

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

AETHLON MEDICAL INC  
Form 10QSB  
August 11, 2006

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-QSB

(Mark One)

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

For the quarterly period ended June 30, 2006

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 NUMBER 0-21846

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.)

3030 Bunker Hill St, Ste 4000, San Diego, CA  
-----

92109  
-----

(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  No .

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

The number of shares of common stock of the registrant outstanding as of August  
10, 2006 was 25,815,789.

Transitional Small Business Disclosure Format: Yes  No

Documents incorporated by reference: None

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)	
CONDENSED CONSOLIDATED BALANCE SHEET AT JUNE 30, 2006	1
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005 AND FOR THE PERIOD JANUARY 31, 1984 (INCEPTION) THROUGH JUNE 30, 2006	2
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005 AND FOR THE PERIOD JANUARY 31, 1984 (INCEPTION) THROUGH JUNE 30, 2006	3
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS	4
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION	12
ITEM 3. CONTROLS AND PROCEDURES	15

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS	16
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	16
ITEM 3. DEFAULTS UPON SENIOR SECURITIES	16
ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	16
ITEM 5. OTHER INFORMATION	16
ITEM 6. EXHIBITS	16

PART I.  
FINANCIAL INFORMATION

All references to "us", "we", "our" "Aethlon", "Aethlon Medical", or "the Company" refer to Aethlon Medical, Inc., its predecessors and its subsidiaries.

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
CONDENSED CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

	June 30, 2006
	-----
ASSETS	
Current assets	
Cash	\$ 421,083
Prepaid expenses	19,500
	-----
	440,586
Property and equipment, net	14,153
Patents, net	129,308
Other assets	13,800
	-----
	\$ 597,847
	=====
LIABILITIES AND STOCKHOLDERS' DEFICIT	
Current Liabilities	
Accounts payable and accrued liabilities	\$ 817,803
Due to related parties	1,195,624
Notes payable	502,500
Convertible notes payable, net of discount	207,345
	-----
	2,723,272
Commitments and Contingencies	
Stockholders' Deficit	
Common stock, par value \$0.001 per share; 50,000,000 shares authorized; 25,626,300 shares issued and outstanding	25,626
Additional paid-in capital	20,563,219
Deferred consulting fees	(32,667)
Deficit accumulated during development stage	(22,681,603)
	-----
	(2,125,425)
	-----
	\$ 597,847
	=====

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

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

(UNAUDITED)

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	JANUARY 31, 1984 (INCEPTION) Through June 30, 2006
	-----	-----	-----
REVENUES			
Grant income	\$ --	\$ --	\$ 1,424,012
Subcontract income	--	--	73,746
Sale of research and development	--	--	35,810
	-----	-----	-----
	--	--	1,533,568
EXPENSES			
Professional fees	200,504	386,270	5,438,639
Payroll and related	184,257	179,090	7,430,262
General and administrative	117,071	169,709	4,549,102
Impairment	--	--	1,313,253
	-----	-----	-----
	501,832	735,069	18,731,256
OPERATING LOSS	(501,832)	(735,069)	(17,197,688)
OTHER (INCOME) EXPENSE			
Change in fair value of warrant liability	--	--	360,125
Interest and other debt expense	114,663	66,933	4,986,115
Interest income	--	--	(17,415)
Other	2,661	--	155,090
	-----	-----	-----
	117,324	66,933	5,483,915
	-----	-----	-----
NET LOSS	\$ (619,156)	\$ (802,002)	\$ (22,681,603)
	=====	=====	=====
BASIC AND DILUTED LOSS PER COMMON SHARE	\$ (0.02)	\$ (0.05)	
	=====	=====	
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING	25,567,776	17,701,182	
	=====	=====	

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

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

For the Three Months Ended June 30, 2006 and 2005 and  
For the Period January 31, 1984 (Inception) Through June 30, 2006  
(UNAUDITED)

	Three Months Ended June 30, 2006 -----	Three Months Ended June 30, 2005 -----
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (619,156)	\$ (802,002)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	8,307	5,972
Amortization of deferred consulting fees	12,250	30,000
Gain on sale of property and equipment	--	--
Gain on settlement of debt	--	--
Loss on settlement of accrued legal liabilities	--	--
Stock based compensation	4,750	--
Fair market value of warrants issued in connection with accounts payable and debt	--	--
Fair market value of common stock, warrants and options issued for services	52,466	208,085
Change in fair value of warrant liability	--	--
Intrinsic value of stock options issued to directors	--	--
Amortization of debt discounts	64,980	39,489
Impairment of patents and patents pending	--	--
Impairment of goodwill	--	--
Deferred compensation forgiven	--	--
Changes in operating assets and liabilities:		
Prepaid expenses	12,719	(4,388)
Other assets	3,400	6,225
Accounts payable and accrued liabilities	(44,220)	194,754
Due to related parties	(43,000)	12,688
	-----	-----
Net cash used in operating activities	(547,504)	(309,177)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(7,791)	--
Acquisition of patents	--	--
Proceeds from sale of property and equipment	--	--
Cash of acquired company	--	--
	-----	-----
Net cash used in investing activities	(7,791)	--
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from issuance of notes payable	\$ --	\$ 100,000
Principal payments of notes payable	--	--
Proceeds from issuance of convertible notes payable	--	30,000
Proceeds from issuance of common stock	140,001	177,600
Professional fees related to registration statement	--	--
	-----	-----
Net cash provided by financing activities	140,001	307,600
	-----	-----
<b>NET (DECREASE) INCREASE IN CASH</b>	<b>(415,294)</b>	<b>(1,577)</b>
CASH - beginning of period	836,377	8,625
	-----	-----

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

CASH - end of period	\$ 421,083	\$ 7,048
	=====	=====

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

3

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

NOTE 1. NATURE OF BUSINESS AND BASIS OF PRESENTATION

Aethlon Medical, Inc. (the "Company") is a development stage therapeutic device company focused on expanding the applications of its Hemopurifier (TM) platform technology, which is designed to rapidly reduce the presence of infectious viruses and other toxins from human blood. In this regard, the Company's core focus is the development of pathogens targeted as potential biological warfare agents, HIV/AIDS, and Hepatitis C. In pre-clinical testing, the Company has published that its HIV-Hemopurifier(TM) removed 55% of HIV from human blood in three hours and in excess of 85% of HIV in twelve hours. Additionally, the HIV-Hemopurifier(TM) captured 90% of gp120, a toxic protein that depletes human immune cells, during a one-hour pre-clinical blood study.

The Hemopurifier(TM) is in the development stage and significant research and testing are still needed to reach commercial viability. Any resulting medical device or process will require approval by the U.S. Food and Drug Administration ("FDA"), and the Company has not yet begun efforts to obtain FDA approval and such approval may take several years. Since some of the Company's patents were issued in the 1980's, they are scheduled to expire in the near future. Thus, such patents may expire before FDA approval is obtained.

The Company 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 principal operations.

The Company's common stock is quoted on the Over-the-Counter Bulletin Board of the National Association of Securities Dealers under the symbol "AEMD.OB".

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with GAAP for interim financial information and with the instructions to Form 10-QSB. 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 (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending March 31, 2007. For further information, refer to the Company's Annual Report on Form 10-KSB for the year ended March 31, 2006, which includes audited financial statements and footnotes as of March 31, 2006 and for the

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

years ended March 31, 2005 and 2006.

### NOTE 2. GOING CONCERN AND LIQUIDITY CONSIDERATIONS

The accompanying condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the ordinary course of business. The Company has experienced a loss of \$22,681,603 for the period from January 31, 1984 (Inception) through June 30, 2006. The Company has not generated significant revenue or any profit from operations since inception. A substantial amount of additional capital will be necessary to advance the development of the Company's products to the point at which they may become commercially viable. The Company's current plan of operation is to fund the Company's anticipated increased research and development activities and operations for the near future utilizing its existing financing agreement with Fusion Capital Fund II, LLC ("Fusion Capital").

No assurance can be given that the Company will receive any additional funds under the Company's agreement with Fusion Capital however, the Company anticipates that the Fusion Capital financing agreement will satisfy its cash requirements for the foreseeable future. However, due to market conditions, and to assure availability of funding for operations in the long term, the Company may arrange for additional funding, subject to acceptable terms, during the next twelve months.

The condensed consolidated financial statements do not include any adjustments relating to the recoverability of assets that might be necessary should the Company be unable to continue as a going concern. The Company's continuation as a going concern is dependent upon its ability to obtain additional financing as may be required, and generate revenue and operating cash flow to meet its obligations on a timely basis.

### NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The summary of significant accounting policies of the Company presented below is designed to assist the reader in understanding the Company's condensed consolidated financial statements. Such financial statements and related notes are the representations of Company management, who is 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.

4

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

### NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

#### PRINCIPLES OF CONSOLIDATION

The accompanying condensed consolidated financial statements include the accounts of Aethlon Medical, Inc. and its inactive legal wholly-owned subsidiaries Aethlon, Inc., Hemex, Inc. and Cell Activation, Inc. ("Cell")

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

(collectively hereinafter referred to as the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

### LOSS PER COMMON SHARE

Loss per common share is based on the weighted average number of shares of common stock and common stock equivalents outstanding during the year in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share."

Securities that could potentially dilute basic loss per share (prior to their conversion, exercise or redemption) were not included in the diluted-loss-per-share computation because their effect is anti-dilutive. Had such securities been factored in, an additional 7,133,811 common stock equivalents would have been included in the calculation of earnings per share.

### PATENTS

The Company capitalizes the cost of patents, some of which were acquired, and amortizes such costs over the shorter of the remaining legal life or their estimated economic life, upon issuance of the patent.

### RESEARCH AND DEVELOPMENT EXPENSES

The Company incurred approximately \$177,107 and \$305,692 of research and development expenses during the three months ended June 30, 2006 and 2005, respectively, which are included in operating expenses in the accompanying condensed consolidated statements of operations.

### EQUITY INSTRUMENTS FOR SERVICES PROVIDED BY OTHER THAN EMPLOYEES

The Company follows SFAS No. 123-R (as interpreted by Emerging Issues Task Force ("EITF") Issue No. 96-18, "ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES") ("EITF No. 96-18") to account for transactions involving goods and services provided by third parties where the Company issues equity instruments as part of the total consideration. Pursuant to paragraph 7 of SFAS No. 123-R, the Company accounts for such transactions 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.

The Company applies EITF No. 96-18, in transactions, when the value of the goods and/or services are 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, using 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, the Company re-measures the consideration at each reporting date based on its then current stock value.

### IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

The Company follows SFAS No. 144, "ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF" ("SFAS No. 144") addresses financial accounting and reporting for the impairment or disposal of long-lived



## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

assets. SFAS No. 144 requires that long-lived assets be reviewed 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. SFAS No. 144 also requires companies to separately report discontinued operations and extends that reporting requirement to a component of an entity that either has been disposed of (by sale, abandonment or in a distribution to owners) or is classified as held for sale. Assets to be disposed of are reported at the lower of the carrying amount or the estimated fair value less costs to sell, if any. Management noted no impairment indicators requiring review for impairment at or during the three months ended June 30, 2006.

5

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

### NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

#### BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

The convertible feature of certain notes payable provides for a rate of conversion that is below market value. Such feature is normally characterized as a "beneficial conversion feature" ("BCF"). Pursuant to EITF No. 98-5, "ACCOUNTING FOR CONVERTIBLE SECURITIES WITH BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIO" and EITF Issue No. 00-27, "APPLICATION OF EITF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS," the estimated fair value of the BCF is recorded in the consolidated financial statements as a discount from the face amount of the notes. Such discounts are amortized to interest expense over the term of the notes.

#### DERIVATIVE LIABILITIES

The Company evaluates free-standing instruments (or embedded derivatives) indexed to its common stock to properly classify such instruments within equity or as liabilities in its financial statements, pursuant to the requirements of the EITF No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," EITF No. 01-06, "The Meaning of Indexed to a Company's Own Stock," EITF No. 05-04, "The Effect of a Liquidated Damages Clause on a Freestanding Financial Instrument Subject to EITF No. 00-19," and Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. The Company's policy is to settle instruments indexed to its common shares on a first-in- first-out basis.

The Company accounts for the effects of registration rights and related liquidated damages pursuant to EITF No. 05-04, View C, subject to EITF No. 00-19. Pursuant to EITF No. 05-04, View C, liquidated damages payable in cash or stock are accounted for as a separate derivative, which requires a periodical valuation of its fair value and a corresponding recognition of liabilities associated with such derivative. The Company accounts for certain embedded conversion features and free-standing warrants pursuant to SFAS No. 133 and EITF

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

No. 00-19, which require corresponding recognition of liabilities associated with such derivatives at their fair values and changes in fair values to be charged to earnings.

### CLASSIFICATION OF WARRANT ISSUANCE

In connection with the issuance of its 10% Series A Convertible Promissory Notes, the Company has an obligation to issue warrants upon conversion of the notes, which are convertible at any time at the discretion of the noteholders (see Note 4). The obligation to issue the warrants meets the criteria of an embedded derivative to be bifurcated pursuant to SFAS No. 133, "ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES" ("SFAS No. 133"), as amended. Under this transaction, the Company is obligated to and has registered for resale the common shares underlying the warrants. At June 30, 2006, the Company has sufficient registered shares to settle the exercise of warrants. As a result, at June 30, 2006, the embedded derivative associated with this warrant obligation meets the scope exception of paragraph 11 (a) of SFAS No. 133. If such were not the case, these warrants would need to be classified as a liability. The classification of these warrants will be evaluated at each reporting date.

### STOCK BASED COMPENSATION

Effective April 1, 2006, the Company adopted the provisions of SFAS No. 123-R, "Share-Based Payment," ("SFAS No. 123-R"). SFAS No. 123-R requires employee stock options and rights to purchase shares under stock participation plans to be accounted for under the fair value method and requires the use of an option pricing model for estimating fair value. Accordingly, share-based compensation is measured at the grant date, based on the fair value of the award. The Company previously accounted for awards granted under its equity incentive plan under the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, "ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES," and related interpretations, and provided the required pro forma disclosures prescribed by SFAS No. 123, "ACCOUNTING FOR STOCK BASED COMPENSATION," as amended. The exercise price of options is generally equal to the market price of the Company's common stock (defined as the closing price as quoted on the Over-the-Counter Bulletin Board administered by Nasdaq) on the date of grant. Accordingly, no share-based compensation was recognized in the financial statements for the three months ended June 30, 2005. Under the modified prospective method of adoption for SFAS No. 123-R, the compensation cost recognized by the Company beginning April 1, 2006 includes (a) compensation cost for all equity incentive awards granted prior to, but not yet vested as of April 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all equity incentive awards granted subsequent to April 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123-R.

From time to time, the Company's Board of Directors grants common share purchase options or warrants to selected directors, officers, employees, consultants and advisors in payment of goods or services provided by such persons on a stand-alone basis outside of any of the Company's formal stock plans. The terms of these grants are individually negotiated and generally expire within five years from the grant date.

In August 2000, the Company adopted the 2000 Stock Option Plan ("Stock Option Plan"), which was approved by its stockholders in September 2000. The Stock Option Plan provides for the issuance of up to 500,000 options to purchase shares of common stock. Such options can be incentive options or nonstatutory options, and may be granted to employees, directors and consultants. The Stock Option Plan has limits as to the eligibility of those stockholders who own more

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

than 10% of Company stock, as defined. The options granted pursuant to the Stock Option Plan may have exercise prices of no less than 100% of fair market value of the Company's common stock at the date of grant (incentive options), or no less than 75% of fair market value of such stock at the date of grant (nonstatutory). At June 30, 2006, the Company had granted 47,500 options under the 2000 Stock Option Plan of which 15,000 had been forfeited, with 467,500 available for future issuance. All of these options vested prior to the adoption of FAS 123-R.

6

AETHLON MEDICAL, INC.  
 (A Development Stage Company)  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 June 30, 2006  
 (UNAUDITED)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The effects of share-based compensation resulting from the application of SFAS No. 123-R to options granted outside of the Company's Stock Option Plan resulted in an expense of \$4,750 for the quarter ended June 30, 2006. This expense was recorded as stock compensation included in payroll and related expenses in the accompanying June 30, 2006 condensed consolidated statement of operations. Share-based compensation recognized as a result of the adoption of SFAS No. 123-R as well as pro forma disclosures according to the original provisions of SFAS No. 123 for periods prior to the adoption of SFAS No. 123-R use the Binomial Lattice option pricing model for estimating fair value of options granted.

The following table summarizes the effect of share-based compensation resulting from the application of SFAS No. 123-R to options granted:

	Three Months Ended June 30, 2006
Payroll and related	\$ (4,750) =====
Net share-based compensation effect in net loss from continuing operations	\$ (4,750) =====
Basic and diluted loss per common share	\$ (0.00) =====

In accordance with SFAS No. 123-R, the Company adjusts share-based compensation on a quarterly basis for changes to the estimate of expected award forfeitures based on actual forfeiture experience. The effect of adjusting the forfeiture rate for all expense amortization after March 31, 2006 is recognized in the period the forfeiture estimate is changed. The effect of forfeiture adjustments in the first quarter of fiscal 2007 was insignificant.

Pro forma information required under SFAS No. 123 for periods prior to fiscal 2007 as if the Company had applied the fair value recognition provisions of SFAS No. 123 to options granted under and outside of the Company's equity incentive plans was as follows:

Three Months Ended  
June 30,  
2005  
-----

Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

Net loss as reported	\$ (802,002)
Less: Total stock-based employee compensation expense determined under the Binomial Lattice option pricing model, net of tax	----- --
Pro forma net loss	\$ (802,002) =====
Basic and diluted loss per common share:	
As reported	\$ (0.05) =====
Pro forma	\$ (0.05) =====

Pro forma compensation expense reported in the above table is generally based on the vesting provisions in the related stock option grants. Since the requisite service period for all options granted prior to April 1, 2005 had been completed prior to such date, there is no pro forma compensation expense to disclose for the three months ended June 30, 2005, as reflected in the above table. The following weighted average assumptions were used as applicable in the above tables:

	Three Months Ended June 30	
	2006	2005
	-----	-----
Annual dividends	zero	N/A
Expected volatility	72%	N/A
Risk free interest rate	4.18%	N/A
Expected life	4.7 years	N/A

7

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The expected volatility is based on the historical volatility. The expected life of options granted is based on the "simplified method" described in the SEC's Staff Accounting Bulletin No. 107 due to changes in the vesting terms and contractual life of current option grants compared to the Company's historical grants. Options outstanding that have vested and are expected to vest as of June 30, 2006 are as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value (1)
	-----	-----	-----	-----
-----	-----	-----	-----	-----

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

Vested	7,135,518	\$ 0.39	6.12	\$ --
Expected to vest	1,877,267	0.23	4.60	\$168,954
	-----			-----
Total	9,012,785			\$168,954
	=====			=====

(1) These amounts represent the difference between the exercise price and \$0.32, the closing market price of the Company's common stock on June 30, 2006 as quoted on the Over-the-Counter Bulletin Board under the symbol "AEMD.OB" for all in-the-money options outstanding.

Options outstanding that are expected to vest are net of estimated future forfeitures in accordance with the provisions of SFAS No. 123-R, which are estimated when compensation costs are recognized. Additional information with respect to stock option activity is as follows:

	Outstanding Options			
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
March 31, 2006	467,500	9,012,785	\$ 0.38	\$3,875,498
Grants	--	--	--	
Exercises	--	--	--	
Cancellations	--	--	--	
	-----	-----	-----	-----
June 30, 2006	467,500	9,012,785	\$ 0.38	\$ 168,954
	=====	=====	=====	=====

Options exercisable at:

March 31, 2006	7,135,518	\$ 0.39
June 30, 2006	7,135,518	\$ 0.39

(1) Represents the difference between the exercise price and the March 31, 2006 or June 30, 2006 market price of the Company's common stock, which was \$0.81 and \$0.32, respectively.

### INCOME TAXES

Under SFAS No. 109, "ACCOUNTING FOR INCOME TAXES," deferred tax assets and liabilities are recognized for the future tax consequences attributable to the difference between the consolidated financial statements and their respective tax basis. Deferred income taxes reflect the net tax effects of (a) temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts reported for income tax purposes, and (b) tax credit carryforwards. The Company records a valuation allowance for deferred tax assets when, based on management's best estimate of taxable income (if any) in the foreseeable future, it is more likely than not that some portion of the deferred tax assets may not be realized.

### RECENT ACCOUNTING PRONOUNCEMENTS

In June 2005, the FASB issued SFAS No. 154, "ACCOUNTING CHANGES AND ERROR CORRECTIONS, A REPLACEMENT OF APB OPINION NO. 20 AND SFAS NO. 3." ("SFAS No. 154") The statement applies to all voluntary changes in accounting principles, and changes the requirements for accounting for and reporting of a change in accounting principle. The Company does not believe the adoption of SFAS No. 154

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

will have a material impact on the Company's financial statements.

8

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

In February 2006, the FASB issued SFAS No. 155 entitled "Accounting for Certain Hybrid Financial Instruments," ("SFAS No. 155") an amendment of SFAS No. 133 ("Accounting for Derivative Instruments and Hedging Activities") ("SFAS 133") and SFAS No. 140 ("Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities") ("SFAS 140"). In this context, a hybrid financial instrument refers to certain derivatives embedded in other financial instruments. SFAS No. 155 permits fair value re-measurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation under SFAS No. 133. SFAS No. 155 also establishes a requirement to evaluate interests in securitized financial assets in order to identify interests that are either freestanding derivatives or "hybrids" which contain an embedded derivative requiring bifurcation. In addition, SFAS No. 155 clarifies which interest/principal strips are subject to SFAS No. 133, and provides that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS No. 155 amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative. When SFAS No. 155 is adopted, any difference between the total carrying amount of the components of a bifurcated hybrid financial instrument and the fair value of the combined "hybrid" must be recognized as a cumulative-effect adjustment of beginning deficit/retained earnings.

SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted only as of the beginning of a fiscal year, provided that the entity has not yet issued any annual or interim financial statements for such year. Restatement of prior periods is prohibited. The Company has not determined the impact of SFAS No. 155 on its future consolidated financial statements.

NOTE 4. NOTES PAYABLE

At June 30, 2006, the Company had \$502,500 in principal amount of notes payable outstanding with 12 noteholders.

The Company is currently in default on \$502,500 of amounts owed under various unsecured notes payable and is currently seeking other financing arrangements to retire all past due notes. At June 30, 2006 the Company had accrued interest in the amount of \$290,066 associated with these defaulted notes payable.

At June 30, 2006, the Company had \$1,000,000 in principal amount of convertible notes payable outstanding, net of \$792,655 discount, held by 4 noteholders (the 10% Series A Convertible Notes). The \$792,655 discount is comprised of \$62,780 in unamortized BCF discount and \$729,875 in unamortized discount attributable to the valuation of warrant rights associated with the issuance of the convertible notes.

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

### NOTE 5. EQUITY TRANSACTIONS

In April 2006, the Company issued 3,782 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.79 per share in payment for regulatory affairs consulting services to the Company valued at \$3,000 based on the value of the services.

In April 2006, the Company issued 25,601 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.50 per share in payment for past due rents owed by the Company valued at \$12,801 based on the value of the services.

In April 2006, the Company issued 6,313 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.79 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000 based on the value of the services.

In April 2006, the Company issued 10,000 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.50 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000 based on the value of the services.

In April 2006, the Company issued 14,563 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.29 per share in payment for regulatory affairs consulting services to the Company valued at \$4,165 based on the value of the services.

In April 2006, the Company issued 3,086 shares of restricted common stock at \$0.81 per share in payment for investor relations valued at \$2,500 based on the value of the services.

9

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

### NOTE 5. EQUITY TRANSACTIONS (continued)

During April 2006, the Company issued 209,679 shares of common stock at prices between \$0.57 and \$0.74 per share to Fusion Capital under its \$6,000,000 common stock purchase agreement for net cash proceeds totaling \$140,002. These shares are registered pursuant to the Company's Form SB-2 registration statement effective December 7, 2004.

In April 2006, the Company repaid a \$25,000 15% promissory notes, including accrued interest of \$18,750, through the issuance of 107,759 restricted common shares at \$0.406 per share to an accredited individual investor.

In May 2006, the Company issued 8,532 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.59 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000 based on the value of the services.

In May 2006, the Company issued 5,703 shares of common stock pursuant to the

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.53 per share in payment for regulatory affairs consulting services to the Company valued at \$3,000 based on the value of the services.

In May 2006, the Company issued 4,545 shares of restricted common stock at \$0.55 per share in payment for investor relations valued at \$2,500 based on the value of the services.

In June 2006, the Company issued 8,681 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.58 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000 based on the value of the services.

In June 2006, the Company issued 5,703 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.53 per share in payment for regulatory affairs consulting services to the Company valued at \$3,000 based on the value of the services.

In June 2006, the Company issued 3,363 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consultant Stock Plan at \$0.45 per share in payment for regulatory affairs consulting services to the Company valued at \$1,500 based on the value of the services.

### NOTE 6. COMMITMENTS AND CONTINGENCIES

#### LEGAL MATTERS

From time to time, claims are made against the Company in the ordinary course of business, which could result in litigation. Claims and associated litigation are subject to inherent uncertainties and unfavorable outcomes could occur, such as monetary damages, fines, penalties or injunctions prohibiting the Company from selling one or more products or engaging in other activities. The occurrence of an unfavorable outcome in any specific period could have a material adverse effect on the Company's results of operations for that period or future periods. The Company is not presently a party to any pending or threatened legal proceedings.

#### REGISTRATION RIGHTS AGREEMENT

In January, 2006 the Company registered the common stock for resale underlying the warrants to be issued upon conversion of its 10% Series A Convertible Notes (the "Series A Notes"). Upon the occurrence of certain events, as defined, including if (i) after a registration statement has been declared effective, such registration statement ceases to be effective at any time prior to the end of the effectiveness period without being succeeded with an amendment within 10 business days of such registration elapsing or by subsequent registration statement filed with and declared effective by the SEC (ii) the common stock is delisted or suspended from trading on an exchange, the Company shall pay liquidated damages in cash of 1% of the original principal amount of the Series A Notes. For each month that the event has not been cured, the Company shall pay 1.5 % in cash of the original principal balance of the Series A Notes. If the Company fails to pay liquidated damages timely within seven days, the Company shall be obligated to pay interest thereon at 12% per annum, accruing daily. At the option of the Company, shares may be issued instead of cash for such liquidated damages based upon the conversion price, then in effect. At June 30, 2006, the Company had an effective registration statement covering these obligations. Accordingly, no value was ascribed to the registration rights agreement obligation as the likelihood of an event triggering liquidated damages is deemed to be remote at June 30, 2006. The Company will re-evaluate this obligation at each reporting date in accordance with SFAS No. 133.



## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
June 30, 2006  
(UNAUDITED)

### NOTE 7. SUBSEQUENT EVENTS

In July 2006, the Company issued 8,721 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consulting Stock Plan at \$0.34 per share in payment for regulatory affairs consulting services to the Company valued at \$3,000.

In July 2006, the Company issued 10,684 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consulting Stock Plan at \$0.47 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000.

In July 2006, the Company issued 6,250 shares of restricted common stock at \$0.40 per share in payment for investor relations services to the Company valued at \$2,500.

In July 2006, the Company issued 7,813 shares of restricted common stock at \$0.32 per share in payment for investor relations services to the Company valued at \$2,500.

In July 2006, the Company issued 8,721 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consulting Stock Plan at \$0.34 per share in payment for regulatory affairs consulting services to the Company valued at \$3,000.

In July 2006, the Company issued 132,765 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consulting Stock Plan at \$0.37 per share in payment for regulatory affairs consulting services to the Company valued at \$48,858.

In July 2006, the Company issued 14,535 shares of common stock pursuant to the Company's S-8 registration statement covering the Company's 2003 Consulting Stock Plan at \$0.34 per share in payment for regulatory affairs consulting services to the Company valued at \$5,000.

11

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following discussion of Aethlon Medical's financial condition and results of operations should be read in conjunction with, and is qualified in its entirety by the condensed consolidated financial statements and notes thereto, included in Item 1 in this Quarterly Report on Form 10-QSB. This item contains forward-looking statements that involve risks and uncertainties. Actual results

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

may differ materially from those indicated in such forward-looking statements.

### FORWARD LOOKING STATEMENTS

All statements, other than statements of historical fact, included in this Form 10-QSB are, or may be deemed to be, "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended ("the Securities Act"), and Section 21E of the Exchange Act. Such forward-looking statements involve assumptions, known and unknown risks, uncertainties and other factors which may cause the actual results, performance, or achievements of Aethlon Medical, Inc. ("the Company") to be materially different from any future results, performance, or achievements expressed or implied by such forward looking statements contained in this Form 10-QSB. Such potential risks and uncertainties include, without limitation, completion of the Company's capital-raising activities, FDA approval of the Company's products, other regulations, patent protection of the Company's proprietary technology, product liability exposure, uncertainty of market acceptance, competition, technological change, and other risk factors detailed herein and in other of the Company's filings with the Securities and Exchange Commission. The forward-looking statements are made as of the date of this Form 10-QSB, and the Company assumes no obligation to update the forward-looking statements, or to update the reasons actual results could differ from those projected in such forward-looking statements.

### THE COMPANY

We are a developmental stage medical device company focused on expanding the applications of our Hemopurifier (TM) platform technology which is designed to rapidly reduce the presence of infectious viruses and other toxins from human blood. As such, we focus on developing therapeutic devices to treat acute viral conditions brought on by pathogens targeted as potential biological warfare agents and chronic viral conditions including HIV/AIDS and Hepatitis-C. The Hemopurifier (tm) combines the established scientific technologies of hemodialysis and affinity chromatography as a means to mimic the immune system's response of clearing viruses and toxins from the blood before cell and organ infection can occur. The Hemopurifier (tm) cannot cure these afflictions but can lower viral loads and allow compromised immune systems to overcome otherwise serious or fatal medical conditions.

### WHERE YOU CAN FIND MORE INFORMATION

We are subject to the informational requirements of the Securities Exchange Act and must file reports, proxy statements and other information with the SEC. The reports, information statements and other information we file with the Commission can be inspected and copied at the Commission Public Reference Room, 450 Fifth Street, N.W. Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at (800) SEC-0330. The Commission also maintains a Web site (<http://www.sec.gov>) that contains reports, proxy, and information statements and other information regarding registrants, like us, which file electronically with the Commission. Our headquarters are located at 3030 Bunker Hill Street, Suite 4000, San Diego, California 92109. Our telephone number is 858/459-7800. Our Web site is maintained at <http://www.aethlonmedical.com>.

Our common stock is traded on the OTCBB under the symbol "AEMD.OB".

### RESULTS OF OPERATIONS

THE THREE MONTHS ENDED JUNE 30, 2006 COMPARED TO THE THREE MONTHS ENDED JUNE 30, 2005.

### OPERATING EXPENSES

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

Consolidated operating expenses were \$501,832 for the three months ended June 30, 2006, versus \$735,069 for the comparable period one year ago. This represents an absolute dollar decrease of \$233,237 or approximately 32% as compared to the prior time period. This difference is comprised of reductions in professional fees and general and administrative expenses of approximately \$185,766 and \$52,637, respectively, offset by a slight increase in payroll expense of \$417.

Professional fees decreased by \$185,766 or approximately 48% from the prior period one year ago. The primary reason for this was a decrease in legal expense of \$201,732 and a decrease in public relations expense of \$21,106 offset by a \$33,418 increase in scientific consulting expense and a net \$3,654 increase in all other professional expenses. The significant decrease in legal expense results from the comparatively high legal expense in the period ending June 30, 2005, a result of three factors:

12

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION (continued)

the first was the payment of a previously outstanding legal bill in a negotiated transaction for restricted stock and warrants in the earlier period. The warrants were provided as an inducement to settle the obligation and were valued at approximately \$145,245; secondly, the prior period's 10-KSB filing required significant legal resources, unnecessary in the more recent quarter as the Company had a full-time Chief Financial Officer; and finally, there were additional legal costs incurred in the prior period associated with a Proxy filing and Special Meeting of Stockholders in June 2005.

General and administrative expenses declined \$52,638 or approximately 31% as compared to the prior comparable quarter one year ago. The decrease is attributable to a reduction in research and development supplies of \$67,525 and rent expense of \$14,901 offset by increases in industry conference expense of \$24,721, license expense of \$5,154 and all other general expenses by \$85. Research and development supplies decreased from the prior quarter one year ago because in the prior period the Company incurred expenses related to the completion of its clinical animal studies and had begun to ramp up to begin its Human Safety Trials in India. Rent expense declined during the current quarter as the Company no longer leased facilities required to maintain its clinical animal trials.

#### INTEREST EXPENSE

Interest expense increased \$47,730 or approximately 71%, reflective of the additional interest expense associated with the issuance of the Company's 10% Series A Convertible Notes, none of which were outstanding in the quarter ended June 30, 2005.

#### NET LOSS

We recorded a consolidated net loss of \$619,156 and \$802,002 for the quarters ended June 30, 2006 and 2005, respectively. The decrease in net loss of approximately 23% was primarily attributable to decreased professional fees and general expenses. These were offset somewhat by increased interest expense associated with the issuance of the Company's 10% Series A Convertible Notes in

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

comparison to the prior year quarter.

Basic and diluted loss per common share were (\$0.02) for the three month period ended June 30, 2006 as compared to (\$0.05) for the same period ended June 30, 2005. This decrease in loss per share was attributable to the decrease in net loss as compared to the prior quarter one year ago and the effect of a greater number of common shares outstanding during the current quarter.

### LIQUIDITY AND CAPITAL RESOURCES

To date, the Company has funded its capital requirements for the current operations from net funds received from the public and private sale of debt and equity securities, as well as from the issuance of common stock in exchange for services. The Company's cash position at March 31, 2006 was \$836,377 compared to \$421,083, at June 30, 2006, representing an decrease of \$421,083. During the three months ended June 30, 2006, operating activities used net cash of \$547,504. The Company received \$140,001 from the issuance of common stock and purchased \$7,791 of property and equipment.

A decrease in working capital during the three months in the amount of \$362,023 increased the Company's negative working capital position to (\$2,282,686) at June 30, 2006 as compared to a negative working capital of (\$1,920,663) at March 31, 2006.

The Company's current deficit in working capital requires us to obtain funds in the short-term to be able to continue in business, and in the longer term to fund research and development on products not yet ready for market.

The Company's operations to date have consumed substantial capital without generating revenues, and will continue to require substantial capital funds to conduct necessary research and development and pre-clinical and clinical testing of Hemopurifier(TM) products, and to market any of those products that receive regulatory approval. The Company does not expect to generate revenue from operations for the foreseeable future, and its ability to meet its cash obligations as they become due and payable is expected to depend for at least the next several years on its ability to sell securities, borrow funds or a combination thereof. The Company's future capital requirements will depend upon many factors, including progress with pre-clinical testing and clinical trials, the number and breadth of our programs, the time and costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other proprietary rights, the time and costs involved in obtaining regulatory approvals, competing technological and market developments, and management's ability to establish collaborative arrangements, effect successful commercialization strategies, marketing activities and other arrangements. The Company expects to continue to incur increasing negative cash flows and net losses for the foreseeable future, and presently requires a minimum of \$150,000 per month to sustain operations.

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION (continued)

Management does not believe that inflation has had or is likely to have any material impact on the Company's limited operations.

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

At the date of this filing, we do not have plans to purchase significant amounts of equipment or hire significant numbers of employees prior to successfully raising additional capital.

### PLAN OF OPERATION

The Company's current plan of operation is to fund our anticipated increased research and development activities and operations through the common stock purchase agreement in place with Fusion Capital, whereby Fusion Capital has committed to buy up to an additional \$6,000,000 of our common stock over a 30-month period, that commenced, at our election, after the SEC declared effective a registration statement under Form SB-2 on December 7, 2004 covering such shares. Through June 30, 2006 the Company had received \$1,685,001 and has \$4,314,999 remaining available from this agreement. However, no assurance can be given that we will receive any additional funds under our agreement with Fusion Capital. Based on our projections of additional employees and equipment for operations and to complete research, development and testing associated with our Hemopurifier(TM) products, we anticipate that these funds will satisfy our cash requirements, including this anticipated increase in operations, in excess of the next twelve months. However, due to market conditions, and to assure availability of funding for operations in the long term, we may arrange for additional funding, subject to acceptable terms, during the next twelve months.

The Company is a development stage medical device company that has not yet engaged in significant commercial activities. The primary focus of our resources is the advancement of our proprietary Hemopurifier(TM) platform treatment technology, which is designed to rapidly reduce the presence of infectious viruses and toxins in human blood. Our main focus is to prepare our Hemopurifier(TM) to treat HIV/AIDS, Hepatitis-C and Flu Viruses in human clinical trials. The Company is also working to advance pathogen filtration devices to treat infectious agents that may be used in biological warfare and terrorism.

The Company plans to continue our research and development activities related to our Hemopurifier(TM) platform technology, with particular emphasis on the advancement of our lead product candidates for the treatment of HIV/AIDS, HCV and Flu Viruses. The Company also plans to implement a regulatory strategy for the use of our Hemopurifier(TM) for biodefense treatments in calendar year 2006 pursuant to a recent rule implemented by the FDA for medical countermeasures to weapons of mass destruction. Under this rule, in situations where it is deemed unethical to conduct efficacy studies in humans, a treatment can be reviewed for approval on the basis of efficacy in the most relevant animal species and safety data in humans.

The Company expects to outsource research and development in the next twelve months, as required to support our increased research and development effort that will include expanding our goal beyond treating infectious diseases HIV/AIDS and Hepatitis-C and new applications to combat infectious agents that may be used in biological warfare and terrorism. This will involve designing Hemopurifier(TM) products that can be rapidly deployed by armed forces as wearable post-exposure treatments on the battlefield, as well as dialysis-based treatments for civilian populations. This will entail developing the new treatment device based on the same proprietary Hemopurifier(TM) filtration technology that is utilized in advancing our HIV/AIDS, and Hepatitis-C treatments.

Accordingly, due to this increase in activity during the next twelve months, management anticipates continuing to increase spending on outsourced research and development during this period.

Operations to date have consumed substantial capital without generating

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

revenues, and will continue to require substantial and increasing capital funds to conduct necessary research and development and pre-clinical and clinical testing of our Hemopurifier(TM) products, as well as market any of those products that receive regulatory approval. The Company does not expect to generate revenue from operations for the foreseeable future, and our ability to meet our cash obligations as they become due and payable is expected to depend for at least the next several years on our ability to sell securities, borrow funds or a combination thereof. Future capital requirements will depend upon many factors, including progress with pre-clinical testing and clinical trials, the number and breadth of our clinical programs, the time and costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims and other proprietary rights, the time and costs involved in obtaining regulatory approvals, competing technological and market developments, as well as management's ability to establish collaborative arrangements, effective commercialization, marketing activities and other arrangements. The Company expects to continue to incur increasing negative cash flows and net losses for the foreseeable future.

14

### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION (continued)

#### CRITICAL ACCOUNTING POLICIES

The preparation of condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make a number of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Such estimates and assumptions affect the reported amounts of expenses during the reporting period. On an ongoing basis, the Company evaluates estimates and assumptions based upon historical experience and various other factors and circumstances. Management believes the Company's estimates and assumptions are reasonable in the circumstances; however, actual results may differ from these estimates under different future conditions.

The Company believes that the estimates and assumptions that are most important to the portrayal of the Company's financial condition and results of operations, in that they require the most difficult, subjective or complex judgments, form the basis for the accounting policies deemed to be most critical to us. These critical accounting policies relate to stock purchase warrants issued with notes payable, beneficial conversion feature of convertible notes payable, impairment of intangible assets and long lived assets, stock compensation, classification of warrant obligation, contingencies and litigation. We believe estimates and assumptions related to these critical accounting policies are appropriate under the circumstances; however, should future events or occurrences result in unanticipated consequences, there could be a material impact on the Company's future financial conditions or results of operations.

There have been no changes to the Company's critical accounting policies as disclosed in its Form 10-KSB for the year ended March 31, 2006.

#### OFF BALANCE SHEET ARRANGEMENTS

There are no guarantees, commitments, lease and debt agreements or other agreements that could trigger an adverse change in our credit rating, earnings,

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

cash flows or stock price, including requirements to perform under standby agreements.

### ITEM 3. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this report (the "Evaluation Date"). Based upon that evaluation, the CEO and CFO concluded that, as of June 30, 2006, our disclosure controls and procedures were effective in timely alerting them to the material information relating to us (or our consolidated subsidiaries) required to be included in our periodic filings with the SEC.

#### Changes in Controls and Procedures

There were no significant changes made in our internal controls over financial reporting during the quarter ended June 30, 2006 that have materially affected or are reasonably likely to materially affect these controls. Thus, no corrective actions with regard to significant deficiencies or material weaknesses were necessary.

#### Limitations on the Effectiveness of Internal Control

Our management, including the CEO, does not expect that our disclosure controls and procedures or our internal control over financial reporting will necessarily prevent all fraud and material errors. An internal control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations on all internal control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Aethlon Medical have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, and/or by management override of the control. The design of any system of internal control is also 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. Over time, controls may become inadequate because of changes in circumstances, and/or the degree of compliance with the policies and procedures may deteriorate. Because of the inherent limitations in a cost-effective internal control system, financial reporting misstatements due to error or fraud may occur and not be detected on a timely basis.

## PART II

### OTHER INFORMATION

## Edgar Filing: AETHLON MEDICAL INC - Form 10QSB

### ITEM 1. LEGAL PROCEEDINGS

None

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In April 2006, the Company issued 3,086 shares of restricted common stock at \$0.81 per share in payment for investor relations. The shares were issued without registration under the Securities Act in reliance upon the exemption from registration set forth in Section 4(2).

In April 2006, the Company repaid a \$25,000 15% promissory notes, including accrued interest of \$18,750, through the issuance of 107,759 restricted common shares at \$0.405 per share to an accredited individual investor. The shares were issued without registration under the Securities Act in reliance upon the exemptions from registration set forth in Section 4(2) and Regulation D.

In May 2006, the Company issued 4,545 shares of restricted common stock at \$0.55 per share in payment for investor relations. The shares were issued without registration under the Securities Act in reliance upon the exemption from registration set forth in Section 4(2).

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

As of the date of this report, various promissory and convertible notes payable in the aggregate principal amount of \$502,500 have reached maturity and are past due. The Company is currently seeking other financing arrangements to retire all past due notes. At June 30, 2006, the Company had accrued interest in the amount of \$290,066 associated with these notes and accrued liabilities payable.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

### ITEM 5. OTHER INFORMATION

None

### ITEM 6. EXHIBITS

The following documents are filed as part of this report:

- 31.1 Certification of our Chief Executive Officer and President, pursuant to Securities Exchange Act rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
- 31.2 Certification of our Chief Financial Officer and Chief Accounting Officer, pursuant to Securities Exchange Act rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
- 32.1 Statement of our Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)
- 32.2 Statement of our Chief Financial Officer and Chief Accounting Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350)



SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AETHLON MEDICAL, INC

Date: August 11, 2006

BY: /S/ JAMES A. JOYCE

BY: /S/ JAMES W. DORST

-----  
JAMES A. JOYCE  
CHAIRMAN, PRESIDENT AND  
CHIEF EXECUTIVE OFFICER

-----  
JAMES W. DORST  
CHIEF FINANCIAL OFFICER AND CHIEF  
ACCOUNTING OFFICER

AETHLON MEDICAL, INC.