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AETHLON MEDICAL INC  
Form 424B3  
November 28, 2008

FILED PURSUANT TO RULE 424(B) (3)  
REGISTRATION NO. 333-153702

Prospectus Supplement No. 1 dated November 26, 2008  
(To Prospectus dated October 21, 2008 - File No. 333-153702)

AETHLON MEDICAL, INC.

PROSPECTUS

12,508,082 SHARES OF COMMON STOCK

THIS PROSPECTUS SUPPLEMENT, TOGETHER WITH THE PROSPECTUS LISTED ABOVE, IS REQUIRED TO BE DELIVERED BY CERTAIN HOLDERS OF THE ABOVE-REFERENCED SHARES OR BY THEIR TRANSFEREES, PLEDGES, DONEES OR THEIR SUCCESSORS IN CONNECTION WITH THE OFFER AND SALE OF THE ABOVE-REFERENCED SHARES.

This Prospectus Supplement supplements our prospectus dated October 21, 2008 with the following additions and changes:

1) Update our prospectus dated October 21, 2008 with the attached following document:

a. Financial Information for the quarterly period ended: September 30, 2008.

THE ATTACHED INFORMATION MODIFIES AND SUPERSEDES, IN PART, THE INFORMATION IN THE PROSPECTUS. ANY INFORMATION THAT IS MODIFIED OR SUPERSEDED IN THE PROSPECTUS SHALL NOT BE DEEMED TO CONSTITUTE A PART OF THE PROSPECTUS EXCEPT AS MODIFIED OR SUPERSEDED BY THIS PROSPECTUS SUPPLEMENT.

FINANCIAL INFORMATION FOR THE QUARTERLY PERIOD ENDED:  
SEPTEMBER 30, 2008

Annex A

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

|                | September 30,<br>2008 | March 31,<br>2008 |
|----------------|-----------------------|-------------------|
|                | -----                 | -----             |
|                | (Unaudited)           |                   |
| ASSETS         |                       |                   |
| Current assets |                       |                   |

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|                                           |    |         |    |         |
|-------------------------------------------|----|---------|----|---------|
| Cash                                      | \$ | --      | \$ | 254,691 |
| Deferred financing costs                  |    | 33,223  |    | 71,139  |
| Prepaid expenses and other current assets |    | 3,600   |    | 3,600   |
|                                           |    | -----   |    | -----   |
| Total current assets                      |    | 36,823  |    | 329,430 |
| Property and equipment, net               |    | 4,075   |    | 8,313   |
| Patents and patents pending, net          |    | 142,273 |    | 137,162 |
| Other assets                              |    | 13,200  |    | 13,200  |
|                                           |    | -----   |    | -----   |
| Total assets                              | \$ | 196,371 | \$ | 488,105 |
|                                           |    | =====   |    | =====   |

LIABILITIES AND STOCKHOLDERS' DEFICIT

Current Liabilities

|                                             |    |           |    |           |
|---------------------------------------------|----|-----------|----|-----------|
| Accounts payable and accrued liabilities    | \$ | 424,363   | \$ | 351,261   |
| Due to related parties                      |    | 598,753   |    | 949,063   |
| Notes payable, net of discounts             |    | 1,055,277 |    | 633,611   |
| Convertible notes payable, net of discounts |    | 875,898   |    | 152,530   |
| Warrant obligation                          |    | 369,128   |    | 633,095   |
| Other current liabilities                   |    | 870,923   |    | 1,090,809 |
|                                             |    | -----     |    | -----     |
| Total current liabilities                   |    | 4,194,342 |    | 3,810,369 |

Commitments and Contingencies

Stockholders' Deficit

|                                                                                                                                                                                                         |    |              |    |              |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----|--------------|----|--------------|
| Common stock, par value \$0.001 per share;<br>100,000,000 shares authorized;<br>42,416,568 and 38,991,151 shares issued<br>and outstanding as of September 30, 2008 and<br>March 31, 2008, respectively |    | 42,418       |    | 38,992       |
| Additional paid-in capital                                                                                                                                                                              |    | 30,998,502   |    | 28,866,000   |
| Deficit accumulated during development stage                                                                                                                                                            |    | (35,038,891) |    | (32,227,256) |
|                                                                                                                                                                                                         |    | -----        |    | -----        |
|                                                                                                                                                                                                         |    | (3,997,971)  |    | (3,322,264)  |
|                                                                                                                                                                                                         |    | -----        |    | -----        |
| Total liabilities and stockholders' deficit                                                                                                                                                             | \$ | 196,371      | \$ | 488,105      |
|                                                                                                                                                                                                         |    | =====        |    | =====        |

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

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AETHLON MEDICAL, INC.  
(A Development Stage Company)  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
For the Three and Six Months Ended  
September 30, 2008 and 2007 and  
For the Period January 31, 1984 (Inception) Through September 30, 2008  
(Unaudited)

Three Months      Three Months      Six Months      Six Months

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|                                                                                   | Ended<br>September 30,<br>2008 | Ended<br>September 30,<br>2007 | Ended<br>September 30,<br>2008 | Ended<br>September 30,<br>2007 |
|-----------------------------------------------------------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| <b>REVENUES</b>                                                                   |                                |                                |                                |                                |
| Grant income                                                                      | \$ --                          | \$ --                          | \$ --                          | \$ --                          |
| Subcontract income                                                                | --                             | --                             | --                             | --                             |
| Sale of research and development                                                  | --                             | --                             | --                             | --                             |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
|                                                                                   | --                             | --                             | --                             | --                             |
| <b>EXPENSES</b>                                                                   |                                |                                |                                |                                |
| Professional Fees                                                                 | 282,325                        | 253,671                        | 442,600                        | 441,076                        |
| Payroll and related                                                               | 302,814                        | 300,590                        | 655,577                        | 821,776                        |
| General and administrative                                                        | 147,520                        | 135,767                        | 258,141                        | 298,449                        |
| Impairment                                                                        | --                             | --                             | --                             | --                             |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
|                                                                                   | 732,659                        | 690,028                        | 1,356,318                      | 1,561,301                      |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
| <b>OPERATING LOSS</b>                                                             | <b>(732,659)</b>               | <b>(690,028)</b>               | <b>(1,356,318)</b>             | <b>(1,561,301)</b>             |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
| <b>OTHER EXPENSE (INCOME)</b>                                                     |                                |                                |                                |                                |
| Loss on extinguishment of debt                                                    | --                             | --                             | --                             | --                             |
| Loss on settlement of accrued<br>interest and damages                             | 607,908                        | --                             | 607,908                        | --                             |
| Change in fair value of<br>warrant obligation                                     | (76,275)                       | (492,250)                      | (263,967)                      | (914,025)                      |
| Interest and other debt expenses                                                  | 551,042                        | 75,107                         | 1,113,890                      | 125,726                        |
| Interest income                                                                   | (2,514)                        | --                             | (2,514)                        | --                             |
| Other                                                                             | --                             | (17,833)                       | --                             | 18,249                         |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
|                                                                                   | 1,080,161                      | (434,976)                      | 1,455,317                      | (770,050)                      |
|                                                                                   | -----                          | -----                          | -----                          | -----                          |
| <b>NET LOSS</b>                                                                   | <b>\$ (1,812,820)</b>          | <b>\$ (255,052)</b>            | <b>\$ (2,811,635)</b>          | <b>\$ (791,251)</b>            |
|                                                                                   | =====                          | =====                          | =====                          | =====                          |
| <b>BASIC AND DILUTED LOSS PER<br/>COMMON SHARE</b>                                |                                |                                |                                |                                |
|                                                                                   | \$ (0.04)                      | \$ (0.01)                      | \$ (0.07)                      | \$ (0.02)                      |
|                                                                                   | =====                          | =====                          | =====                          | =====                          |
| <b>WEIGHTED AVERAGE NUMBER OF COMMON<br/>SHARES OUTSTANDING-BASIC AND DILUTED</b> |                                |                                |                                |                                |
|                                                                                   | 41,318,195                     | 32,997,498                     | 40,476,073                     | 32,489,949                     |
|                                                                                   | =====                          | =====                          | =====                          | =====                          |

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

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AETHLON MEDICAL, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

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FOR THE SIX MONTHS ENDED SEPTEMBER 30, 2008 AND 2007 AND  
FOR THE PERIOD JANUARY 31, 1984 (INCEPTION) THROUGH SEPTEMBER 30, 2008  
(Unaudited)

|                                                                                   | Six Months<br>Ended<br>September 30,<br>2008 | Six Months<br>Ended<br>September 30,<br>2007 | Janua<br>(I<br>Sep |
|-----------------------------------------------------------------------------------|----------------------------------------------|----------------------------------------------|--------------------|
|                                                                                   | -----                                        | -----                                        | ---                |
| Cash flows from operating activities:                                             |                                              |                                              |                    |
| Net loss                                                                          | \$ (2,811,635)                               | \$ (791,251)                                 | \$ (3              |
| Adjustments to reconcile net loss to net cash used in operating activities:       |                                              |                                              |                    |
| Depreciation and amortization                                                     | 8,820                                        | 12,668                                       |                    |
| Amortization of deferred consulting fees                                          | --                                           | --                                           |                    |
| Loss on settlement of accrued interest and damages                                | 607,908                                      | --                                           |                    |
| Gain on sale of property and equipment                                            | --                                           | 1,777                                        |                    |
| Gain on settlement of debt                                                        | --                                           | --                                           |                    |
| Loss on settlement of accrued legal liabilities                                   | --                                           | --                                           |                    |
| Stock based compensation                                                          | 134,192                                      | 352,951                                      |                    |
| Loss on debt extinguishment                                                       | --                                           | --                                           |                    |
| 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       | 90,072                                       | 194,119                                      |                    |
| Change in fair value of warrant liability                                         | (263,967)                                    | (914,025)                                    |                    |
| Amortization of debt discount and deferred financing costs                        | 949,352                                      | 7,958                                        |                    |
| Impairment of patents and patents pending                                         | --                                           | --                                           |                    |
| Impairment of goodwill                                                            | --                                           | --                                           |                    |
| Deferred compensation forgiven                                                    | --                                           | --                                           |                    |
| Changes in operating assets and liabilities:                                      |                                              |                                              |                    |
| Prepaid expenses                                                                  | --                                           | (3,709)                                      |                    |
| Other assets                                                                      | --                                           | --                                           |                    |
| Accounts payable and other current liabilities                                    | 138,260                                      | 77,270                                       |                    |
| Due to related parties                                                            | (28,000)                                     | (5,000)                                      |                    |
|                                                                                   | -----                                        | -----                                        | ---                |
| Net cash used in operating activities                                             | (1,174,998)                                  | (1,067,242)                                  | (1                 |
|                                                                                   | -----                                        | -----                                        | ---                |
| Cash flows from investing activities:                                             |                                              |                                              |                    |
| Purchases of property and equipment                                               | --                                           | (3,997)                                      |                    |
| Additions to patents and patents pending                                          | (9,693)                                      | (6,669)                                      |                    |
| Proceeds from the sale of property and equipment                                  | --                                           | --                                           |                    |
| Cash of acquired company                                                          | --                                           | --                                           |                    |
|                                                                                   | -----                                        | -----                                        | ---                |
| Net cash used in investing activities                                             | (9,693)                                      | (10,666)                                     |                    |
|                                                                                   | -----                                        | -----                                        | ---                |
| Cash flows from financing activities:                                             |                                              |                                              |                    |
| Proceeds from the issuance of notes payable                                       | --                                           | --                                           |                    |
| Principal repayments of notes payable                                             | --                                           | --                                           |                    |
| Proceeds from the issuance of convertible notes payable                           | 430,000                                      | 60,000                                       |                    |
| Proceeds from the issuance of common stock                                        | 500,000                                      | 757,948                                      |                    |
| Professional fees related to registration statement                               | --                                           | --                                           |                    |
|                                                                                   | -----                                        | -----                                        | ---                |

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|                                           |           |            |    |
|-------------------------------------------|-----------|------------|----|
| Net cash provided by financing activities | 930,000   | 817,948    | 1  |
| Net decrease in cash                      | (254,691) | (259,960)  |    |
| Cash at beginning of period               | 254,691   | 440,106    |    |
| Cash at end of period                     | \$ --     | \$ 180,146 | \$ |

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

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AETHLON MEDICAL, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)  
FOR THE SIX MONTHS ENDED SEPTEMBER 30, 2008 AND 2007 AND  
FOR THE PERIOD JANUARY 31, 1984 (INCEPTION) THROUGH SEPTEMBER 30, 2008  
(Unaudited)

|                                                                                                             | Six Months<br>Ended<br>September 30,<br>2008 | Six Months<br>Ended<br>September 30,<br>2007 | Janu<br>(I<br>Se |
|-------------------------------------------------------------------------------------------------------------|----------------------------------------------|----------------------------------------------|------------------|
| Supplemental disclosures of non-cash investing and financing information:                                   |                                              |                                              |                  |
| Debt and accrued interest converted to common stock                                                         | \$ 232,675                                   | \$ --                                        | \$               |
| Stock option exercise by director for accrued expenses                                                      | --                                           | --                                           |                  |
| Conversion of accrued debt to common stock by officers and directors                                        | 332,279                                      | --                                           |                  |
| Debt discount on notes payable associated with detachable warrants                                          | --                                           | --                                           |                  |
| Issuance of common stock, warrants and options in settlement of accrued expenses and due to related parties | --                                           | --                                           |                  |
| Issuance of common stock in connection with license agreements                                              | --                                           | --                                           |                  |
| Net assets of entities acquired in exchange for equity securities                                           | --                                           | --                                           |                  |
| Debt placement fees paid by issuance of warrants                                                            | --                                           | --                                           |                  |
| Patent pending acquired for 12,500 shares of common stock                                                   | --                                           | --                                           |                  |
| Common stock issued for prepaid expenses                                                                    | --                                           | --                                           |                  |

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

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AETHLON MEDICAL, INC.  
(A Development Stage Company)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
September 30, 2008

### NOTE 1. NATURE OF BUSINESS AND BASIS OF PRESENTATION

Aethlon Medical, Inc. ("Aethlon", "We" or the "Company") is a development stage medical device company focused on expanding the applications of our Hemopurifier (R) platform technology, which is designed to rapidly reduce the presence of infectious viruses and other toxins from human blood. In this regard, our core focus is the development of therapeutic devices that treat acute viral conditions, chronic viral diseases and pathogens targeted as potential biological warfare agents. The Hemopurifier(R) combines the established scientific principles of affinity chromatography and hemodialysis 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(R) cannot cure viral conditions but can prevent virus and toxins from infecting unaffected tissues and cells. We have completed pre-clinical blood testing of the Hemopurifier(R) to treat HIV and Hepatitis-C, and have completed human safety trials on Hepatitis-C infected patients in India and are in the process of obtaining regulatory approval from the U.S. Food and Drug Administration ("FDA") to initiate clinical trials in the United States.

The commercialization of the Hemopurifier(R) will require the completion of human efficacy clinical trials. The approval of any application of the Hemopurifier(R) in the United States will necessitate the approval of the FDA to initiate human studies. Such studies could take years to demonstrate safety and effectiveness in humans and there is no assurance that the Hemopurifier(R) will be cleared by the FDA as a device we can market to the medical community. We also expect to face similar regulatory challenges from foreign regulatory agencies, should we attempt to commercialize and market the Hemopurifier(R) outside of the United States. As a result, we have not generated revenues from the sale of any Hemopurifier(R) application. Additionally, there have been no independent validation studies of our Hemopurifiers(R) to treat infectious disease. We manufacture our products on a small scale for testing purposes but have yet to manufacture our products on a large scale for commercial purposes. All of our pre-clinical human blood studies have been conducted in our laboratories under the direction of Dr. Richard Tullis, our Chief Science Officer.

We are classified as a development stage enterprise under accounting principles generally accepted in the United States of America ("GAAP"), and have not generated revenues from our principal operations.

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

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The accompanying unaudited condensed consolidated interim financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments necessary in order to make the financial statements not misleading have been included. The condensed consolidated balance sheet as of March 31, 2008 was derived from our audited financial statements. Operating results for the three and six month periods ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending March 31, 2009. For further information, refer to our Annual Report on Form 10-KSB for the year ended March 31, 2008, which includes audited financial statements and footnotes as of March 31, 2008 and for the years ended March 31, 2008 and 2007 and the period January 31, 1984 (Inception) through March 31, 2008.

### NOTE 2. GOING CONCERN AND LIQUIDITY CONSIDERATIONS

The accompanying unaudited condensed consolidated interim financial statements have been prepared on a going concern basis, which contemplates, among other things, the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have experienced continuing losses from operations, are in default on certain debt, have negative working capital of approximately (\$4,158,000), recurring losses from operations and a deficit accumulated during the development stage of approximately (\$35,039,000) at September 30, 2008, which among other matters, raises significant doubt about our ability to continue as a going concern. We have not generated significant revenue or any profit from operations since inception. A significant amount of additional capital will be necessary to advance the development of our products to the point at which they may become commercially viable. Our current financial resources are insufficient to fund our capital expenditures, working capital and other cash requirements (consisting of accounts payable, accrued liabilities, amounts due to related parties and amounts due under various notes payable) for the fiscal year ending March 31, 2009. Therefore we will be required to seek additional funds through debt and/or equity financing arrangements to finance our current and long-term operations.

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We are currently addressing our liquidity issue by exploring investment capital opportunities through the public markets, specifically, through private placement of common stock. We believe that our access to capital, together with existing cash resources, will be sufficient to meet our liquidity needs for fiscal 2009. However, no assurance can be given that we will receive any funds in a connection with our capital raising efforts, in which case we will be required to significantly curtail operations, sell or license out significant portions of our technology, or possibly cease operations.

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

### NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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consolidated financial statements.

### PRINCIPLE OF CONSOLIDATION

The accompanying condensed consolidated financial statements include the accounts of Aethlon Medical, Inc. and its wholly-owned subsidiaries Aethlon, Inc., Hemex, Inc. and Cell Activation, Inc. (collectively hereinafter referred to as the "Company" or "Aethlon"). These subsidiaries are dormant and there are no material intercompany transactions or balances.

### 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 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. Based on the treasury method, the potentially dilutive common shares outstanding for the three and six month periods ended September 30, 2008 and 2007, which include shares underlying outstanding stock options, warrants and convertible debentures were as follows:

|                    | September 30,<br>2008 | September 30,<br>2007 |
|--------------------|-----------------------|-----------------------|
| Three months ended | 3,699,270             | 18,459,500            |
| Six months ended   | 7,065,020             | 17,899,812            |

### PATENTS

We capitalize the cost of patents, some of which were acquired, and amortize such costs over the shorter of the remaining legal life or their estimated economic life, upon issuance of the patent.

### RESEARCH AND DEVELOPMENT EXPENSES

We incurred approximately \$383,000 and \$440,000 of research and development expenses during the six months ended September 30, 2008 and 2007, respectively, which are included in various operating expense line items in the accompanying condensed consolidated statements of operations.

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

We follow 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 we issue equity instruments as part of the total consideration. Pursuant to paragraph 7 of SFAS No. 123-R, we account 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.

We apply 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



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

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### IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

SFAS No.144 ("SFAS 144"), "ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF" addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS 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 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. We believe that no impairment existed at or during the three or six months ended September 30, 2008.

### BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

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

### DERIVATIVE LIABILITIES AND CLASSIFICATION

We evaluate free-standing instruments (or embedded derivatives) indexed to its common stock to properly classify such instruments within equity or as liabilities in our financial statements, pursuant to the requirements of the EITF Issue No. 00-19, "ACCOUNTING FOR DERIVATIVE FINANCIAL INSTRUMENTS INDEXED TO AND POTENTIALLY SETTLED IN, A COMPANY'S OWN STOCK," EITF Issue No. 01-06, "THE MEANING OF INDEXED TO A COMPANY'S OWN STOCK," FSP EITF Issue No. 00-19-2, "ACCOUNTING FOR REGISTRATION PAYMENT ARRANGEMENTS," and SFAS No. 133, "ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES," as amended. Our policy is to settle instruments indexed to our common shares on a first-in-first-out basis. Pursuant to EITF Issue No. 00-19, the classification of an instrument indexed to our stock, which is carried as a liability, must be reassessed at each balance sheet date. If the classification required under this

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Consensus changes as a result of events during a reporting period, the instrument is reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

### REGISTRATION PAYMENT ARRANGEMENTS

We account for our liquidated damages on registration rights agreements in accordance with FASB Staff Position EITF Issue No. 00-19-2 "ACCOUNTING FOR REGISTRATION PAYMENT ARRANGEMENTS" which specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement should be separately recognized and measured in accordance with SFAS No. 5, "ACCOUNTING FOR CONTINGENCIES" ("SFAS No. 5"). Pursuant to SFAS No. 5, a liability related to potential liquidated damages if such damages were determined to be both probable and reasonably estimable. We had accrued liquidated damages on the 10% Series A Convertible Notes. In connection with the amendment of these instruments and related warrants on November 29, 2007, the liquidated damages related to these Notes were settled. As of September 30, 2008, we made a payment to the holders of the Amended Series A 10% Convertible Notes in the form of common stock and warrants to settle accrued amounts of interest and liquidated damages. Since we filed a registration statement to register the relevant securities relating to the 10% Series A Convertible Notes and that registration statement was declared effective in October 2008, we will not incur any further liquidated damages relating to the 10% Series A Convertible Notes.

We also have accrued \$201,900 in liquidated damages in connection with potential liquidated damages related to other transactions that required liquidated damages on registration rights agreements.

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The following table lists the amounts of liquidated damages accrued by Transaction. As registration has now occurred for each of the following transactions, no further liquidated damages are being accrued.

| Transaction   | Accrued Damages | Damages Formula      |
|---------------|-----------------|----------------------|
| 8% Notes      | 119,000         | Maximum of \$150,000 |
| 2008 9% Notes | 48,400          | Maximum of \$75,000  |
| Stock Units   | 34,500          | No cap on damages    |
|               | -----           |                      |
|               | \$201,900       |                      |
|               | =====           |                      |

See Notes 4 and 5 for further description.

### STOCK BASED COMPENSATION

Effective April 1, 2006, we 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. We previously accounted for awards granted under our equity incentive plan under

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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 our common stock (defined as the closing price as quoted on the Over-the-Counter Bulletin Board on the date of grant. Accordingly, no share-based compensation was recognized in the financial statements for periods prior to April 1, 2006.

Under the modified prospective method of adoption for SFAS No. 123-R, the compensation cost that we recognize 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, our 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 our formal stock plans. The terms of these grants are individually negotiated and generally expire within five years from the grant date. Such grants are recorded based on the grant date fair value of the equity instruments.

In August 2000, we adopted the 2000 Stock Option Plan ("Stock Option Plan"), which was approved by our stockholders in December 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 than 10% of our 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 September 30, 2008, we had granted 47,500 options under the 2000 Stock Option Plan of which 15,000 had been forfeited. All of these options vested prior to the adoption of SFAS 123-R. We have reserved 467,500 shares for future issuance.

Share-based compensation resulting from direct stock grants and from the application of SFAS No. 123-R to options outstanding resulted in expenses of \$64,696 and \$134,192 for the three and six month periods ended September 30, 2008 and \$69,446 and \$352,951 for the three and six month periods ended September 30, 2007. We use the Binomial Lattice option pricing model for estimating fair value of options granted.

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

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|                                                                               | Three Months Ended<br>September 30, 2008 | Three Months Ended<br>September 30, 2007 | Six Months Ended<br>September 30, 2008 |
|-------------------------------------------------------------------------------|------------------------------------------|------------------------------------------|----------------------------------------|
| Payroll and related                                                           | \$ 64,696                                | \$ 69,446                                | \$ 134,192                             |
|                                                                               | =====                                    | =====                                    | =====                                  |
| Net share-based compensation effect<br>in net loss from continuing operations | \$ 64,696                                | \$ 69,446                                | \$ 134,192                             |
|                                                                               | =====                                    | =====                                    | =====                                  |
| Basic and diluted loss per common share                                       | \$ (0.00)                                | \$ (0.00)                                | \$ (0.00)                              |
|                                                                               | =====                                    | =====                                    | =====                                  |

In accordance with SFAS No. 123-R, beginning on April 1, 2006, we adjust share-based compensation on a quarterly basis for changes to the estimate of expected award forfeitures based on actual forfeiture experience. The effect, if any, of adjusting the forfeiture rate for all expense amortization is recognized in the period the forfeiture estimate is changed. The effect of forfeiture adjustments for the three month period ended September 30, 2008 was insignificant.

The following weighted average assumptions were used in the valuation of these instruments.

|                         | Six Months Ended<br>September 30 |            |
|-------------------------|----------------------------------|------------|
|                         | 2008                             | 2007       |
|                         | None Issued                      |            |
| Annual dividends        | n/a                              | zero       |
| Expected volatility     | n/a                              | 92%        |
| Risk free interest rate | n/a                              | 4.72%      |
| Expected life           | n/a                              | 2.14 years |

The expected volatility is based on the historic 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 our historical grants. Options outstanding that have vested and are expected to vest as of September 30, 2008 are as follows:

|                  | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term in Years | Aggregate<br>Intrinsic<br>Value (1) |
|------------------|---------------------|------------------------------------------|------------------------------------------------------------------|-------------------------------------|
| Vested (2)       | 9,772,394           | \$ 0.38                                  | 4.80                                                             | \$ --                               |
| Expected to vest | 1,166,666           | 0.35                                     | 8.64                                                             | \$ 35,000                           |
|                  | -----               |                                          |                                                                  | -----                               |
| Total            | 10,939,060          |                                          |                                                                  | \$ 35,000                           |
|                  | =====               |                                          |                                                                  | =====                               |

(1) These amounts represent the difference between the exercise price and \$0.38, the closing market price of our common stock on September 30, 2008 as quoted on the Over-the-Counter Bulletin Board under the symbol "AEMD.OB" for all in-the-money options outstanding.

(2) 4,278,375 options were granted prior to April 1, 2006 (the date of adoption

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for SFAS 123-R) and were fully vested at the date of adoption.

Additional information with respect to stock option activity is as follows:

|                         | Outstanding Options |                                       |                                     |
|-------------------------|---------------------|---------------------------------------|-------------------------------------|
|                         | Number of<br>Shares | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value (1) |
| March 31, 2008          | 10,954,060          | \$ 0.38                               | \$1,643,109<br>=====                |
| Grants                  | --                  | --                                    |                                     |
| Exercises               | --                  | --                                    |                                     |
| Cancellations           | (15,000)            | --                                    |                                     |
| September 30, 2008      | 10,939,060          | \$ 0.38                               | \$ 35,000<br>=====                  |
| Options exercisable at: |                     |                                       |                                     |
| September 30, 2008      | 9,772,394           | \$ 0.38                               | =====                               |

(1) Represents the difference between the exercise price and the March 31, 2008 or September 30, 2008 market price of our common stock, which was \$0.53 and \$0.38, respectively.

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At September 30, 2008, there was approximately \$710,000 of unrecognized compensation cost related to share-based payments which is expected to be recognized over a weighted average period of 2.15 years.

### INCOME TAXES

Under SFAS 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. We record a valuation allowance for deferred tax assets when, based on our 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.

### SIGNIFICANT RECENT ACCOUNTING PRONOUNCEMENTS

In December 2006, the FASB issued SFAS No. 157, "FAIR VALUE MEASUREMENTS," which defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. SFAS No. 157 simplifies and codifies related guidance within GAAP, but does not require any new fair value measurements. The guidance in SFAS No. 157 applies to derivatives and other financial instruments measured at estimated fair value under SFAS No. 133 and related pronouncements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We adopted Statement of Financial Accounting Standards No. 157 ("SFAS No. 157") as of April 1, 2008. SFAS No. 157 applies to certain assets and liabilities that are being measured and reported

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on a fair value basis. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosure about fair value measurements. This Statement enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability of the information used to determine fair values. The Statement requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

The fair value of our warrant liabilities is determined based on observable market based inputs or unobservable inputs that are corroborated by market data, which is a Level 3 classification. We record variations in our warrant liability account on our balance sheet at fair value with changes in fair value recorded in our consolidated statements of operations.

The following outlines the significant weighted average assumptions used to estimate the fair value information presented, with respect to warrants utilizing the Binomial Lattice option pricing model:

|                         | Quarter Ended September 30, 2008 |
|-------------------------|----------------------------------|
| Risk free interest rate | 2.64% - 3.01%                    |
| Average expected life   | 3 - 5 years                      |
| Expected volatility     | 83.6% - 84.8%                    |
| Expected dividends      | None                             |

We did not make any changes to our valuation techniques in the quarter ended September 30, 2008.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." SFAS No. 159 expands the scope of specific types of assets and liabilities that an entity may carry at fair value on its statement of financial position, and offers an irrevocable option to record the vast majority of financial assets and liabilities at fair value, with changes in fair value recorded in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We have not yet elected to use the fair value option, and as such, our adoption AFAS No. 159 as of April 1, 2008 did not have a material impact on our consolidated financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants, and the Securities and Exchange Commission did not or are not believed by management to have a material impact on our present or future consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles ("SFAS 162"). This statement identifies the sources of and framework for selecting the accounting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles ("GAAP") in the United States ("GAAP hierarchy"). Because the current GAAP hierarchy is set forth in the American Institute of Certified Public Accountants Statement on Auditing Standards No. 69, it is directed to the auditor rather than to the entity responsible for selecting accounting principles for financial statements

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presented in conformity with GAAP. Accordingly, the FASB concluded the GAAP hierarchy should reside in the accounting literature established by the FASB and issued this statement to achieve that result. The provisions of SFAS 162 are effective November 15, 2008, which is 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. Management believes that adoption of SFAS 162 will not have a material effect on the consolidated financial statements.

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### NOTE 4. NOTES PAYABLE

#### 12% NOTES

From August 1999 through May 2005, we entered into various borrowing arrangements for the issuance of notes payable from private placement offerings (the "12% Notes"). At September 30, 2008, \$347,500 of the principal balance of the 12% Notes was past due, in default, and bears interest at the default rate of 15%.

#### 10% NOTES

From time to time, we issued convertible notes payable ("10% Note") to various investors, bearing interest at 10% per annum, with principal and interest due six months from the date of issuance. The 10% Notes required no payment of principal or interest during the term and may be converted to our common stock at the conversion price of \$0.50 per share at any time at the option of the noteholder. The total amount of the original notes issued was \$275,000. One remaining 10% Note in the amount of \$5,000 was past due and in default at September 30, 2008. At September 30, 2008, interest payable on this note totaled \$3,625.

#### 8% NOTES

In December 2007, we issued notes payable ("8% Notes") to two accredited investors in the aggregate amount of \$495,000 with 8% interest maturing on September 5, 2008. In conjunction with the issuance of the 8% Notes, we also issued three year warrants to acquire 1,485,000 shares of Common Stock at \$0.50 per share.

Under this transaction, we are obligated to register for resale the common shares underlying the warrants, and as a result, this warrant obligation does not meet the scope exception of paragraph 11(a) of SFAS No. 133. Specifically, at the commitment date, we did not have any uncommitted registered shares to settle the warrant obligation and accordingly, such obligation was required to be classified as a liability (outside of stockholders' deficit) in accordance with EITF Issue No.00-19. The warrants were valued at \$693,050 on the commitment date using a Binomial Lattice option pricing model. Such amount was recorded as a derivative liability with an offsetting debt discount recorded against the \$495,000 face amount of the 8% Notes and the remaining \$198,050 recorded as interest expense. The debt discount was amortized to expense over the term of the 8% Notes.

On September 5, 2008, the 8% Notes matured. We are currently in negotiations to extend those notes but there can be no assurance that such extension will be obtained on terms acceptable to us or at all.

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### 2008 9% NOTES

In January 2008, we issued notes payable ("2008 9% Notes") to an accredited investor in the amount of \$220,000 with 9% interest maturing on October 19, 2008. In conjunction with the issuance of the 2008 9% Notes, we also issued three year warrants to acquire 660,000 shares of Common Stock at \$0.50 per share.

Under this transaction, we are obligated to register for resale the common shares underlying the warrants, and as a result, this warrant obligation does not meet the scope exception of paragraph 11(a) of SFAS No. 133. Specifically, at the commitment date, we did not have any uncommitted registered shares to settle the warrant obligation and accordingly, such obligation was required to be classified as a liability (outside of stockholders' deficit) in accordance with EITF Issue No. 00-19. The warrants were valued at \$222,450 on the commitment date using a Binomial Lattice option pricing model. Such amount was recorded as a derivative liability with an offsetting debt discount recorded against the \$220,000 face amount of the 2008 9% Notes and the remaining \$2,450 recorded as interest expense. The debt discount is amortized to expense over the term of the 2008 9% Notes.

Notes payable consist of the following at September 30, 2008:

|                                 | Face Amount of<br>Notes Payable | Note Discounts | Notes Payable,<br>Net of Discounts |
|---------------------------------|---------------------------------|----------------|------------------------------------|
| 12% Notes payable, all past due | \$ 347,500                      | --             | \$ 347,500                         |
| 10% Note payable, past due      | 5,000                           | --             | 5,000                              |
| 8% Note payable                 | 495,000                         | --             | 495,000                            |
| 2008 9% Note payable            | 220,000                         | (12,223)       | 207,777                            |
|                                 | -----                           | -----          | -----                              |
| Total Notes Payable             | \$ 1,067,500                    | (\$ 12,223)    | \$ 1,055,277                       |
|                                 | =====                           | =====          | =====                              |

Our plans to satisfy the remaining outstanding balance on these notes include converting the notes to common stock at market value or repayment with available funds.

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### NOTE 5. CONVERTIBLE NOTES PAYABLE

#### 10% CONVERTIBLE NOTES

On December 15, 2006, we issued two 10% Convertible Notes ("December 10% Notes") totaling \$50,000 to accredited investors. The December 10% Notes accrue interest at a rate of ten percent (10%) per annum and matured on March 15, 2007. Such notes are convertible into shares of restricted common stock at any time at the election of the holder at a fixed conversion price of \$0.17 per share for any conversion occurring on or before the maturity date. In addition, upon issuance, we issued five-year Warrants ("December 10% Note Warrants") to purchase a number of shares equal to the number of shares into which the December 10% Notes can be



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converted at a fixed exercise price of \$0.17. Additionally, if the December 10% Note Warrants were exercised prior to December 15, 2007, the holder would have received an additional warrant on the same terms as the December 10% Note Warrants on a one to one basis. The warrants can be settled in unregistered shares of our common stock. The December 10% Note Warrants have been valued using a Binomial Lattice option pricing model and an associated discount of \$15,627, the relative fair value measured at the commitment date, was recorded and presented net against the face amount of the December 10% Notes. The convertible feature of the December 10% Notes provides for an effective conversion rate that is below market value. Pursuant to EITF No. 98-5 and EITF No. 00-27, we estimated the fair value of such beneficial conversion feature to be \$34,373 and recorded such amount as a debt discount. The discounts associated with the warrants and the beneficial conversion feature were accreted to interest expense over the term of the December 10% Notes.

On May 1, 2008, a holder of \$33,000 of the December 10% Notes converted his \$33,000 principal amount and accrued interest of \$6,325 at the agreed conversion rate of \$0.17 per share. As a result, we issued 232,033 shares of common stock under this conversion.

At September 30, 2008, \$17,000 of the December 10% Notes remained outstanding and were in default.

### 10% SERIES A CONVERTIBLE NOTES AND AMENDMENT

From July 11, 2005 through December 15, 2005 we received cash investments totaling \$1,000,000 from accredited investors based on agreed-upon terms reached on the cash receipt dates. Such investments were documented in November and December 2005 in several 10% Series A Convertible Promissory Notes. The 10% Series A Convertible Notes accrue interest at a rate of ten percent (10%) per annum and matured on January 2, 2007. The 10% Series A Convertible Notes were convertible into shares of our common stock at any time at the election of the holder at a fixed conversion price equal to \$0.20 per share for any conversion occurring on or prior to the maturity date.

On November 2007, we entered into Amended and Restated 10% Series A Convertible Promissory Notes (the "Amended Notes") with the holders of certain promissory notes that we previously issued (the "Prior Notes"), and all amendments to the Prior Notes.

The Amended Notes, in the principal amount of \$1,000,000, are convertible into an aggregate of 5,000,000 shares of our Common Stock and mature on February 15, 2009. The Amended Notes provide for the payment of accrued and default interest through December 31, 2007 in the aggregate amount of \$295,248 to be paid in units ("Units") at a fixed rate of \$0.20 per Unit, each Unit consisting of one share of our Common Stock and one Class A Common Stock Purchase Warrant (the "Class A Warrant") to purchase one share of our Common Stock at a fixed exercise price of \$0.20 per share. If the Holders exercise the Class A Warrants on or before February 15, 2010, we will issue them one Class B Common Stock Purchase Warrant (the "Class B Warrant") for every two Class A Warrants exercised. The Class B Warrants will have a fixed exercise price of \$0.60 per share.

The Amended Notes also provided for the payment of liquidated damages through November 29, 2007 in the aggregate amount \$269,336 to be paid in units ("Damages Units") at a fixed rate of \$0.40 per Damages Unit, each Damages Unit consisting of one share of our Common Stock and one Class A-1 Common Stock Purchase Warrant (the "Class A-1 Warrant") to purchase one share of our Common Stock at a fixed exercise price of \$0.40 per share. If the Holders exercise the Class A-1 Warrants on or before February 15, 2010, we will issue them one Class B-1 Common Stock Purchase Warrant (the "Class B-1 Warrant") for every two Class A-1 Warrants exercised. The Class B-1 Warrants will have a fixed exercise price of \$0.40 per share.

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In addition, the Amended Notes provided for the issuance of Class A Principal Common Stock Purchase Warrants (the "Class A Principal Warrant") to purchase an aggregate of 5,000,000 shares of our Common Stock on the same terms as the Class A Warrants.

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The following table summarizes the number of shares of the our Common Stock issuable upon the conversion of the Amended Notes or the exercise of the various warrants issued or issuable pursuant to the Amended Notes.

|                            |            |
|----------------------------|------------|
| Note Conversion            | 5,000,000  |
| Accrued Interest           | 1,476,242  |
| Liquidated Damages         | 673,340    |
| Class A Warrants           | 1,476,242  |
| Class A-1 Warrants         | 673,340    |
| Class A Principal Warrants | 5,000,000  |
| Class B Warrants           | 738,121    |
| Class B-1 Warrants         | 336,670    |
|                            | -----      |
| Total                      | 15,373,955 |
|                            | =====      |

We were obligated to register the shares underlying the Class A Warrants, the Class A-1 Warrants and the Class A Principal Warrants with the SEC by March 31, 2008, and the shares underlying the Class B Warrants and to register the Class B-1 Warrants with the SEC by the 30th day following the issuance date of such warrants. Since we failed to effect a registration statement by March 31, 2008, we recorded liquidated damages of \$15,000 per month through September 30, 2008, when we stopped recording damages due to the effectiveness of a registration statement in October 2008.

For accounting purposes, the amendment of the 10% Series A Convertible Notes was treated as an extinguishment pursuant to EITF Issue No. 06-6. The changes in the note agreements, conversion feature and warrants were considered substantive as prescribed in that consensus. Consequently, at the amendment date we initially recorded an estimated loss on extinguishment of \$489,013 as follows:

|                                                            |              |
|------------------------------------------------------------|--------------|
| Reacquisition Price (Fair value of new notes and warrants) | \$ 5,392,664 |
| Less amounts relieved at date of extinguishment:           |              |
| Carrying amount of the unamortized notes                   | (166,667)    |
| Carrying amount of derivative liability                    | (4,172,400)  |
| Accrued interest and liquidated damages                    | (564,584)    |
|                                                            | -----        |
| Loss on extinguishment                                     | \$ 489,013   |
|                                                            | =====        |

Subsequently, we engaged a third party valuation firm to value the various components of the amendment of the Series A Convertible Notes. As a result of that valuation, we recorded an additional \$58,106 of loss on extinguishment of debt with the offset being recorded to additional paid-in capital.

The new warrants issued in connection with the Amended Notes were evaluated pursuant to EITF Issue No. 00-19 and classified as equity instruments. In connection with the new warrants, we recorded \$4,392,664 as an increase to additional paid in capital, based on the estimated fair value at issuance. The

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amended conversion feature contains a BCF at the date of the Amended Notes; consequently, we recorded a discount of \$1,000,000 against the notes and a corresponding increase in additional paid in capital.

In January 2008, one of the holders of the Amended Series A Convertible Notes converted \$100,000 of their notes into 500,000 shares of common stock at the agreed conversion rate of \$0.20 per share.

On July 30, 2008, the holders of the Amended Series A Convertible Notes notified us that we were in default on the notes due to our failure to register the warrants by March 31, 2008 and for failing to make required interest payments. We subsequently registered their warrants under a registration statement declared effective in October 2008. To satisfy the accrued interest and damages through September 30, 2008, on September 19, 2008, we issued 966,750 shares of restricted common stock, valued at the closing price of \$0.49, and 966,750 warrants with a strike price of \$0.20 in payment of accrued interest of \$89,500 and accrued damages of \$103,850 per the payment formula in the Loan Agreement. The difference in value of equity instruments issued upon settlement and the liabilities settled resulted in a non-cash loss on settlement of \$607,908. We have not yet paid an agreed amount of legal fees, which total \$15,379 and are accrued in our accounts payable, associated with the amendment to the notes.

### 2008 10% CONVERTIBLE NOTES

During the three months ended September 30, 2008, we raised an aggregate amount of \$430,000 from the sale to accredited investors of 10% convertible notes and warrants (2008 10% Convertible Notes). The notes are convertible into our common stock at \$0.50 per share and the warrants are exercisable at \$0.50 per share. We agreed to pay to the investment banking firm that arranged this sale a cash commission of seven percent of the proceeds and warrants equal to seven percent of the gross.

Convertible Notes Payable consists of the following at September 30, 2008:

|                                        | Principal<br>----- | Discount<br>----- | Net<br>Amount<br>----- |
|----------------------------------------|--------------------|-------------------|------------------------|
| Amended Series A 10% Convertible Notes | \$ 900,000         | \$(342,457)       | \$ 557,543             |
| 2008 10% Convertible Notes             | 430,000            | (128,645)         | 301,355                |
| December 10% Convertible Notes         | 17,000             | --                | 17,000                 |
|                                        | -----              | -----             | -----                  |
| Total - Convertible Notes              | \$1,347,000        | \$(471,102)       | \$ 875,898             |
|                                        | =====              | =====             | =====                  |

### NOTE 6. EQUITY TRANSACTIONS

In April 2008, we issued 10,170 shares of common stock pursuant to our S-8 registration statement covering our 2003 Consultant Stock Plan at \$0.59 per share in payment for regulatory affairs consulting services valued at \$6,000 based on the value of the services. Effective as of April 22, 2008, per a patent license agreement, we issued 10,849 shares of restricted common stock to Boston University. This issuance represented the initial payment under the license agreement and was based on our share price at April 22, 2008 and the payment amount of \$5,750.

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In May 2008, we entered into a Private Placement Agreement with Fusion Capital Fund II, LLC, an Illinois limited liability company for the sale of 1,000,000 shares of our common stock for an aggregate purchase price of \$500,000.

In May 2008, we issued 6,667 shares of common stock pursuant to our S-8 registration statement covering our 2003 Consultant Stock Plan at \$0.45 per share in payment for regulatory affairs consulting services valued at \$3,000 based on the value of the services.

In May 2008, a holder of \$33,000 of the December 10% Notes converted his \$33,000 principal amount and accrued interest of \$6,325 at the agreed conversion rate of \$0.17 per share. As a result, we issued 232,033 shares of common stock under this conversion (See Note 5).

In June 2008, we issued 25,610 shares of common stock pursuant to our S-8 registration statement covering our 2003 Consultant Stock Plan at \$0.41 per share in payment for regulatory affairs consulting services valued at \$10,500 based on the value of the services.

In June 2008, we issued grants of restricted common stock to two employees of 5,000 shares each as additional compensation. Those grants were valued at \$2,400 apiece based our closing stock price of \$0.48 on the date of issuance.

In July 2008, our Chief Executive Officer converted \$35,000 of accrued debt to 100,000 shares of unregistered common stock based upon the closing stock price of \$0.35 per share on that day.

In July 2008, a board member and his spouse, both former executives at Hemex, a company we acquired in 1999, converted \$147,279 of accrued debt to 446,300 shares of unregistered common stock based upon the closing stock price of \$0.33 per share on that day.

In July 2008, our Chief Science Officer converted \$150,000 of accrued debt to 468,750 shares of unregistered common stock based upon the closing stock price of \$0.32 per share on that day.

In September 2008, we issued 110,138 shares of common stock pursuant to our S-8 registration statement covering our 2003 Consultant Stock Plan at \$0.45 per share in payment for legal services valued at \$49,562 based on the value of the services.

In September 2008, we issued 38,150 shares of common stock pursuant to our S-8 registration statement covering our 2003 Consultant Stock Plan at \$0.40 per share in payment for regulatory affairs consulting services valued at \$15,260 based on the value of the services.

In September 2008, we issued 966,750 shares of restricted common stock and 966,750 warrants with a strike price of \$0.20 in payment of accrued interest of \$89,500 and accrued damages of \$103,850 (see note 5) per the payment formula in the Loan Agreement.

### NOTE 7. OTHER CURRENT LIABILITIES

At September 30, 2008 and March 31, 2008, our other current liabilities were comprised of the following items:

|                            | September 30,<br>2008 | March 31,<br>2008 |
|----------------------------|-----------------------|-------------------|
| Accrued liquidated damages | 201,900               | 337,400           |

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|                                 |            |             |
|---------------------------------|------------|-------------|
| Accrued interest                | 396,794    | 412,914     |
| Accrued legal fees and other    | 272,229    | 340,495     |
|                                 | -----      | -----       |
| Total other current liabilities | \$ 870,923 | \$1,090,809 |
|                                 | =====      | =====       |

### NOTE 8. COMMITMENTS AND CONTINGENCIES

#### LEGAL MATTERS

From time to time, claims are made against us 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 us 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 our results of operations for that period or future periods. We are not presently a party to any pending or threatened legal proceedings.

#### OTHER

We have not filed our income tax returns for certain prior periods. Whereas we are in the process of remediating this matter, we may be subject to penalties; however, those amounts are not expected to be significant.

### NOTE 9. SUBSEQUENT EVENTS

In October 2008, we issued 51,398 registered common shares under our 2000 Stock Option Plan to two employees as compensation.

In October and November 2008, warrant holders exercised 485,000 warrants with a strike price of \$0.50 per share and received a matching 485,000 restricted shares of common stock. This generated \$242,500 in proceeds.

In June and in November 2008, our Board of Directors approved stock option grants in an aggregate amount of 4,050,000 shares to certain of our employees, officers and directors. We have not yet completed the stock option agreement forms but intend to complete that documentation during the third fiscal quarter ending December 2008 and expect to record the related stock option expense in that period.

In October 2008, the Securities and Exchange Commission declared effective a registration statement that we filed to fulfill registration obligations on certain shares and warrants.