AETHLON MEDICAL INC
Form 10-Q
November 18, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from _____to_____

COMMISSION FILE NUMBER 000-21846

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

| NEVADA | 13-3632859 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

8910 UNIVERSITY CENTER LANE, SUITE 660, SAN DIEGO, CA 92122

(Address of principal executive offices) (Zip Code)

(858) 459-7800
(Registrant's telephone number, including area code)

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

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 (ss.232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x NO o

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

| | |
|---|---|
| Large accelerated filer o | Accelerated filer o |
| Non-accelerated filer o | Smaller reporting company x |
| (Do not check if a 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 o NO x

As of November 15, 2011, the registrant had outstanding 108,471,606 shares of common stock, $.001 par value.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AETHLON MEDICAL, INC. AND SUBSIDIARY
(A Development Stage Company)
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2011 (Unaudited) | March 31, 2011 |
|---|---|---|
| ASSETS | | |
| Current assets | | |
| Cash | $ 45,579 | $ 15,704 |
| Deferred financing costs | 110,193 | 157,732 |
| Note receivable | -- | 200,000 |
| Interest receivable | -- | 7,096 |
| Prepaid expenses and other current assets | 18,413 | 29,711 |
| Total current assets | 174,185 | 410,243 |
| | | |
| Property and equipment, net | 4,329 | 7,785 |
| Patents and patents pending, net | 135,399 | 139,981 |
| Deposits | 9,210 | 9,210 |
| Total assets | $ 323,123 | $ 567,219 |
| | | |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| | | |
| Current Liabilities | | |
| Accounts payable | $ 410,655 | $ 308,413 |
| Due to related parties | 617,570 | 617,570 |
| Notes payable | 594,796 | 190,000 |
| Convertible notes payable, net of discounts | 2,335,044 | 2,181,852 |
| Derivative liabilities | 1,341,726 | 2,002,896 |
| Accrued liquidated damages | 437,800 | 437,800 |
| Other current liabilities | 924,521 | 804,386 |
| Total current liabilities | 6,662,112 | 6,542,917 |
| | | |
| Commitments and Contingencies (Note 12) | | |
| | | |
| Stockholders' Deficit | | |
| Common stock, par value $0.001 per share; 250,000,000 shares authorized as of September 30, 2011 and March 31, 2011; 100,995,917 and 77,467,361 shares issued and outstanding as of September 30, 2011 and March 31, 2011, respectively | 100,998 | 77,469 |
| Additional paid-in capital | 45,071,336 | 42,418,778 |
| Deficit accumulated during development stage | (51,511,323) | (48,471,945) |
| Total stockholders’ deficit | (6,338,989) | (5,975,698) |
| Total liabilities and stockholders' deficit | $ 323,123 | $ 567,219 |

See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY
(A Development Stage Company)
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
For the Three and Six Month Periods Ended September 30, 2011 and 2010 and
For the Period January 31, 1984 (Inception) Through September 30, 2011
(Unaudited)

| | Three Months Ended September 30, 2011 | Three Months Ended September 30, 2010 | Six Months Ended September 30, 2011 | Six Months Ended September 30, 2010 | January 31, 1984 (Inception) through September 30, 2011 |
|---|---|---|---|---|---|
| REVENUES | | | | | |
| Grant income | $ – | $ – | $ – | $ – | $ 1,424,012 |
| Subcontract income | – | – | – | – | 73,746 |
| Sale of research and development | – | – | – | – | 35,810 |
| | – | – | – | – | 1,533,568 |
| OPERATING EXPENSES | | | | | |
| Professional fees | 242,001 | 323,417 | 610,194 | 502,333 | 10,602,836 |
| Payroll, consulting and related services | 515,622 | 933,475 | 1,065,555 | 1,816,078 | 16,352,268 |
| General and administrative | 125,334 | 152,787 | 239,687 | 253,575 | 7,182,607 |
| Impairment | – | – | – | – | 1,313,253 |
| Total operating expenses | 882,957 | 1,409,679 | 1,915,436 | 2,571,986 | 35,450,964 |
| OPERATING LOSS | (882,957) | (1,409,679) | (1,915,436) | (2,571,986) | (33,917,396) |
| OTHER EXPENSE (INCOME) | | | | | |
| Loss on extinguishment of debt | -- | – | -- | 2,226,924 | 6,606,225 |
| Loss on settlement of accrued interest and damages | – | – | -- | 68,703 | 410,687 |
| (Gain)/loss on change in fair value of derivative liability | (1,029,675) | (1,125,755) | (1,521,502) | (1,668,877) | (6,158,379) |
| Interest and other debt expenses | 600,226 | 2,165,952 | 2,286,140 | 2,752,119 | 16,156,563 |
| Interest income | (31) | (8,183) | (882) | (13,897) | (47,718) |
| Other | -- | 300,000 | 360,185 | 300,000 | 626,549 |
| Total other expense (income) | (429,480) | 1,332,014 | 1,123,941 | 3,664,972 | 17,593,927 |
| NET LOSS | $ (453,477) | $ (2,741,693) | $ (3,039,377) | $ (6,236,958) | $ (51,511,323) |
| BASIC AND DILUTED LOSS PER COMMON SHARE | $ (0.00) | $ (0.04) | $ (0.03) | $ (0.09) | |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING – BASIC AND DILUTED | 99,702,921 | 68,659,443 | 93,772,418 | 66,527,900 | |

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY
(A Development Stage Company)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Three and Six Month Periods Ended September 30, 2011 and 2010 and
For the Period January 31, 1984 (Inception) Through September 30, 2011
(Unaudited)

| | Six Months Ended September 30, 2011 | Six Months Ended September 30, 2010 | January 31, 1984 (Inception) Through September 30, 2011 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Net loss | $ (3,039,377) | $ (6,236,958) | $ (51,511,323) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Depreciation and amortization | 9,773 | 9,383 | 1,087,752 |
| Amortization of deferred consulting fees | -- | -- | 109,000 |
| Loss on settlement of accrued interest and damages | -- | 68,703 | 1,037,951 |
| Valuation allowance on note receivable | | 300,000 | -- |
| Gain on sale of property and equipment | -- | -- | (13,065) |
| Gain on settlement of debt | -- | -- | (131,175) |
| Loss on settlement of accrued legal liabilities | -- | -- | 142,245 |
| Stock based compensation | 448,062 | 1,298,168 | 4,497,801 |
| Legal fees paid through the issuance of convertible debt | -- | -- | 63,412 |
| Fair market value of common shares donated to research institute | -- | -- | 25,000 |
| Loss on debt extinguishment | -- | 2,226,924 | 5,978,865 |
| Fair market value of warrants issued in connection with accounts payable and debt | -- | -- | 2,715,736 |
| Fair market value of conditional warrants that subsequently were issued | -- | -- | 106,201 |
| Non cash interest expense | 538,736 | 1,675,693 | 1,791,425 |
| Liquidated damages | -- | -- | 685,800 |
| Fair market value of common stock, warrants and options issued for services | 249,878 | 382,217 | 5,594,577 |
| Change in fair value of derivative liabilities | (1,521,502) | (1,668,877) | (6,282,598) |
| Termination fees paid through the issuance of notes payable | 360,186 | -- | 360,186 |
| Patent license fees paid in stock | -- | -- | 45,250 |
| Amortization of debt discount and deferred financing costs | 1,522,486 | 848,199 | 8,175,951 |
| Impairment of intangible assets | -- | -- | 1,313,253 |
| Deferred compensation forgiven | -- | -- | 217,223 |
| Changes in operating assets and liabilities: | | | |
| Prepaid expenses and other assets | 18,394 | 20,021 | 221,008 |
| Accounts payable and other current liabilities | 377,318 | 113,278 | 3,351,132 |
| Due to related parties | -- | -- | 1,268,383 |
| Net cash used in operating activities | (1,036,046) | (963,249) | (19,150,010) |

| | | | |
|---|---|---|---|
| Cash flows from investing activities: | | | |
| Purchases of property and equipment | (1,735) | (875) | (294,194) |
| Additions to patents and patents pending | -- | (5,873) | (407,235) |
| Proceeds from the sale of property and equipment | -- | -- | 17,065 |
| Cash of acquired company | -- | -- | 10,728 |
| Net cash used in investing activities | (1,735) | (6,748) | (673,636) |
| | | | |
| Cash flows from financing activities: | | | |
| Proceeds from the issuance of notes payable | -- | -- | 2,350,000 |
| Principal repayments of notes payable | (5,000) | -- | (381,500) |
| Net proceeds from the issuance of convertible notes payable | 872,656 | 1,105,000 | 6,523,921 |
| Proceeds from the issuance of common stock | -- | 283,600 | 10,753,535 |
| Proceeds from collection of secured notes receivable | 200,000 | -- | 700,000 |
| Professional fees related to registration statement | -- | -- | (76,731) |
| Net cash provided by financing activities | 1,067,656 | 1,388,600 | 19,869,225 |
| | | | |
| Net (decrease) increase in cash | 29,875 | 418,603 | 45,579 |
| | | | |
| Cash at beginning of period | 15,704 | 67,950 | -- |
| | | | |
| Cash at end of period | $ 45,579 | $ 486,553 | $ 45,579 |

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY
(A Development Stage Company)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
For the Three and Six Month Periods Ended September 30, 2011 and 2010 and
For the Period January 31, 1984 (Inception) Through September 30, 2011
(Unaudited)

| | Six Months Ended September 30, 2011 | Six Months Ended September 30, 2010 | January 31, 1984 (Inception) Through September 30, 2011 |
|---|---|---|---|
| Supplemental disclosures of cash flow information: | | | |
| Cash paid during the period for: | | | |
| Interest | $ -- | $ -- | $ 266,975 |
| Income taxes | $ -- | $ -- | $ 13,346 |
| Supplemental disclosures of non-cash investing and financing activities: | | | |
| Derivative liabilities recorded in connection with embedded conversion feature of convertible notes and/or warrants | -- | 3,200,961 | -- |
| Debt and accrued interest converted to common stock | 1,472,611 | 385,508 | 7,824,434 |
| Deferred financing costs recorded in connection with debt restructuring | -- | 80,054 | 80,054 |
| Debt discount recorded in connection with beneficial conversion feature of convertible notes and related warrants | 827,130 | 75,000 | 4,000,059 |
| Issuance of convertible notes in settlement of accrued legal fees | -- | 35,469 | 35,469 |
| Reclassification of accounts payable to notes payable | -- | -- | 24,001 |
| Reclassification of warrant derivative liability into equity | 247,608 | -- | 666,800 |
| Additional convertible debt issued in debt restructuring | -- | -- | 573,211 |
| Stock option exercise by director for accrued expenses | -- | -- | 95,000 |
| Issuance of common stock, warrants and options in settlement of accrued expenses and due to related parties | -- | -- | 1,003,273 |
| | -- | -- | 118,000 |

| | | | |
|---|---|---|---|
| Issuance of common stock in connection with acquisition of patent pending and with license agreements | | | |
| Net assets of entities acquired in exchange for equity securities | -- | -- | 1,597,867 |
| Debt placement fees paid by issuance of warrants | -- | -- | 856,845 |
| Common stock issued for prepaid expenses | -- | -- | 161,537 |

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY
(A Development Stage Company)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
September 30, 2011

NOTE 1. NATURE OF BUSINESS AND BASIS OF PRESENTATION

Aethlon Medical, Inc. ("Aethlon", the "Company", "we" or "us") is a medical device company focused on creating innovative devices that address unmet medical needs in cancer, infectious disease and other life-threatening conditions. At the core of our developments is the Aethlon ADAPT™ (Adaptive Dialysis-Like Affinity Platform Technology) system, a medical device platform that converges single or multiple affinity drug agents with advanced plasma membrane technology to create therapeutic filtration devices that selectively remove harmful particles from the entire circulatory system without loss of essential blood components. Approval to embark on human trials is still needed to reach commercial viability of the Hemopurifier® and approval by the U.S. Food and Drug Administration ("FDA"). Successful outcomes of human trials will be required by the regulatory agencies of certain foreign countries where we intend to sell this device. We have submitted an Investigational Device Exemption ("IDE") to the FDA. Some of our patents may expire before FDA approval or approval in a foreign country, if any, is obtained. However, we believe that certain patent applications and/or other patents issued more recently will help protect the proprietary nature of the Hemopurifier(R) treatment technology.

Aethlon is classified as a development stage enterprise under accounting principles generally accepted in the United States of America ("GAAP"), and has not generated revenues from its planned principal operations.

Our common stock is quoted on the Over-the-Counter Bulletin Board administered by the Financial Industry Regulatory Authority ("OTCBB") under the symbol "AEMD.OB."

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-Q and applicable sections of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments necessary to make the financial statements not misleading have been included. The condensed consolidated balance sheet as of March 31, 2011 was derived from our audited financial statements. Operating results for the six months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending March 31, 2012. For further information, refer to our Annual Report on Form 10-K for the year ended March 31, 2011, which includes audited financial statements and footnotes as of March 31, 2011 and for the years ended March 31, 2011 and 2010 and the period January 31, 1984 (Inception) through March 31, 2011.

NOTE 2. LIQUIDITY

The accompanying unaudited condensed consolidated financial statements have been prepared on a going concern basis, which contemplates, among other things, the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have experienced continuing losses from operations, are in default on certain debt, have negative working capital of approximately $6,488,000, recurring losses from operations and a deficit accumulated during the development stage of approximately $51,511,000 at September 30, 2011, which among other matters, raises significant doubt about our ability to continue as a going concern. We have not generated significant revenue or any profit from operations since inception. A significant amount of additional capital will be necessary to advance the development of our products to the point at which they may become commercially viable. Our current financial resources are insufficient to fund our capital expenditures, working capital and other cash requirements (consisting of accounts payable, accrued liabilities, amounts due to related parties and amounts due under various

notes payable) for the fiscal year ending March 31, 2012 ("fiscal 2012"). Therefore we will be required to seek additional funds through debt and/or equity financing arrangements to finance our current and long-term operations.

On September 30, 2011, we entered into a contract with the United States of America, issued by SPAWAR Systems Center Pacific, pursuant to a contract award from the Defense Advanced Research Projects Agency (“DARPA”). Under the DARPA award, we have been engaged to develop a therapeutic device to reduce the incidence of sepsis, a fatal bloodstream infection that often results in the death of combat-injured soldiers. The award from DARPA is a fixed-price contract with potential total payments to us of $6,794,389 over the course of five years, including payments of up to $1,975,047 in the first year. Fixed price contracts require the achievement of multiple, incremental milestones to receive the full award during each year of the contract. Under the terms of the contract, we will perform certain incremental work towards the achievement of specific milestones against which we will invoice the government for fixed payment amounts. Assuming all such work is performed according to the contract terms, we will receive up to $1,975,047 of contract payments during the first twelve months of the contract with the aggregate payment amounts in years two through five varying between approximately $775,000 and $1.6 million. The milestones are comprised of planning, engineering and clinical targets, the achievement of which in some cases will require the participation and contribution of third party participants under the contract. There can be no assurance that we alone, or with third party participants, will meet such milestones to the satisfaction of the government and in compliance with the terms of the contract or that we will be paid the full amount of the contract revenues during any year of the contract term. We commenced work under the contract in October 2011.

Subsequent to September 30, 2011, we received the initial payment under the DARPA contract in the amount of $358,284.

Also subsequent to September 30, 2011, we raised an additional $175,000 in net proceeds from a bridge financing that may yield up to $1 million in total gross proceeds through the private placement of convertible promissory notes and corresponding warrants with accredited investors (see Note 14 - Subsequent Events above for more details of this offering) per the terms of the subscription agreement. There can be no assuance that the entire bridge financing will be subscribed by investors.

In addition to the funds received to date under the DARPA contract and the first closing under the bridge financing and beyond additional fundings under the DARPA contract, we will require additional capital as our current financial resources, while improved, remain insufficient to fund our working capital and other cash requirements for the remainder of our fiscal year ending March 31, 2012. Therefore we will be required to seek additional funds through debt and/or equity financing arrangements to finance our current and long-term operations. We are currently addressing our liquidity needs by exploring investment capital opportunities through the private placement of common stock or issuance of additional debt, including the remaining portion of the bridge financing. We believe that our access to additional capital, together with existing cash resources, will be sufficient to meet our short term liquidity needs for fiscal 2012. However, no assurance can be given that we will receive any funds in connection with our capital raising efforts on terms acceptable to the Company, if at all.

The unaudited condensed consolidated financial statements do not include any adjustments relating to the recoverability of assets that might be necessary should we be unable to continue as a going concern.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The summary of our significant accounting policies presented below is designed to assist the reader in understanding our condensed consolidated financial statements. Such financial statements and related notes are the representations of our management, who are responsible for their integrity and objectivity. These accounting policies conform to GAAP in all material respects, and have been consistently applied in preparing the accompanying condensed consolidated financial statements.

PRINCIPLES OF CONSOLIDATION

The accompanying condensed consolidated financial statements include the accounts of Aethlon Medical, Inc. and its wholly-owned subsidiary, Exosome Sciences, Inc., (collectively hereinafter referred to as the "Company" or "Aethlon"). There exist no material intercompany transactions or balances between Aethlon and its subsidiary.

LOSS PER COMMON SHARE

Basic loss per common share is computed by dividing net loss available to common stockholders by the weighted average number of common shares assumed to be outstanding during the period of computation. Diluted loss per common share is computed similar to basic loss per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued, and if the additional common shares were dilutive. As we had net losses for all periods presented, basic and diluted loss per common share are the same, since additional potential common shares have been excluded as their effect would be antidilutive.

The potentially dilutive common shares outstanding for the quarters ended September 30, 2011 and 2010, which include common shares underlying outstanding stock options, warrants and convertible debentures, were 110,033,840

and 78,287,876, respectively. At September 30, 2011, we had 936,546 shares available under our 2003 and 2010 S-8 Stock Plans.

PATENTS

We capitalize the cost of patents, some of which were acquired, and amortize such costs over the estimated useful life, upon issuance of the patent.

RESEARCH AND DEVELOPMENT EXPENSES

We incurred research and development expenses during the three and six month periods ended September 30, 2011 and 2010, which are included in various operating expense line items in the accompanying condensed consolidated statements of operations. Our research and development expenses in those periods were as follows:

| | September 30, 2011 | September 30, 2010 |
|---|---|---|
| Three months ended | $ 118,585 | $ 101,635 |
| Six months ended | $ 321,354 | $ 193,358 |

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of the Company's cash, accounts payable and accrued liabilities approximates their estimated fair values due to the short-term maturities of these financial instruments. The fair value of certain convertible notes and related warrants at September 30, 2011 is $1,341,726 based upon a third party valuation report that we commissioned. Warrants classified as derivative liabilities are reported at their estimated fair value, with changes in fair value being reported in current period results of operations.

Management has concluded that it is not practical to determine the estimated fair value of amounts due to related parties because the transactions cannot be assumed to have been consummated at arm's length, the terms are not deemed to be market terms, there are no quoted values available for these instruments, and an independent valuation would not be practicable due to the lack of data regarding similar instruments, if any, and the associated potential costs.

EQUITY INSTRUMENTS FOR SERVICES PROVIDED BY OTHER THAN EMPLOYEES

We account for transactions involving goods and services provided by third parties where we issue equity instruments as part of the total consideration using the fair value of the consideration received (i.e., the value of the goods or services) or the fair value of the equity instruments issued, whichever is more reliably measurable.

In transactions, when the value of the goods and/or services is not readily determinable and (1) the fair value of the equity instruments is more reliably measurable and (2) the counterparty receives equity instruments in full or partial settlement of the transactions, we use the following methodology:

(a) For transactions where goods have already been delivered or services rendered, the equity instruments are issued on or about the date the performance is complete (and valued on the date of issuance).
(b) For transactions where the instruments are issued on a fully vested, non-forfeitable basis, the equity instruments are valued on or about the date of the contract.
(c) For any transactions not meeting the criteria in (a) or (b) above, we re-measure the consideration at each reporting date based on its then current stock value.

IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the cost basis of a long-lived asset is greater than the projected future undiscounted net cash flows from such asset (excluding interest), an impairment loss is recognized. Impairment losses are calculated as the difference between the cost basis of an asset and its estimated fair value. We believe that no impairment occurred at or during the six months ended September 30, 2011 and 2010.

BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

The convertible feature of certain notes payable provides for a rate of conversion that is below the market value of our common stock. Such feature is normally characterized as a "Beneficial Conversion Feature" ("BCF"). We record the estimated fair value of the BCF, when applicable, in the condensed consolidated financial statements as a discount from the face amount of the notes. Such discounts are accreted to interest expense over the term of the notes using the effective interest method.

DERIVATIVE LIABILITIES AND CLASSIFICATION

We evaluate free-standing derivative instruments (or embedded derivatives) to properly classify such instruments within equity or as liabilities in our financial statements. Our policy is to settle instruments indexed to our common shares on a first-in-first-out basis.