MEDISTEM LABORATORIES, INC.
Form 10QSB
August 11, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended: June 30, 2006

Or

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

For the transition period from ____________ to _____________

Commission File Number: 333-100137

MEDISTEM LABORATORIES, INC.
(Exact name of small business issuer as specified in its charter)

Nevada (State or other jurisdiction of incorporation or organization)	86-1047317 (I.R.S. Employer Identification No.)
2027 E. Cedar St. Tempe, AZ (Address of principal executive offices)	85281 (Zip Code)

(954) 727-3662
(Issuer s telephone number)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act.) Yes o No x

Number of shares outstanding of common stock, as of the latest practicable date: 130,680,693 as of August 1, 2006

Transitional Small Business Disclosure Format (Check one): Yes o No x

---

MEDISTEM LABORATORIES, INC.

(A Development Stage Company)

Table of Contents

Page

PART I FINANCIAL INFORMATION	**3**
Item 1. Financial Statements:	**4**
Consolidated Balance Sheets	**4**
Consolidated Statements of Operations	**5**
Consolidated Statements of Cash Flows	**6**
Notes	**7**
Item 2. Management s Discussion and Analysis or Plan of Operation	**14**
Item 3. Controls and Procedures	**18**
PART II OTHER INFORMATION	**19**
Item 1. Legal Proceedings	**19**
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	**19**
Item 3. Defaults Upon Senior Securities	**20**
Item 4. Submission of Matters to a Vote of Security Holders	**20**
Item 5. Other Information	**20**
Item 6. Exhibits	**20**
SIGNATURES	**21**

PART I FINANCIAL INFORMATION

Forward-Looking Information

The statements contained in this Quarterly Report on Form 10-QSB that are not historical fact are forward-looking statements (as such term is defined in the Private Securities Litigation Reform Act of 1995), within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The forward-looking statements contained herein are based on current expectations that involve a number of risks and uncertainties. These statements can be identified by the use of forward-looking terminology such as believes, expects, may, will, should, intend, plan, could, is likely, or anticipates, or the negative thereof or other variations comparable terminology, or by discussions of strategy that involve risks and uncertainties. The Company wishes to caution the reader that these forward-looking statements that are not historical facts are only predictions. No assurances can be given that the future results indicated, whether expressed or implied, will be achieved. While sometimes presented with numerical specificity, these projections and other forward-looking statements are based upon a variety of assumptions relating to the business of the Company, which, although considered reasonable by the Company, may not be realized. Because of the number and range of assumptions underlying the Company s projections and forward-looking statements, many of which are subject to significant uncertainties and contingencies that are beyond the reasonable control of the Company, some of the assumptions inevitably will not materialize, and unanticipated events and circumstances may occur subsequent to the date of this report. These forward-looking statements are based on current expectations and the Company assumes no obligation to update this information. Therefore, the actual experience of the Company and the results achieved during the period covered by any particular projections or forward-looking statements may differ substantially from those projected. Consequently, the inclusion of projections and other forward-looking statements should not be regarded as a representation by the Company or any other person that these estimates and projections will be realized, and actual results may vary materially. There can be no assurance that any of these expectations will be realized or that any of the forward-looking statements contained herein will prove to be accurate.

Item 1. Financial Statements.

Medistem Laboratories, Inc.

(a Development Stage Company)

Consolidated Balance Sheets

	June 30, 2006 (unaudited)	December 31, 2005
Assets		
Cash and equivalents	$ 1,595,861	$ 410,613
Short-term investments	20,000	20,000
Other current assets	17,436	
Total current assets	1,633,297	430,613
Property and equipment, net	405,255	170,731
Intangible assets	3,566	3,566
Total assets	$ 2,042,118	$ 604,910
Liabilities and Stockholders Equity		
Accounts payable	$ 20,604	$ 10,942
Accrued expenses	30,651	
Deferred revenue	13,943	
Total current liabilities	65,198	10,942
Total liabilities	65,198	10,942
Common stock, $0.0001 par value, 300,000,000 shares authorized, 130,680,693 and 125,593,602 shares issued and outstanding	13,068	12,559
Series A convertible preferred stock, $0.0001 par value, no stated interest rate, dividend or liquidation preference, 200,000,000 shares authorized, 5,142,858 and no shares issued and outstanding	514	
Paid-in capital	8,377,173	3,510,430
Deferred compensation	(1,146,082)	
Accumulated deficit	(5,267,753)	(2,929,021)
Total stockholders equity	1,976,920	593,968
Total liabilities and stockholders equity	$ 2,042,118	$ 604,910

See accompanying notes to unaudited consolidated financial statements.

4

Medistem Laboratories, Inc.

(a Development Stage Company)

Consolidated Statements of Operations

(unaudited)

	Three Months Ended June 30, 2006	**2005**	**Six Months Ended June 30, 2006**	**2005**	**Inception to June 30, 2006**
Net revenues	$	$	$	$	$
Operating expenses:					
Professional fees	473,167		1,056,540		3,820,155
Stock-based compensation - officers and directors	256,930		857,294		858,794
General and administrative	224,644	1,134	397,021	3,597	515,117
General and administrative - related party			25,000		75,346
Total operating expenses	954,741	1,134	2,335,855	3,597	5,269,412
Operating loss	(954,741)	(1,134)	(2,335,855)	(3,597)	(5,269,412)
Other income (expense):					
Interest income	11,314		15,394		17,017
Other income (expense)	(18,271)		(18,271)	3,060	(15,211)
Total other income (expense)	(6,957)		(2,877)	3,060	1,806
Loss before income tax provision	(961,698)	(1,134)	(2,338,732)	(537)	(5,267,606)
Income tax provision				(45)	(147)
Net loss	$(961,698)	$(1,134)	$(2,338,732)	$(582)	$(5,267,753)
Net loss per share:					
Basic	$(0.01)	$(0.00)	$(0.02)	$(0.00)	
Diluted	$(0.01)	$(0.00)	$(0.02)	$(0.00)	
Weighted average common shares outstanding:					
Basic	130,033,962	81,600,000	128,845,449	81,600,000	
Diluted	130,033,962	81,600,000	128,845,449	81,600,000	

See accompanying notes to unaudited consolidated financial statements.

Medistem Laboratories, Inc.

(a Development Stage Company)

Consolidated Statements of Cash Flows

(Unaudited)

	Six Months Ended June 30, 2006	**2005**	**Inception to June 30, 2006**
Cash flows from operating activities:			
Net loss	$(2,338,732)	$(582)	$(5,267,753)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	25,239		30,035
Stock-based compensation	1,624,280		4,253,203
Changes in assets and liabilities:			
Other current assets	(17,436)		(17,436)
Accounts payable	9,662		20,604
Accrued expenses	30,651		30,651
Deferred revenue	13,943		13,943
Net cash used in operating activities	(652,393)	(582)	(936,753)
Cash flows from investing activities:			
Purchase of short-term investment			(20,000)
Purchases of equipment	(259,763)		(435,290)
Net cash used in investing activities	(259,763)		(455,290)
Cash flows from financing activities:			
Repurchase of common stock			(31,500)
Receipt of contributed capital			43,000
Proceeds from sale of preferred stock and warrants	1,519,539		1,519,539
Proceeds from sale of common stock	577,865		1,456,865
Net cash provided by financing activities	2,097,404		2,987,904
Change in cash and equivalents	1,185,248	(582)	1,595,861
Cash and equivalents, beginning of year	410,613	696	
Cash and equivalents, end of year	$1,595,861	$114	$1,595,861
Supplemental Disclosures:			
Cash paid for interest	$	$	$
Cash paid for income taxes	$	$	$

See accompanying notes to unaudited consolidated financial statements.

6

Note 1: Background and Basis of Presentation

Medistem Laboratories, Inc. (the Company) was organized December 5, 2001 (Date of Inception) under the laws of the State of Nevada, as SGC Holdings, Inc. In accordance with Statement of Financial Accounting Standards (SFAS) No. 7, the Company is considered a development stage company. On November 4, 2005, SGC Holdings, Inc. filed with the Secretary of State of Nevada an amendment to its Articles of Incorporation to effect a corporate name change to Medistem Laboratories, Inc. and its OTC Bulletin Board trading symbol was changed to MDSM .

The Company s primary business is the licensing of intellectual property related to the clinical application of adult stem cell treatments on a fee-for-service basis.

The accompanying consolidated financial statements include the accounts of the Company and any entities determined to be variable interest entities for which the Company is the primary beneficiary. All intercompany accounts and transactions have been eliminated.

On February 23, 2006, the Company entered into a licensing agreement with Institute for Cellular Medicine (ICM), a Costa Rican corporation that is controlled by the Company s Chief Executive Officer. Under the terms of this agreement, which was effective retroactively to October 12, 2005, the Company granted a license to ICM relating to the use of certain intellectual property of the Company and has agreed to fund all necessary operating expenses in exchange for the receipt of 85% of the net revenues generated by ICM from the use of the intellectual property. See Note 4.

The Company has determined that ICM meets the definition of a variable interest entity (VIE) through its existing capitalization and license agreement with the Company, and that the Company is the primary beneficiary of this VIE, as both terms are defined in Financial Accounting Standards Board (FASB) Interpretation No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB No. 41* as amended December 2003 (FIN No. 46). As required by FIN No. 46, ICM has been consolidated in the accompanying consolidated financial statements for all periods presented. ICM was formed for the purpose of developing and operating a medical clinic in Costa Rica. As of June 30, 2006, ICM had assets of $177,825 and liabilities of $281,000 (consisting of amounts owed to Medistem Laboratories, Inc.). For the three and six months ended June 30, 2006, ICM had no revenues and expenses of $98,574 and $164,383, respectively.

The accompanying unaudited financial statements as of June 30, 2006 and for the three and six months ended June 30, 2006 and 2005, respectively, have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for audited financial statements. In the opinion of the Company s management, the interim information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results for the interim periods. The footnote disclosures related to the interim financial information included herein are also unaudited. Such financial information should be read in conjunction with the consolidated financial statements and related notes thereto as of December 31, 2005 and for the year then ended included in the Company s annual report on Form 10-KSB for the fiscal year ended December 31, 2005.

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Significant estimates and assumptions have been used by management in conjunction with the estimated useful lives of fixed assets and the computation of stock-based compensation. Actual results could differ from these estimates. Certain

prior period amounts have been revised to conform to the current period presentation. These changes had no impact on previously reported net income or stockholders equity.

Note 2: Going Concern and Operations

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. As shown in the accompanying financial statements, the Company has incurred a net loss of

$5,267,753 for the period from December 5, 2001 (inception) to June 30, 2006, and has no sales. The future of the Company is dependent upon its ability to obtain financing and upon future profitable operations from the development of its new business opportunities. Management may need to raise additional funds through a combination of equity and/or debt offerings, although no assurance can be given that such financing will be available or, if available, will be on terms acceptable to the Company. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts of and classification of liabilities that might be necessary in the event the Company cannot continue in existence.

These conditions raise substantial doubt about the Company s ability to continue as a going concern. These financial statements do not include any adjustments that might arise from this uncertainty.

Note 3: Balance Sheet Information

Property and equipment consisted of the following:

	June 30, 2006	**December 31, 2005**
Lab equipment	$331,703	$108,139
Leasehold improvements	60,583	43,500
Furniture and fixtures	24,004	4,888
Vehicles	19,000	19,000
	$435,290	$175,527
Less: accumulated depreciation	(30,035)	(4,796)
	$405,255	$170,731

Included in lab equipment is a $158,406 deposit on lab equipment that has yet to be placed in service, which deposit represents 50% of the cost of such equipment.

Depreciation expense was $14,175 and $0 for the three months ended June 30, 2006 and 2005, respectively, and $25,239 and $0 for the six months ended June 30, 2006 and 2005, respectively.

Note 4: Acquisitions and Business Combinations

On October 12, 2005, the Company entered into a Contribution Agreement with Neil Riordan, whereby Mr. Riordan transferred all of his right, title and interest to certain intellectual property in exchange for 100,223,602 shares of the Company s common stock. The agreement provides the Company with proprietary, licensing, patent, marketing and other intellectual property rights related to the intellectual property. As this transaction was an exchange between entities under common control, the intangible assets were carried forward at their original capitalized

costs.

Note 5: Stockholders Equity

On February 10, 2006, the Company authorized 200,000,000 shares of Series A Convertible Preferred Stock, par value $0.0001 per share, and amended its articles of incorporation accordingly. These shares are convertible into one share of common stock, have no stated interest rate, no dividend preference and liquidation preference of $0.35 per share.

During the quarterly period ended March 31, 2006, the Company completed the following private placements of equity securities:

The Company received aggregate proceeds totaling $1,285,000 (net of offering expenses of $215,000) in exchange for: (i) 4,285,715 shares of Series A Convertible Preferred Stock with a stated value of $0.35; (ii) 4,285,715 Class A Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at a per share exercise price of $0.50; and (iii) 4,285,715 Class B Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at per share exercise price of $0.75. The Company also granted an aggregate of 4,285,715 Unit Purchase Warrants (entitling the holder thereof to purchase for $0.35 one Unit comprised of one Series A Convertible Preferred Stock, one Class A Common Stock Purchase Warrant and one Class B Common Stock Purchase Warrant).

The Company granted registration rights for the Series A Convertible Preferred Stock, Class A Common Stock Purchase Warrants and Class B Common Stock Purchase Warrants as described in Note 9. In accordance with the provisions of EITF 00-19 and EITF 05-04, the Company has determined that these securities meet the criteria for classification as stockholders equity in the accompanying consolidated balance sheet at June 30, 2006.

The Company issued an aggregate of 760,000 shares of common stock in exchange for cash totaling $190,000. All shares were issued at $0.25 per share

On February 1, 2006, the Company issued 3,000,000 restricted shares of common stock as compensation to two employees of ICM. The Company valued these grants, which vest on February 1, 2008, at $1,440,000 based on the fair market value of the Company s common stock on the date of grant and is recognizing the expense on a straight line basis over the service period.

During the quarterly period ended June 30, 2006, the Company completed the following private placements of equity securities:

In exchange for $300,000 the Company issued (i) 857,143 shares of Series A Convertible Preferred Stock with a stated value of $0.35; (ii) 857,143 Class A Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at a per share exercise price of $0.50; and (iii) 857,143 Class B Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at per share exercise price of $0.75. The Company also granted an aggregate of 857,143 Unit Purchase Warrants (entitling the holder thereof to purchase for $0.35 one Unit comprised of one Series A Convertible Preferred Stock, one Class A Common Stock Purchase Warrant and one Class B Common Stock Purchase Warrant). Under an agreement with the purchasers of the Company s securities during the period ended March 31, 2006, the purchaser during the period ended June 30, 2006, became a party to the prior Securities Purchase Agreement and related documentation. These agreements were previously filed by the Company as exhibits to its quarterly report of Form 10-QSB for the quarter ended March 31, 2006.

The Company granted registration rights for the Series A Convertible Preferred Stock, Class A Common Stock Purchase Warrants and Class B Common Stock Purchase Warrants as described in Note 9. In accordance with the provisions of EITF 00-19 and EITF 05-04, the Company has determined that these securities meet the criteria for classification as stockholders equity in the accompanying consolidated balance sheets. The Company also incurred offering costs of $65,461 that have been reflected as a reduction in stockholder s equity in the accompanying balance sheet.

The Company issued an aggregate of 1,327,091 shares of common stock in a private placement in exchange for cash totaling $464,500, of which $50,000 was received in the quarter ended March 31, 2006. All shares were issued at $0.35 per share. In connection with this transaction, the Company incurred offering costs of $60,385 that have been reflected as a reduction in stockholder s equity in the accompanying balance sheet. During the second quarter of 2006, the Company also paid an additional $16,250 of offering costs related to prior issuances of common stock that have been reflected as a reduction in stockholders equity in the accompanying balance sheet.

Note 6: Stock Options and Warrants

Effective April 21, 2005, the Financial Accounting Standards Board (FASB) issued SFAS 123(R), which is a revision of SFAS 123. SFAS 123(R) supersedes APB 25 and amends Statement of Accounting Standards No. 95, Statement of Cash Flows . Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS123(R) will require all share-based payments to employees, including grants of employee stock options, to be recognized in the Company s Statement of Operations based on their fair values. Pro forma disclosures will no longer be an alternative. The Company adopted the provisions of SFAS 123(R) in the first quarter of 2006. As the Company had no outstanding stock options to employees at December 31, 2005, the initial adoption of SFAS 123(R) had no impact to the Company.

On February 1, 2006, the Company issued an aggregate of 9,850,000 stock options to various employees, directors and consultants. All options were issued with an exercise price of $0.50, expire in ten years (or earlier in the event of termination) and are subject to the following vesting schedule:

1,500,000 vested immediately;

3,850,000 vested on May 1, 2006; and

1,500,000 vest annually on February 1st, 2007, 2008 and 2009

The aggregate fair value of such stock options totaled $2,093,380 based on the Black-Scholes option pricing model using the following estimates: 4% risk free rate, 43% volatility, and expected lives ranging from 5 to 6.5 years. An aggregate of 7,500,000 shares underlying the stock options granted were Incentive Stock Options as defined by the Internal Revenue Code. The Company is expensing all stock options on a straight line basis over their respective vesting periods. No stock options were granted during the three months ended June 30, 2006.

A summary of stock option transactions follows:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (In-The-Money) Options)
Outstanding at December 31, 2005		$		
Grants	9,850,000	$0.50		
Outstanding at June 30, 2006	9,850,000	$0.50	9.6	$
Exercisable at June 30, 2006	5,250,000	$0.50	9.6	$

The Company has historically granted warrants as stock-based compensation and as part of equity offerings (described in Note 5). The following is a summary of warrant activity:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (In-The-Money Warrants)
Outstanding at December 31, 2005	5,000,000	$0.25		
Grants	10,285,716	$0.63		
Outstanding and exerciseable at June 30, 2006	15,285,716	$0.50	4.0	$950,000

The following summarizes the Company s outstanding warrants and their respective exercise prices:

Exercise Price	Number of Shares
$0.25	5,000,000
$0.50	5,142,858
$0.75	5,142,858

Note 7: Net Loss Per Share

Net loss per share is calculated using the weighted average number of shares of common stock outstanding during the period. As the Company incurred a net loss in all periods presented, the following dilutive securities were excluded from the calculation of earnings per share as the effects were anti-dilutive:

	Three and Six Months Ended June 30, 2006	2005
Stock options	9,850,000	
Warrants	15,285,716	
Series A convertible preferred stock	5,142,858	
	30,278,574	

Note 8: Related Party Transactions

License Agreement

On February 23, 2006, the Company entered into a License Agreement with Institute for Cellular Medicine (ICM), a Costa Rica corporation controlled by the Company s Chief Executive Officer. Under the terms of the License Agreement, which was deemed effective retroactively to October 12, 2005, ICM received an exclusive license for the development and commercialization within Costa Rica of any new and useful processes involving infusion quality umbilical cord stem cells for use in the therapeutic treatment of various medical conditions in humans.

In consideration for the rights granted under the License Agreement, Medistem will receive (a) 85% of the net-revenue resulting from ICM s sale of any product derived from or involving infusion quality adult stem cells,

---

and (b) 15% of the gross profits derived from non-stem cell based related activities. In addition, Medistem will retain the rights to any new or useful process, manufacture, compound or composition of matter developed by ICM relating to infusion quality umbilical cord stem cells. The License Agreement terminates five years from the date of the agreement.

During the three months ended March 31, 2006 and 2005, the Company paid $25,000 and $0 to entities controlled by the Company s Chief Executive Officer as reimbursement for research and development expenditures and equipment purchases, respectively. There were no related party transactions during the three months ended June 30, 2006 and 2005.

Of the 9,850,000 stock options granted to employees, directors and officers during the three months ended March 31, 2006 (as indicated in Note 6), 7,500,000 were granted to directors and officers. These awards had an aggregate value of $1,610,850, of which $256,930 and $857,294 were recognized as expense in the three and six months ended June 30, 2006. No stock options were granted to employees, directors and officers during the three months ended June 30, 2006.

Note 9: Commitments and Contingencies

Litigation

The Company is from time to time involved in legal proceedings arising from the normal course of business. As of the date of this report, the Company is not currently involved in any legal proceedings.

Operating Leases

The Company leases office space pursuant to a non-cancelable operating lease agreement. Future minimum lease payments pursuant to the leases as of June 30, 2006 were as follows:

	Years ended December 31:
2006	$ 32,958
2007	65,916
2008	54,930
Thereafter	
	$ 153,804

Rent expense totaled $20,979 and $0 for the three months ended June 30, 2006 and 2005, and $42,072 and $0 for the six months ended June 30, 2006 and 2005, respectively.

Registration Rights

In connection with the issuance of preferred stock and related warrants described in Note 5, the Company and the investors entered into a registration rights agreement pursuant to which the Company agreed to prepare and file a shelf registration statement with the Securities and Exchange Commission Commission covering the resale of the preferred stock and related warrants.

In the event the Company fails to file a registration statement within 60 days or fails to meet specified deadlines with respect to causing this registration statement to be declared effective, the Company must pay partial liquidated damages until such matters are remedied according to the terms of the agreement. Such liquidated damages are payable in cash equal to 1.5% of the aggregate amount of capital paid by each purchaser for the first month and either cash or stock equal to 1.5% per month thereafter, up to a maximum of 18% of aggregate liquidated damages. Interest is assessed on unpaid liquidated damages of 18% per annum.

As of June 30, 2006, the Company had not yet filed a registration statement with respect to these securities and is in violation of the agreement. However, for 1.4 million of the 1.8 million preferred shares outstanding at June 30, 2006, the Company has received a waiver of liquidated damages that would otherwise have been incurred under this agreement through September 15th, 2006. The Company has accrued $18,281 of liquidated damages pertaining to the remaining 0.4 million shares for which a waiver has not been received. These liquidated damages are included in other income (expense) in the accompanying consolidated statement of operations for the three and six months ended June 30, 2006 and are reflected as accrued expenses in the accompanying consolidated balance sheet as of June 30, 2006.

Note 10: Risks and Uncertainties

A substantial portion of the Company s operations are conducted in Costa Rica. The Company s operations are subject to various political, economic, and other risks and uncertainties inherent in the countries in which the Company operates. Among other risks, the Company s operations may be subject to the risks of restrictions on transfer of funds; export duties, quotas and embargoes; domestic and international customs and tariffs; changing taxation policies; foreign exchange restrictions; and political conditions and governmental regulations.

Note 11: Segment Information

Although a portion of the Company s property and equipment is owned by its United States entity, all of the Company s fixed assets are physically located in Costa Rica.

Note 12: Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48 Accounting For Uncertain Tax Positions (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 Accounting for Income Taxes . It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 to its financial position and results of operations.

13

Item 2. Management s Discussion and Analysis or Plan of Operation

The following plan of operation discussion and analysis provides information that management believes is relevant for an assessment and understanding of our plans and financial condition. The following selected financial information is derived from our historical financial statements and should be read in conjunction with such financial statements and notes thereto set forth elsewhere herein and the Forward-Looking Statements explanation included herein. This information should also be read in conjunction with our audited historical consolidated financial statements which are included in our Form 10-KSB for the fiscal year ended December 31, 2005 filed with the Securities and Exchange Commission on March 30, 2006.

Overview

We are a development stage company that is focused on the licensing of intellectual property related to the clinical application of adult stem cells as well as the administration of adult stem cells on a fee-for-services basis. We intend to use our newly acquired intellectual property in the application of non-controversial adult stem cells in certain medical treatments. We intend to use adult stem cells derived from muscle, bone marrow or fat of the patient being treated and adult stem cells generated from full term, healthy placentas and umbilical cords, all of which are deemed to be non-controversial sources of stem cells. We intend to generate revenues by the administration of adult stem cells on a fee-for-services basis.

Our revenue model relies substantially on the assumption that we will be able to successfully develop sources of adult stem cells and other materials and develop offshore clinics for the administration of these stem cells until we are able to obtain approval for such processes in the United States. To be successful, we must, among other things:

Continue to expand our research and development efforts for our products;
Provide desirable products to customers at attractive prices;
Rapidly respond to technological advancements; and
Attract, retain and motivate qualified personnel.

We believe that the continued growth in demand for adult stem-cell products will create markets for the treatment of certain medical conditions such as cerebral palsy, stroke, cardiovascular disease, and orthopedic diseases.

Plan of Operation

On February 23, 2006, we entered into a license agreement with Institute for Cellular Medicine (ICM), a Costa Rican corporation that is controlled by our Chief Executive Officer. Under the terms of this agreement, which was effective retroactively to October 12, 2005, we granted a license to ICM to use certain of our intellectual property and agreed to fund all necessary operating expenses in exchange for (a) 85% of the net-revenue resulting from ICM s sale of any product derived from or involving infusion quality adult stem cells, and (b) 15% of the gross profits derived from non-stem cell based related activities.

ICM has focused its efforts toward developing the processes and infrastructure necessary to begin operations, including developing sources of umbilical stem cells and other materials, developing its clinic in Costa Rica, and locating and hiring appropriate medical and general and administrative personnel. These development activities are nearing completion and ICM is currently awaiting approval from the government of Costa Rica to commence operations.

In addition, we expect to perform significant research and development around adult stem cell research during the course of the next 12 months. We may also enter into significant acquisitions, joint ventures, or intellectual property licensing programs to rapidly increase our access to the latest technology and innovations surrounding the use of adult stem cells in medical treatments, although we do not currently have any agreements in place as of the date of this report.

We do not have any off-balance sheet arrangements as defined in Item 303 of Regulation S-B.

Recent Developments

Stock Issuances

During the second quarter of fiscal 2006, we continued to raise capital through the issuance of preferred and common stock offerings as follows:

In exchange for $300,000 we issued (i) 857,143 shares of Series A Convertible Preferred Stock with a stated value of $0.35; (ii) 857,143 Class A Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at a per share exercise price of $0.50; and (iii) 857,143 Class B Common Stock Purchase Warrants exercisable for common stock for a period of five (5) years from the date of the transaction at per share exercise price of $0.75. The Company also granted an aggregate of 857,143 Unit Purchase Warrants (entitling the holder thereof to purchase for $0.35 one Unit comprised of one Series A Convertible Preferred Stock, one Class A Common Stock Purchase Warrant and one Class B Common Stock Purchase Warrant). In connection with this transaction, we incurred offering costs of $65,461 that have been reflected as a reduction in stockholder s equity in the accompanying balance sheet. Under an agreement with the purchasers of the Company s securities during the period ended March 31, 2006, the purchaser during the period ended June 30, 2006, became a party to the prior Securities Purchase Agreement and related documentation. These agreements were previously filed by us as exhibits to its quarterly report of Form 10-QSB for the quarter ended March 31, 2006.

We issued an aggregate of 1,327,091 shares of common stock in a private placement in exchange for cash totaling $464,500, of which $50,000 was received in the quarter ended March 31, 2006. All shares were issued at $0.35 per share. In connection with this transaction, we incurred offering costs of $60,385 that have been reflected as a reduction in stockholder s equity in the accompanying balance sheet. During the second quarter of 2006, we also paid an additional $16,250 of offering costs related to prior issuances of common stock that have been reflected as a reduction in stockholders equity in the accompanying balance sheet.

In connection with the issuance of preferred stock and related warrants during the first and second quarters of 2006, we and our investors entered into a registration rights agreement pursuant to which we agreed to prepare and file a shelf registration statement with the Securities and Exchange Commission Commission covering the resale of the preferred stock and related warrants.

In the event we fail to file a registration statement within 60 days or fail to meet specified deadlines with respect to causing this registration statement to be declared effective, we must pay partial liquidated damages until such matters are remedied according to the terms of the agreement. Such liquidated damages are payable in cash equal to 1.5% of the aggregate amount of capital paid by each purchaser for the first month and either cash or stock equal to 1.5% per month thereafter, up to a maximum of 18% of aggregate liquidated damages. Interest is assessed on unpaid liquidated damages of 18% per annum.

As of June 30, 2006, we had not yet filed a registration statement with respect to these securities and are in violation of the agreement. However, for 1.4 million of the 1.8 million preferred shares outstanding at June 30, 2006, we have received a waiver of liquidated damages that would otherwise have been incurred under this agreement through September 15th, 2006. The Company has accrued $18,281 of liquidated damages pertaining to the remaining 0.4 million shares for which a waiver has not been received. Such liquidated damages are included in other income (expense) in the accompanying consolidated statement of operations for the three and six months ended June 30, 2006 and are reflected as accrued expenses in the accompanying consolidated balance sheet as of June 30, 2006 included elsewhere in this report.

Hiring of Chief Financial Officer

Effective July 3, 2006, we hired Steven M. Rivers as our Chief Financial Officer. Under Mr. Rivers employment agreement, he will receive an annual base salary of $110,000 and will devote at least 50% of his time to our business and no more than 50% of his time to Rivers & Moorehead, PLLC, an internal controls, accounting and

financial reporting consulting firm he co-founded in 2004. He also received an aggregate of 720,000 stock options, of which the first 33% will vest on the first anniversary of the agreement, the second 33% on the second anniversary of the agreement and the remaining 33% will vest on the third anniversary of the agreement. The exercise price for the options was determined by the closing market price of the common stock on the date of grant. In connection with the employment agreement, we also entered into an Indemnification Agreement which contains provisions that may require us to, among other things: indemnify Mr. Rivers against liabilities that may arise by reason of his status or service as an officer to the fullest extent permitted under Nevada law and Medistem s bylaws and certificate of incorporation and advance Mr. Rivers expenses incurred as a result of any proceeding against him as to which he could be indemnified.

Results of Operations

Revenues. We had no revenues in either the six months ended June 30, 2006 or June 30, 2005 as we are a development stage company that has yet to commence operations.

Professional Fees

	Professional Fees		
	2006	**2005**	**Change**
Three Months Ended June 30,	$473,167	$	$473,167
Six Months Ended June 30,	$1,056,540	$	$1,056,540

Professional fees for the three and six months ended June 30, 2006 include stock based compensation of $347,267 and $766,987, respectively, paid to third-party consultants for medical, laboratory, research and development and investor relations services. Stock-based compensation is based on grant date fair value of awarded options and restricted stock and is recognized on a straight-line basis over the vesting period. The remaining fees include cash payments to attorneys, accountants, laboratory consultants and other third-party service providers. There were no such activities in 2005.

Stock-Based Compensation Officers and Directors

	Stock Based Compensation - Officers and Directors		
	2006	**2005**	**Change**
Three Months Ended June 30,	$256,930	$	$256,930
Six Months Ended June 30,	$857,294	$	$857,294

Stock based compensation in the three and six months ended June 30, 2006 consists of the expensing of stock options issued to officers and directors issued during the first quarter of 2006. Compensation is based on grant date fair value of awarded options and is recognized on a straight-line basis over the vesting period. There were no such grants in 2005

General and Administrative

	General and Administrative		
	2006	**2005**	**Change**
Three Months Ended June 30,	$224,644	$1,134	$223,510
Six Months Ended June 30,	$422,021	$3,597	$418,424

16

General and administrative expense in the three and six months ended June 30, 2006 includes advertising and marketing expenses, and rent, travel and other expenses associated with the development of the Company s laboratory and clinic in Costa Rica. As the Company was largely dormant in 2005, minimal general and administrative expenses were incurred.

Other Income (Expense)

	Other Income (Expense)		
	2006	**2005**	**Change**
Three Months Ended June 30,	$(6,957)	$	$(6,957)
Six Months Ended June 30,	$(2,877)	$3,060	$(5,937)

Other income (expense) in the three and six months ended June 30, 2006 includes expense of $18,271 associated with liquidated damages related to our registration rights agreements previously described, which was partially offset by interest income on cash deposits and short term investments. Other income (expense) was $3,060 in the year ended March 31, 2005, consisting of miscellaneous income items.

Net Loss

	Net Loss		
	2006	**2005**	**Change**
Three Months Ended June 30,	$(961,698)	$(1,134)	$(960,564)
Six Months Ended June 30,	$(2,338,732)	$(582)	$(2,338,150)

Net loss in the three and six months ended June 30, 2006 are due largely to the professional fees, stock-based compensation and general and administrative expenses incurred as described above. There were minimal activities in 2005.

Liquidity and Capital Resources

During the quarter ended June 30, 2006, we incurred $652,393 in operating cash outflows and $259,763 of investing cash outflows, which were financed primarily by proceeds from the sale of equity securities. At June 30, 2006, we had cash and short-term investments totaling $1,615,861, working capital of $1,568,099, liabilities of $65,198 and stockholders equity of $1,976,920.

Sources and Uses of Cash

We require cash to fund the expenditures necessary to develop our offshore clinic, to build our operating infrastructure, and to pay our medical personnel and management team. We expect that we will incur in excess of $1.5 million of expenditures over the next 12 months.

We believe we have raised sufficient capital to finance our operations until we can commence revenue-generating activities. However, delays in the licensing process and other unforeseen events may negatively impact our ability to commence revenue-generating activities and we may need to obtain future sources of financing. Such future sources may include cash from equity offerings, exercise of warrants and stock options and proceeds from debt instruments. There can be no assurance that such equity or borrowings will be available or, if available, will be at rates or prices acceptable to us.

Analysis of Cash Flows

Our operating cash outflows were $652,393 during the six months ended June 30, 2006. These cash flows consisted of payments for legal, professional and consulting expenses, medical supplies, rent and other expenditures necessary to develop our business infrastructure. Investing cash outflows were $259,763 for the six months ended June 30, 2006, consisting of expenditures for medical and laboratory equipment, leasehold improvements and other fixed assets. Financing cash inflows totaled $2,097,404 for the six months ended June 30, 2006 and consisted of proceeds (net of offering expenses) from the issuance of 5,087,091 shares of common stock and the issuance of 5,142,858 shares of preferred stock and warrants to purchase up to 10,285,716 shares of common stock (as well as 5,142,858 unit purchase warrants allowing the purchaser to acquire additional shares of preferred stock and warrants). We had nominal cash flow activity in the three and six months ended March 31, 2005 and June 30, 2005, respectively.

Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections . SFAS No. 154 replaces Accounting Principles Board (APB) No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements and establishes retrospective application as the required method for reporting a change in accounting principle. SFAS No. 154 provides guidance for determining whether retrospective application of a change in accounting principle is impracticable and for reporting a change when retrospective application is impracticable. The reporting of a correction of an error by restating previously issued financial statements is also addressed. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of SFAS No. 154 did not have a material impact on our financial condition or results of operations.

In December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, Share-Based Payment . Under this new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB 25. Instead, companies will be required to account for such transactions using a fair-value method and to recognize the expense over the service period. This new standard also changes the way in which companies account for forfeitures of share-based compensation instruments. SFAS 123R is effective for fiscal years beginning after June 15, 2005 and allows for several alternative transition methods. The adoption of SFAS No. 123R did not have a material effect on our financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48 Accounting For Uncertain Tax Positions (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 Accounting for Income Taxes . It prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact of FIN 48 to its financial position and results of operations.

Inflation and Seasonality

We do not believe that our operations are significantly impacted by inflation. Our business is not seasonal in nature.

Item 3. Controls and Procedures

In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-QSB, the Company s management evaluated, with the participation of the Company s principal executive officer and principal financial officer, the effectiveness of the design and operation of the Company s disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Exchange Act). Based on their evaluation of these disclosure controls and

procedures, the Company s chairman of the board and chief executive officer and the Company s chief financial officer have concluded that the disclosure controls and procedures were effective as of the end of the period covered by this report.

There has been no change in the Company s internal control over financial reporting that occurred during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless how remote.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

As of the date of this report, the Company is not currently involved in any legal proceedings.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On April 7, 2006, the Company consummated a private placement pursuant to the terms of the Securities Purchase Agreement (the Purchase Agreement) entered into with an accredited investor. Under the Purchase Agreement, the Company received gross proceeds of $300,000 in exchange for: (i) 857,143 shares of Series A Convertible Preferred Stock with a stated value of $0.35; (ii) 857,143 Class A Common Stock Purchase Warrants exercisable for a period of five (5) years from the date of the transaction at an exercise price of $0.50; (iii) 857,143 Class B Common Stock Purchase Warrants exercisable for a period of five (5) years from the date of the transaction at an exercise price of $0.75; and (iv) 857,143 Unit Purchase Warrants (entitling the holder thereof to purchase for $0.35 one Unit comprised of one Series A Convertible Preferred Stock, one Class A Common Stock Purchase Warrant, and one Class B Common Stock Purchase Warrant).

In connection with the Purchase Agreement, the Company and the investors entered into a Registration Rights Agreement, dated April 7th, 2006 (the Rights Agreement), pursuant to which the Company agreed to prepare and file a shelf registration statement pursuant to Rule 415 under the Securities Act of 1933, as amended (the Securities Act), covering the resale of: (i) all of the shares of Common Stock issuable upon conversion of the Preferred Stock, (ii) all of the shares underlying the above-referenced Warrants, (iii) any securities issued or issuable upon any stock split, dividend or other distribution recapitalization or similar event with respect to the foregoing, and (iv) any additional shares issuable in connection with any anti-dilution provisions in the Preferred Stock and the Warrants (the Registrable Securities) that were issued pursuant to the Purchase Agreement. The Company must prepare and file the initial shelf registration statement on or prior to the 60th calendar day from the execution of the Registration Rights Agreement. If, during the effectiveness period of a registration statement the number of Registrable Securities at any time exceeds 75% of the number of shares of Common Stock then registered in a registration statement, the Company must file an additional registration statement on or before the 15th calendar day the Company knew or reasonably should have known of such a situation.

In the event the Company: (i) fails to file a registration statement in accordance with the applicable time frame set forth in the preceding paragraph; or (ii) fails to file with the Securities and Exchange Commission (the Commission) a request for acceleration in accordance with Rule 461 of the Securities Act, within five (5) Trading Days of the date of notification by the Commission that a registration statement will not be reviewed or not subject to further review; or (iii) fails to file a pre-effective amendment and otherwise respond in writing to comments made by the Commission regarding a registration statement within ten (10) Trading Days of receipt of such comments or notice from the Commission requiring such pre-effective amendment to make the registration statement effective; or (iv) a registration statement filed or required to be filed is not declared effective by the Commission within the allotted time frame; or (v) an effective registration statement ceases for any reason to remain

effective for fifteen (15) consecutive days or an aggregate of twenty-five (25) days during any twelve (12) month span, then the Company will be in breach and must pay to each holder of Registrable Security an amount in cash, as partial liquidated damages, equal to 1.5% of the aggregate amount of capital paid by each Purchaser pursuant to the Purchase Agreement for any Registrable Securities then held by such Purchaser. The Company must pay to each holder, in either cash or stock, 1.5% per month thereafter until such breaches are cured or until the related securities are eligible for sale under Rule 144.

As of June 30, 2006, the Company had not yet filed a registration statement with respect to these securities and is in violation of the agreement. However, for 1.4 million of the 1.8 million preferred shares outstanding at June 30, 2006, the Company has received a waiver of liquidated damages that would otherwise have been incurred under this agreement through September 15th, 2006. The Company has accrued $18,281 of liquidated damages pertaining to the remaining 0.4 million shares for which a waiver has not been received. These liquidated damages are included in other income (expense) in the accompanying consolidated statement of operations for the three and six months ended June 30, 2006 and are reflected as accrued expenses in the accompanying consolidated balance sheet as of June 30, 2006 included elsewhere in this report.

All of the above described unregistered sales of securities were issued in reliance on the exemption provided under Section 4(2) of the Securities Act of 1933, as amended, and Regulation D thereunder. The proceeds from the private offering will be used for general working capital needs.

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information.

None

Item 6. Exhibits.

Exhibit Number	Description	By Reference from Document
10.9	Employment Agreement, dated effective as of July 3, 2006, between the registrant and Steven M. Rivers 10.10	*
	Indemnification Agreement, dated effective as of July 3, 2006, between the registrant and Steven M. Rivers *	

31.1

Certification of Chief Executive Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934

*

31.2

Certification of Chief Financial Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934

*

32.1

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*

32.2

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*

* Filed herewith

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.

MEDISTEM LABORATORIES, INC.
(Registrant)

Signature	Title	Date
/s/ Neil H. Riordan, Ph.D. Neil H. Riordan, Ph.D.	President and Chief Executive Officer	August 11, 2006
/s/ Steven M. Rivers Steven M. Rivers	Chief Financial Officer	August 11, 2006

Exhibit Number	**Description**	**By Reference from Document**
10.9	Employment Agreement, dated effective as of July 3, 2006, between the registrant and Steven M. Rivers	*
10.10	Indemnification Agreement, dated effective as of July 3, 2006, between the registrant and Steven M. Rivers	*
31.1	Certification of Chief Executive Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934	*
31.2	Certification of Chief Financial Officer Pursuant to Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934	*
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*

* Filed herewith