors, assigns, present and former partners, principals, employees, agents, attorneys, and all other persons acting on behalf of the aforementioned parties (the "*Woods Parties*") hereby release and forever discharge the Company and its successors, assigns, affiliates, subsidiaries, divisions, present and former officers, directors, employees, shareholders, agents, attorneys, and all other persons acting on behalf of the aforementioned parties (the "*Company Parties*") from any and all claims, debts, demands, suits, actions and causes of action of whatsoever kind and nature, whether in law or in equity, known or unknown that Woods or the Woods Parties may now have, at any time prior hereto ever had, or hereafter may have or could assert against the Company or the Company Parties for, upon or by reason of any matter, cause or thing whatsoever arising out of, set forth in, or connected with the employment of or services rendered by Woods. Woods acknowledges and agrees that she does not claim or have any interest in any patents, copyrights or any other intellectual property rights relating to the Company's products, marketing materials, documentation or other assets, and that any such rights have vested in the Company as works for hire to the extent permitted by applicable law or have been assigned to the Company. This paragraph shall not affect Woods's rights as a shareholder of the Company.

(b) *Company Release.* The Company and the Company Parties hereby release and forever discharge Woods from any and all claims, debts, demands, suits, actions and causes of action of whatsoever kind and nature, whether in law or in equity, known or unknown that the Company or the Company Parties may now have, at any time prior hereto ever had, or hereafter may have or could assert against Woods for, upon or by reason of any matter, cause or thing whatsoever arising out of, set forth in, or connected with the employment of or services rendered by Woods.

3.2. *Antidiscrimination Release.* Woods hereby releases and forever discharges the Company and the Company Parties from any and all claims, demands, debts, suits, actions, causes of action of whatever kind and nature, in law or in equity known or unknown, that Woods may now have or at any time hereto ever had, or hereafter may have or could assert against the Company for, upon or by reason of any matter, cause or thing whatsoever arising out of, set forth in or in connection with Woods's employment by the Company, including but not limited to claims under the Age Discrimination in Employment Act, as modified by the Older Workers Benefit Protection Act (or any similar applicable state or federal laws).

3.3. *No Release of Obligations Contained in this Agreement.* The Company and Woods hereby each acknowledge and agree that nothing contained in this Agreement shall release or discharge any of them from rights, duties and obligations contained in or assumed under this Agreement.

3.4. *Covenant Not to Sue.* Woods and the Woods Parties hereby agree and covenant not to sue the Company or the Company Parties for any and all claims, counterclaims, crossclaims, set-offs, debts, actions for contribution or indemnity, demands or any action whatsoever, in law or in equity, which Woods may now have, at any time prior hereto ever had or hereafter may have or could assert against the Company or the Company Parties for, upon or by reason of any matter, cause or thing whatsoever arising out of, set forth in or connected with the employment of or services rendered by Woods or any dealings between the Company or the Company Parties and Woods or the Woods Parties. This paragraph shall not affect Woods's rights as a shareholder of the Company. The Company and the Company Parties hereby agree and covenant not to sue Woods or the Woods Parties for any and all claims, counterclaims, crossclaims, set-offs, debts, actions for contribution or indemnity, demands or any action whatsoever, in law or in equity, which the Company may now have, at any time prior hereto ever had or hereafter may have or could assert against Woods or the Woods Parties for, upon or by reason of any matter, cause or thing whatsoever arising out of, set forth in or connected with the employment of or services rendered by Woods or any dealings between the Company or the Company Parties and Woods or the Woods Parties.

3.5. *Confidentiality; Covenant Not to Compete; Non-Solicitation.* Woods acknowledges and agrees that as partial consideration for the Severance Pay to be provided hereunder, she shall be subject to the following covenants following execution of this Agreement:

(a) *Covenant Not to Compete.* Woods shall not engage in any business or perform any service, directly or indirectly, or have any interest, whether as a proprietor, partner, employee, investor, principal, agent, consultant, director or officer, in any enterprise which manufactures Cesium-131, Iodine-125 or Palladium-103 used in the treatment of prostate, head and neck, or lung cancers, ocular melanoma, or any other treatment applications that the Company is considering as of the Effective Date, for a period of twelve months (12) months after the Effective Date. Nothing in this Section 3.5(a) shall be deemed to prohibit Woods from purchasing less than five percent (5%) of the outstanding shares of any corporation whose shares are traded on a national exchange and which, at the time of purchase, is not engaged in competition with the Company. In the event Woods desires to accept an employment position which would otherwise violate the restrictive covenant set forth in this Section 3.5(a), the Company agrees to consider waiving such covenant, in its sole discretion, subject to getting a written summary from Woods describing the proposed position, the proposed employer and its business and any other reasonable information requested by the Company.

If any court shall determine that the duration or geographical limit of the foregoing restriction is unenforceable, it is the intention of the parties that the foregoing restriction shall not be terminated but shall be deemed amended to the extent required to render it valid and enforceable, such amendment to apply only with respect to the operation of this Section 3.5(a) in the jurisdiction of the court that has made the adjudication.

(b) *Confidential Information.* Woods acknowledges that she has had and will have access to trade secrets and confidential business information of the Company throughout the term of her service to the Company and that any such trade secret or confidential information, regardless of whether Woods alone or with others developed any such trade secret or confidential information, shall be and shall remain the property of the Company. After the Effective Date, Woods shall not, either voluntarily or involuntarily, on either her own account, as a member of a firm, or on behalf of another employer or otherwise, directly or indirectly use or reveal to any person, partnership, corporation or association any trade secret or confidential information of the Company, its parents, subsidiaries, or affiliates. Such trade secrets shall include, but shall not be limited to, business plans, marketing plans or programs, financial information, forecasts, compensation arrangements, contracts (whether leases, financing arrangements, or other contracts), customer lists, and business opportunities. The term "trade secrets" shall not include information generally available to the public or a governmental agency except such term "trade secrets" shall include information provided to the Securities and Exchange Commission or other governmental agency on a confidential basis. Woods will not make available to any person, partnership, limited liability company, corporation or association, or retain after termination of employment, any Company policy manuals, contracts or other written materials.

(c) *Non-Disparagement.* So long as Woods owns any shares of the Company's common or preferred stock, or has options or warrants to acquire shares of the Company's common or preferred stock, and for a period of twelve (12) months following date on which Woods ceases to own any equity interest in the Company (the "*Non-Disparagement Period*"), Woods and her affiliates (including Woods's trust beneficiaries, representatives, agents, attorneys, dependents, spouse, administrators, executors, heirs, assigns, predecessors and successors-in-interest) shall not provide oral or written information or disparage or in any manner cause harmful remarks or comments to be disseminated to any third parties regarding the business, aptitude, skills, practices, procedures, operations, methods, or any other subject which may have a detrimental impact on the future business prospects or extant business relationships of the Company or any officers or directors of the Company, except as required by law if called as a witness in any court proceedings. During the Non-Disparagement Period, the Company and its officers and directors shall not provide oral or written information or disparage or in any manner cause harmful remarks or comments to be disseminated to any third parties regarding the business, aptitude, skills, practices, procedures, operations, methods, or any other subject which may have a detrimental impact on the future business prospects or extant business relationships of Woods, except as required by law if called as a witness in any court proceedings

(d) *Non-Solicitation.* Woods will not, during the twelve (12) month period following the Effective Date for any reason, directly or indirectly solicit for employment, or employ any person who, at the time of such solicitation or employment, is employed by the Company or its affiliates or was employed by the Company or its affiliates during the twelve (12) month period prior to the solicitation or employment or induce or attempt to induce any person to terminate his or her employment with the Company or its affiliates.

(e) *Injunctive Relief.* Woods acknowledges that the restrictions contained in this Section 3.5 are a reasonable and necessary protection of the immediate interests of the Company and that any violation of these restrictions would cause substantial injury to the Company. In the event of a breach or threatened breach by Woods of these restrictions, the Company shall be entitled to apply to any court of competent jurisdiction for an injunction restraining Woods from such breach or threatened breach; *provided, however*, that the right to apply for an injunction shall not be construed as prohibiting the Company from pursuing any other available remedies for such breach or threatened breach.

3.6. *Release Not Applicable to Future Services.* Notwithstanding any language to the contrary contained herein, in the event that the parties engage in future contracts for services, including but not limited to the services contemplated pursuant to Section 1.6, any and all claims, debts, demands, suits, actions, and courses of action arising from such services, occurring after the execution date shall not be released and discharged by Sections 3.1 or 3.2 of this Agreement and the covenant not to sue contained in Section 3.4 shall not apply to such future services.

## ARTICLE IV

### MISCELLANEOUS

4.1. *Confidentiality.* Woods will not discuss or disclose this Agreement or any of its terms with or to any unaffiliated person or entity not signing this Agreement, except as required by law, and will not voluntarily cooperate or aid any claimant adverse to the Company. Woods may disclose the terms of this agreement only with her legal and financial advisors.

4.2. *Effectiveness.* Woods acknowledges that she has freely, knowingly and voluntarily entered into this Agreement. This Agreement shall be null and void and of no further legal force or effect unless executed by all parties by 5 p.m. (PDT) on January 12, 2010.

4.3. *Separate Counsel.* The parties stipulate and agree that, in entering into this Agreement, they have relied upon the advice and representation of counsel and other advisors selected by them, the Company having urged Woods to rely on separate counsel chosen by her. Woods particularly stipulates and agrees that she was afforded time within which to consider the terms of this Agreement, with her legal counsel if she so chose, and that she and her counsel and advisors have not received and are not relying on any representations or warranty from any person or entity retained or employed by the Company in connection with Woods' entry into this Agreement. Woods acknowledges that Keller Rohrback, P.L.C. and its attorneys serve as counsel for the Company and do not represent Woods.

4.4. *Waiver of Breach or Default.* No waiver of any breach or default hereunder shall be considered valid unless in writing and signed by the party giving such waiver, and no such waiver shall be deemed a waiver of any subsequent breach or default of the same or similar nature.

4.5. *Successors and Assigns.* This Agreement shall be binding upon and inure to the benefit of each party hereto and its successors and assigns.

4.6. *Paragraph Headings.* The paragraph headings contained herein are for the purposes of convenience only and are not intended to define or limit the contents of said paragraphs.

4.7. *Counterparts.* This Agreement may be executed in one or more counterparts, all of which taken together shall be deemed one original.

4.8. *Applicable Law.* This Agreement and all amendments thereof shall be governed by and construed in accordance with the laws of the State of Washington applicable to contracts made and to be performed therein and the parties herein are subject to the personal jurisdiction of the courts in and for the State of Washington, with venue to lie in Benton County, and to the extent permitted by law, are also subject to the personal jurisdiction of the Federal District Court, with venue to lie in the Eastern District of Washington.

4.9. *Severability.* Wherever there is any conflict between any provisions of this Agreement and any statute, law, regulation or judicial precedent, the latter shall prevail, but in such event the provisions of this Agreement thus affected shall be curtailed and limited only to the extent necessary to bring it within the requirement of the law. In the event that any part, section, paragraph or clause of this Agreement shall be held by a court of proper jurisdiction to be invalid or unenforceable, the entire Agreement shall not fail on account thereof, but the balance of the Agreement shall continue in full force and effect unless such construction would clearly be contrary to the intention of the parties or would result in unconscionable injustice.

4.10. *Litigation.* In the event of any litigation between the parties arising out of this Agreement, the prevailing party shall be entitled to recover its court costs and reasonable attorneys' fees.

4.11. *Entire Agreement and Modification.* This Agreement represents the entire agreement by, between and among any of the parties and may be modified only by a duly authorized writing, executed by the Company and Woods or their respective heirs, successors or assigns. This Agreement terminates and supersedes the Executive Employment Agreement between the parties dated as of January 1, 2007.

4.12 *No Admission of Liability; Reference Letter; Mutual Statement to Public.* This Agreement shall not be considered as evidence of any violation of any statute or law, or any wrongdoing or liability on the part of the Company or its directors, officers, agents, trustees, employees, employee-spouses, successors and assigns agents or employees. In partial consideration for Woods entering into this Agreement and the promises and covenants contained herein, IsoRay shall provide to Woods a mutually agreed upon letter of reference. Woods and IsoRay will also negotiate, in good faith and no later than the Resignation Date, a mutually satisfactory statement to be provided to prospective employers seeking an employment reference, and separate mutually satisfactory statements to be provided by the Company to the public in the event of any inquiries concerning Woods and to be provided by Woods to the public in the event of any inquiries concerning the Company.

**[Signature Page Follows]**

**Medical:**

ISORAY MEDICAL, INC., a Delaware corporation

By /s/ Dwight Babcock  
Dwight Babcock, CEO

Date: 1/12/10

**IsoRay:**

ISORAY, INC., a Minnesota corporation

By /s/ Dwight Babcock  
Dwight Babcock, CEO

Date: 1/12/10

ISORAY INTERNATIONAL LLC, a Washington limited liability company

By /s/ Dwight Babcock  
Dwight Babcock, CEO

Date: 1/12/10

**Lori Woods:**

/s/ Lori Woods  
Lori Woods

Date: 1/12/10

**CERTIFICATION**

I, Dwight Babcock, certify that:

1. I have reviewed this quarterly report on Form 10-Q of IsoRay, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2010

/s/ Dwight Babcock  
Dwight Babcock  
Chief Executive Officer

**CERTIFICATION**

I, Brien L. Ragle, certify that:

1. I have reviewed this quarterly report on Form 10-Q of IsoRay, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2010

/s/ Brien L. Ragle

*Brien L. Ragle*

*Principal Financial and Accounting Officer*

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**Exhibit 32**

**Section 1350 Certifications**

Pursuant to 18 U.S.C. § 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, each of the undersigned officers of IsoRay, Inc., a Minnesota corporation (the "Company"), hereby certify that:

To my knowledge, the Quarterly Report on Form 10-Q of the Company for the quarterly period ended March 31, 2010 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: May 10, 2010

/s/ Dwight Babcock

DWIGHT BABCOCK

CHIEF EXECUTIVE OFFICER

(Principal Executive Officer)

Dated: May 10, 2010

/s/ Brien Ragle

BRIEN RAGLE

CONTROLLER

(Principal Financial and Accounting Officer)

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