AETHLON MEDICAL INC
Form 10-Q
November 13, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from _____to_____

COMMISSION FILE NUMBER 000-21846

AETHLON MEDICAL, INC.

(Exact name of registrant as specified in its charter)

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

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

(Address of principal executive offices) (Zip Code)

(858) 459-7800

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

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

As of November 13, 2012, the registrant had outstanding 156,956,675 shares of common stock, $.001 par value.

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2012 (Unaudited)	March 31, 2012
ASSETS		
Current assets		
Cash	$271,747	$143,907
Accounts receivable	–	400,114
Deferred financing costs	2,273	120,563
Prepaid expenses and other current assets	63,514	31,452
Total current assets	337,534	696,036
Property and equipment, net	578	1,465
Patents and patents pending, net	126,235	130,817
Deposits	10,376	10,376
Total assets	$474,723	$838,694
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current Liabilities		
Accounts payable	$616,250	$586,340
Due to related parties	720,070	730,070
Notes payable	452,114	654,796
Convertible notes payable, net of discounts	2,392,179	3,005,473
Derivative liabilities	3,194,394	3,588,615
Accrued liquidated damages	437,800	437,800
Other current liabilities	1,133,269	1,131,221
Total current liabilities	8,946,076	10,134,315
Commitments and Contingencies (Note 13)		
Stockholders' Deficit		
Common stock, par value $0.001 per share; 500,000,000 shares authorized as of September 30, 2012 and 250,000,000 as of March 31, 2012; 153,743,553 and 117,515,892 shares issued and outstanding as of September 30, 2012 and March 31, 2012, respectively	153,746	117,518

Additional paid-in capital	50,397,321	47,170,146
Accumulated deficit	(59,022,420)	(56,583,285)
Total stockholders’ deficit	(8,471,353)	(9,295,621)
Total liabilities and stockholders' deficit	$474,723	$838,694

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three and Six Month Periods Ended September 30, 2012 and 2011

(Unaudited)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Six Months Ended September 30, 2012	Six Months Ended September 30, 2011
REVENUES				
Government contract revenue	$400,114	$–	$616,861	$–
OPERATING EXPENSES				
Professional fees	450,999	242,001	928,120	610,194
Payroll and related expenses	559,470	515,622	1,113,566	1,065,555
General and administrative	189,439	125,334	366,758	239,687
Total operating expenses	1,199,908	882,957	2,408,444	1,915,436
OPERATING LOSS	(799,794)	(882,957)	(1,791,583)	(1,915,436)
OTHER EXPENSE (INCOME)				
Loss on debt conversion	71,080	–	96,059	–
(Gain)/loss on change in fair value of derivative liability	326,138	(1,029,675)	(361,462)	(1,521,502)
Interest and other debt expenses	224,374	600,226	913,062	2,286,140
Interest income	(62)	(31)	(107)	(882)
Other	–	–	–	360,185
Total other expense (income)	621,530	(429,480)	647,552	1,123,941
NET LOSS	$(1,421,324)	$(453,477)	$(2,439,135)	$(3,039,377)
BASIC AND DILUTED LOSS PER COMMON SHARE	$(0.01)	$(0.00)	$(0.02)	$(0.03)
WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING – BASIC AND DILUTED	144,700,999	99,702,921	135,175,838	93,772,418

See accompanying notes.

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AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Six Month Periods Ended September 30, 2012 and 2011

(Unaudited)

	Six Months Ended September 30, 2012	Six Months Ended September 30, 2011
Cash flows from operating activities:		
Net loss	$(2,439,135)	$(3,039,377)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,469	9,773
Stock based compensation	395,495	448,062
Loss on debt conversion	96,059	–
Non cash interest expense	11,846	538,736
Fair market value of common stock, warrants and options issued for services	139,182	249,878
Change in fair value of derivative liabilities	(361,462)	(1,521,502)
Loss on settlement of convertible note termination	–	360,186
Amortization of debt discount and deferred financing costs	582,497	1,522,486
Changes in operating assets and liabilities:		
Prepaid expenses and other assets	(32,062)	18,394
Accounts receivable	400,114	–
Accounts payable and other current liabilities	296,447	377,318
Due to related parties	(10,000)	–
Net cash used in operating activities	(915,550)	(1,036,046)
Cash flows from investing activities:		
Purchases of property and equipment	–	(1,735)
Net cash used in investing activities	–	(1,735)
Cash flows from financing activities:		
Principal repayments of notes payable	(29,610)	(5,000)
Net proceeds from the issuance of convertible notes payable	–	872,656
Proceeds from the issuance of common stock	1,073,000	–
Proceeds from collection of secured notes receivable	–	200,000
Net cash provided by financing activities	1,043,390	1,067,656
Net increase in cash	127,840	29,875
Cash at beginning of period	143,907	15,704

Cash at end of period	$271,747	$45,579

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

For the Six Month Periods Ended September 30, 2012 and 2011

(Unaudited)

	Six Months Ended September 30, 2012	Six Months Ended September 30, 2011
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$2,821	$–
Income taxes	$–	$–
Supplemental disclosures of non-cash investing and financing activities:		
Debt and accrued interest converted to common stock	$1,515,062	$1,472,611
Deferred financing costs recorded in connection with debt amendment	$2,500	$–
Debt discount recorded in connection with beneficial conversion feature of convertible notes and related warrants	$–	$827,130
Reclassification of note payable to convertible notes payable	$75,000	$–
Reclassification of warrant derivative liability into equity	$32,759	$247,608

See accompanying notes.

AETHLON MEDICAL, INC. AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

September 30, 2012

NOTE 1. NATURE OF BUSINESS AND BASIS OF PRESENTATION

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

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and applicable sections of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments necessary to make the financial statements not misleading have been included. The condensed consolidated balance sheet as of March 31, 2012 was derived from our audited financial statements. Operating results for the six months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending March 31, 2013. For further information, refer to our Annual Report on Form 10-K for the year ended March 31, 2012, which includes audited financial statements and footnotes as of March 31, 2012 and for the years ended March 31, 2012 and 2011.

NOTE 2. LIQUIDITY

The accompanying unaudited condensed consolidated financial statements have been prepared on a going concern basis, which contemplates, among other things, the realization of assets and the satisfaction of liabilities in the ordinary course of business. We have experienced continuing losses from operations, are in default on certain debt, have negative working capital of approximately $8,609,000, recurring losses from operations and an accumulated deficit of approximately $59,022,000 at September 30, 2012, 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, 2013 ("fiscal 2013"). Therefore we will be required to seek additional funds through debt and/or equity financing arrangements to finance our current and long-term operations.

We are currently addressing our liquidity needs by exploring investment capital opportunities through the private placement of common stock or issuance of additional debt. We believe that our access to additional capital, together with existing cash resources and anticipated receipts under the Defense Advanced Research Projects Agency (DARPA) contract, as discussed in Note 12, will be sufficient to meet our liquidity needs for fiscal 2013. However, no assurance can be given that we will receive any funds in connection with our capital raising efforts.

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

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

PRINCIPLES OF CONSOLIDATION

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

LOSS PER COMMON SHARE

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

The potentially dilutive common shares outstanding at September 30, 2012 and 2011, which include common shares underlying outstanding stock options, warrants and convertible debentures, were 132,459,618 and 110,033,840, respectively.

REVENUE RECOGNITION

With respect to revenue recognition, we entered into a government contract with DARPA and have recognized revenue during the fiscal year ended March 31, 2012 of $1,358,189 under such contract. We adopted the Milestone method of revenue recognition for the DARPA contract under ASC 605-28 “Revenue Recognition – Milestone Method” and we believe we meet the requirements under ASC 605-28 for reporting contract revenue under the Milestone Method for the fiscal year ended March 31, 2012.

In order to account for this contract, the Company identifies the deliverables included within the contract and evaluates which deliverables represent separate units of accounting based on if certain criteria are met, including whether the delivered element has standalone value to the collaborator. The consideration received is allocated among the separate units of accounting, and the applicable revenue recognition criteria are applied to each of the separate units.

A milestone is an event having all of the following characteristics:

(1) There is substantive uncertainty at the date the arrangement is entered into that the event will be achieved. A vendor’s assessment that it expects to achieve a milestone does not necessarily mean that there is not substantive uncertainty associated with achieving the milestone.

(2) The event can only be achieved based in whole or in part on either: (a) the vendor’s performance; or (b) a specific outcome resulting from the vendor’s performance.

(3) If achieved, the event would result in additional payments being due to the vendor.

A milestone does not include events for which the occurrence is either: (a) contingent solely upon the passage of time; or (b) the result of a counterparty’s performance.

The policy for recognizing deliverable consideration contingent upon achievement of a milestone must be applied consistently to similar deliverables.

The assessment of whether a milestone is substantive is performed at the inception of the arrangement. The consideration earned from the achievement of a milestone must meet all of the following for the milestone to be considered substantive:

(1) The consideration is commensurate with either: (a) the vendor’s performance to achieve the milestone; or (b) the enhancement of the value of the delivered item or items as a result of a specific outcome resulting from the vendor’s performance to achieve the milestone;

(2) The consideration relates solely to past performance; and

(3) The consideration is reasonable relative to all of the deliverables and payment terms (including other potential milestone consideration) within the arrangement.

A milestone is not considered substantive if any portion of the associated milestone consideration relates to the remaining deliverables in the unit of accounting (i.e., it does not relate solely to past performance). To recognize the milestone consideration in its entirety as revenue in the period in which the milestone is achieved, the milestone must be substantive in its entirety. Milestone consideration cannot be bifurcated into substantive and nonsubstantive components. In addition, if a portion of the consideration earned from achieving a milestone may be refunded or adjusted based on future performance, the related milestone is not considered substantive.

PATENTS

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

RESEARCH AND DEVELOPMENT EXPENSES

We incurred research and development expenses during the three and six month periods ended September 30, 2012 and 2011, which are included in various operating expense line items in the accompanying condensed consolidated statements of operations. Our research and development expenses in those periods were as follows:

	September 30, 2012	September 30, 2011
Three months ended	$ 360,090	$ 117,820
Six months ended	$ 649,787	$ 318,859

FAIR VALUE OF DERIVATIVE FINANCIAL INSTRUMENTS

The fair value of certain convertible notes and related warrants at September 30, 2012 and March 31, 31, 2012 are $3,194,394 and $3,588,615, respectively, based upon a third party valuation report that we commissioned. Warrants classified as derivative liabilities are reported at their estimated fair value, with changes in fair value being reported in current period results of operations.

EQUITY INSTRUMENTS FOR SERVICES PROVIDED BY PARTIES OTHER THAN EMPLOYEES

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

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

(a) For transactions where goods have already been delivered or services rendered, the equity instruments are issued on or about the date the performance is complete (and valued on the date of issuance).

(b) For transactions where the instruments are issued on a fully vested, non-forfeitable basis, the equity instruments are valued on or about the date of the contract.

(c) For any transactions not meeting the criteria in (a) or (b) above, we re-measure the consideration at each reporting date based on its then current stock value.

IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS

We review our long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If the cost basis of a long-lived asset is greater than the projected future undiscounted net cash flows from such asset (excluding interest), an impairment loss is recognized. Impairment losses are calculated as the difference between the cost basis of an asset and its estimated fair value. We believe that no impairment occurred at or during the three and six months ended September 30, 2012 and 2011.

BENEFICIAL CONVERSION FEATURE OF CONVERTIBLE NOTES PAYABLE

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

DERIVATIVE LIABILITIES AND CLASSIFICATION

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

The classification of a derivative instrument is reassessed at each balance sheet date. If the classification 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.

On April 1, 2009 we adopted new guidance, as codified in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 815-40, *Derivatives and Hedging*, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* (previously EITF 07-5), that requires us to apply a two-step model in determining whether a financial instrument or an embedded feature is indexed to our own stock and thus enables it to qualify for equity classification. We have identified several convertible debt or warrant agreements in which the embedded conversion feature or exercise price contains certain provisions that may result in an adjustment of the conversion or exercise price, which results in the failure of the these instruments to be considered to be indexed to our stock. Accordingly, under this guidance, we are required to record the estimated fair value of these instruments as derivative liabilities (see Note 9).

We re-measure the estimated fair value of derivative liabilities at each reporting period and record changes in fair value in other expense (income) in the current statement of operations.

REGISTRATION PAYMENT ARRANGEMENTS

We account for contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement separately from any related financing transaction agreements, and any such contingent obligations are recognized only when it is determined that it is probable that the Company will become obligated for future payments and the amount, or range of amounts, of such future payments can be reasonably estimated (see Note 7).

STOCK-BASED COMPENSATION

Employee stock options and rights to purchase shares under stock participation plans are accounted for under the fair value method. Accordingly, share-based compensation is measured when all granting activities have been completed, generally the grant date, based on the fair value of the award. 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 OTCBB) on the date of grant. Compensation cost recognized by the Company 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 the then current accounting standards, 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 subsequent accounting standards. We use a Binomial Lattice option pricing model for estimating fair value of options granted (see Note 10).

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

There were no recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the American Institute of Certified Public Accountants, or the Securities and Exchange Commission during the six months ended September 30, 2012 or that were issued in prior periods but do not become effective until future periods that in the opinion of management had, or are expected to have a material impact on our present or future consolidated financial statements.

NOTE 4. NOTES PAYABLE

Notes payable consist of the following:

	September 30, 2012		March 31, 2012	
	Principal Balance	Accrued Interest	Principal Balance	Accrued Interest
12% Notes payable, past due	$185,000	$312,187	$185,000	$298,312
10% Note payable, past due	5,000	5,625	5,000	5,375
IP Law Firm Note, past due	–	–	29,610	986
Law Firm Note	–	–	75,000	104
Tonaquint Note	262,114	2,054	360,186	1,835
Total	$452,114	$319,866	$654,796	$306,612

During the six month period ended September 30, 2012, we recorded interest expense of $32,447 related to the contractual interest rates of our 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"). On April 21, 2010, a holder of $100,000 of the 12% Notes converted his principal balance and $71,758 of accrued interest into 687,033 shares of common stock at an agreed conversion price of $0.25 per share. We incurred a loss upon this conversion of $68,703 since the closing price of our common stock was $0.35 at the date of conversion. At September 30, 2012, 12% Notes with a principal balance of $185,000 are outstanding, all of which are past due, in default, and bearing interest at the default rate of 15%. At September 30, 2012, interest payable on the 12% Notes totaled $312,187 and we are recording interest at the default rate of 15%.

10% NOTES

At September 30, 2012, one 10% Note in the amount of $5,000, which is past due and in default, remained outstanding. At September 30, 2012, interest payable on this note totaled $5,625 and we are recording interest at the default rate of 15%.

Management's plans to satisfy the remaining outstanding balance on these 12% and 10% Notes include converting the notes to common stock at market value or repayment with available funds.

IP LAW FIRM NOTE

On August 2, 2011, we entered into a Promissory Note with our intellectual property law firm for the amount of $49,610, which represented the amount we owed to that firm. The Promissory Note called for monthly payments of $5,000 from August 2011 through December 2011 and bore interest at 10% per annum. We paid off this note and related accrued interest with cash in April 2012.

LAW FIRM NOTE

On March 22, 2012, we entered into a Promissory Note with our corporate law firm for the amount of $75,000, which represented the majority of the amount we owed to that firm. The Promissory Note has a maturity date of December 31, 2012 and bears interest at five percent per annum. The note is convertible at the option of the holder into shares of our common stock at a 10% discount to the market price of the common stock on the date prior to conversion with a floor price on such conversions of $0.08 per share. This ability of the holder to convert became exercisable upon the amendment of the Articles of Incorporation increasing the authorized shares of our common stock to a number greater than 250,000,000. As that increase in the authorized number of shares of our common stock was approved by our stockholders at a Special Stockholders Meeting on June 4, 2012, this note was reclassified to a convertible note as of June 30, 2012 (see Note 5).

TONAQUINT NOTE

On June 28, 2011, we entered into a Termination Agreement with Tonaquint, Inc. (see Note 5) under which both parties agreed that in consideration of the termination of a warrant, the waiving of all fees, penalties, the creation of the selling program and other factors, we agreed to issue an unsecured non-convertible promissory note (the "New Note") in the principal amount of $360,186, which provides for annual interest at a rate of 6%, payable monthly in either cash or our stock, at our option. The New Note originally had a maturity date of April 30, 2012. We subsequently extended the note initially to July 31, 2012 and then subsequently to July 31, 2013 and converted $100,572 of the principal and $19,614 of the accrued interest related to the note into common stock (see Note 6). We also recorded into principal $2,500 of the lender’s legal fees related to documentation of the extension agreement. We recorded a loss on conversion of $50,262 on those partial conversions. At September 30, 2012, the balance of this note was $262,114 and accrued interest totaled $2,054.

NOTE 5. CONVERTIBLE NOTES PAYABLE

Convertible Notes Payable consisted of the following at September 30, 2012:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Amended and Restated Series A 12% Convertible Notes, past due	$885,000	$ –	$885,000	$309,750
2008 10% Convertible Notes, past due	25,000	–	25,000	13,542
December 2006 10% Convertible Notes, past due	17,000	–	17,000	14,521
October & November 2009 10% Convertible Notes	50,000	(2,664)	47,336	17,500
April 2010 10% Convertible Note	75,000	(7,072)	67,928	20,188

September 2010 10% Convertible Notes, past due	308,100	–	308,100	29,285
April 2011 10% Convertible Notes, past due	400,400	–	400,400	70,070
July and August 2011 10% Convertible Notes, $257,656 past due	357,655	–	357,655	44,380
September 2011 Convertible Notes, past due	208,760	–	208,760	–
Law Firm Note	75,000	–	75,000	1,979
Total – Convertible Notes	$2,401,915	$ (9,736)	$2,392,179	$521,215

All but two of the Convertible Notes Payable in the above table are presently past due or will be due within one year of the September 30, 2012 balance sheet date. As a result, we expect to amortize all but $4,284 of the remaining discounts during the fiscal year ending March 31, 2013.

During the six months ended September 30, 2012, we recorded interest expense of $287,272 related to the contractual interest rates of our convertible notes and interest expense of $461,707 related to the amortization of debt discounts on the convertible notes for a total of $769,568.

Convertible Notes Payable consisted of the following at March 31, 2012:

	Principal	Unamortized Discount	Net Amount	Accrued Interest
Amended and Restated Series A 12% Convertible Notes, past due	$900,000	$ –	$900,000	$168,750
2008 10% Convertible Notes, past due	25,000	–	25,000	11,667
December 2006 10% Convertible Notes, past due	17,000	–	17,000	13,246
October & November 2009 10% Convertible Notes, $25,000 past due	75,000	(4,833)	70,167	22,500
April 2010 10% Convertible Note	75,000	(10,107)	64,893	16,438
September 2010 10% Convertible Notes	338,100	–	338,100	70,804
April 2011 10% Convertible Notes	400,400	–	400,400	40,040
July and August 2011 10% Convertible Notes	357,655	(109,911)	247,744	24,262
September 2011 Convertible Notes	238,760	(106,932)	131,828	–
November 2011 Convertible Notes	525,000	(51,220)	473,780	39,177
February 2012 Convertible Notes	525,000	(188,439)	336,561	12,120
Total – Convertible Notes	$3,476,915	$ (471,442)	$3,005,473	$419,004

AMENDED AND RESTATED SERIES A 12% CONVERTIBLE NOTES

In June 2010, we entered into Amended and Restated 12% Series A Convertible Promissory Notes (the "Amended and Restated Notes") with the holders of certain promissory notes previously issued by the Company ("Amended Series A 10% Convertible Notes" or the "Prior Notes"), and all amendments to the Prior Notes.

The Amended and Restated Notes, in the principal amount of $900,000 matured on December 31, 2010. In connection with the restructuring we paid $54,001 of accrued and default interest through the date of the restructuring, liquidated damages of $205,000 and $54,003 of prepaid interest through the expiration date in the aggregate amount of $313,004 through the issuance of units ("Units") at a fixed rate of $0.20 per Unit, each Unit consisting of one share of our common stock and one common stock purchase warrant to purchase one share of our common stock at a fixed exercise price of $0.20 per share as prescribed in the Amended and Restated Note Agreement. The noteholders have antidilution price protection on the Amended and Restated Notes.

In addition to the extension of the expiration date of the Amended and Restated Notes to December 31, 2010, we agreed to increase the annual interest rate from ten percent to twelve percent. We also agreed to change the exercise prices on all of the warrants held by the noteholders to $0.20 per share, to change certain formerly contingent warrants to non-contingent warrants and to extend the expiration date of their warrants to February 2016.

As of December 31, 2010, the Amended and Restated Notes matured and as of September 30, 2012 remain in default. We are accruing interest at the revised default rate of 20% following the expiration date of December 31, 2010.

In June 2012, the holder of $15,000 of the Amended and Restated Notes converted his principal and related accrued interest into common stock per the conversion formula.

We have begun discussions with the noteholders regarding an extension to the notes but there can be no assurance that we will be able to do so on terms that we deem acceptable or at all. At September 30, 2012, the balance of the Amended and Restated Notes was $885,000 and interest payable on the Amended and Restated Notes totaled $309,750.

2008 10% CONVERTIBLE NOTES

One 2008 10% Convertible Note in the amount of $25,000 which matured in January 2010 remained outstanding at September 30, 2012. This note is convertible into our common stock at $0.50 per share. At September 30, 2012, the $25,000 principal balance was in default and interest payable on the remaining note totaled $13,542 and we are recording interest at the default rate of 15%..

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DECEMBER 2006 10% CONVERTIBLE NOTES

At September 30, 2012, $17,000 of the December 2006 10% Notes remained outstanding and in default. These notes are convertible into our common stock at $0.17 per share. At September 30, 2012, the $17,000 balance of the notes was in default and interest payable on those notes totaled $14,521 and we are recording interest at the default rate of 15%.

OCTOBER & NOVEMBER 2009 10% CONVERTIBLE NOTES

In October and November 2009, we raised $430,000 from the sale to accredited investors of 10% convertible notes ("October & November 2009 10% Convertible Notes"). The October & November 2009 10% Convertible Notes matured at various dates between April 2011 and May 2011 and are convertible into our common stock at a fixed conversion price of $0.25 per share prior to maturity. The investors also received matching three year warrants to purchase unregistered shares of our common stock at a price of $0.25 per share. We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a 100% discount against the principal of the notes. We are amortizing this discount using the effective interest method over the term of the notes.

Deferred financing costs of $20,250 incurred in connection with this financing were issued in the form of a convertible note with warrants on the same terms as those received by the investors. We capitalized the $20,250 of deferred financing costs and amortized them over the term of the notes using the effective interest method.

Prior to March 31, 2012, $355,000 of the October and November 2009 financing had been converted to common stock. On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of one of the note holders by two years in exchange for the extension of $50,000 of the October & November 2009 10% Convertible Notes and the $75,000 April 2010 10% Convertible Note (see below) by that same two year period. We recorded a charge of $77,265 relating to this modification.

At June 30, 2012, there were two notes remaining, one for $25,000 which was past due and the other for $50,000, which had been extended.

In July 2012, we issued 461,409 shares of common stock to the holder of the $25,000 note in exchange for the value of the principal and related accrued interest of $8,000 under the same terms that we used to sell units consisting of one share of common stock and one-half of a stock purchase warrant on June 29, 2012 (see Note 6). As part of that structure, the noteholder also received seven year warrants to purchase 230,705 share of common stock at a price of $0.107 per share. We recorded a loss on conversion of $45,796 on the conversions.

At September 30, 2012, there was one note remaining for $50,000 and interest payable on that note was $17,500.

APRIL 2010 10% CONVERTIBLE NOTE

In April 2010, we raised $75,000 from the sale to an accredited investor of a 10% convertible note. The convertible note matures in October 2011 and is convertible into our common stock at a fixed conversion price of $0.25 per share prior to maturity. The investor also received three year warrants to purchase 300,000 unregistered shares of our common stock at a price of $0.25 per share.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a 100% discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note.

On March 31, 2012, we agreed to extend the expiration date and to change the exercise price of certain warrants of the note holder by two years in exchange for his extension of $50,000 of the October & November 2009 10% Convertible Notes and the $75,000 April 2010 10% Convertible Note by that same two year period. We recorded a charge of $77,265 relating to this modification.

At September 30, 2012, the remaining outstanding principal balance is $75,000 and interest payable on this note totaled $20,188.

JULY 2010 6% CONVERTIBLE NOTES

In July 2010, we entered into a Note and Warrant Purchase Agreement (the "Purchase Agreement") with Tonaquint, Inc., a Utah corporation (the "Investor"), whereby we issued and sold, and the Investor purchased: (i) a Convertible Promissory Note of the Company in the principal amount of $890,000 (the "Company Note") and (ii) a Warrant to purchase common stock of the Company (the "Warrant"). As consideration for the issuance and sale of the Company Note and Warrant, the Investor paid cash in the amount of $400,000 and issued two Secured Trust Deed Notes to us (the "Trust Notes") each in the principal amount of $200,000. The variance of $90,000 represents fees and expenses paid by us and an original issue discount which was recorded as deferred offering costs.

The Company Note is convertible into shares of the Company's common stock, at the option of the Investor, at a price per share equal to (a) the principal and interest due under the Company Note divided by (b) 80% of the average of the closing bid price for the three (3) trading days with the lowest closing bid prices during the twenty (20) trading days immediately preceding the conversion date (the “Conversion Price”). In no event shall the Conversion Price be greater than the "Ceiling Price", which is $0.30 per share. The principal and interest subject to conversion under the Note shall be eligible for conversion in tranches ("Tranches"), as follows: (1) an initial Tranche in an amount equal to $450,000 and any interest and/or fees accrued thereon under the terms of the Company Note and the other Transaction Documents (as defined in the Purchase Agreement), and (2) two additional subsequent Tranches each in an amount equal to $220,000 and any interest or fees accrued thereon under the terms of the Company Note or the other Transaction Documents. The first subsequent Tranche shall correspond to payment of the first Trust Note and the second subsequent Tranche shall correspond to payment of the second Trust Note (as defined in the Purchase Agreement). The Investor's right to convert any of the subsequent Tranches is conditioned upon the Investor’s payment in full of the Trust Notes corresponding to such subsequent Tranche. Accordingly, principal and interest under the Company Note may only be converted by the Investor in proportion to the amounts paid under each of the Trust Notes. However, up to $450,000 may be converted at the Investor's option at any time, representing amounts paid by the Investor on the closing of the transaction on July 15, 2010 (the "Closing"). The Company Note bears interest at a rate of 6% per annum. The maturity date of the Company Note was July 15, 2011. The Company Note contains "anti-dilution" protection, such that if the Company issues and sells common stock, or securities convertible into or exercisable for common stock of the Company, at a price per share that is less than the applicable Conversion Price, then the Conversion Price is adjusted downward to match such lower issuance price. However, in no event will the Conversion Price based on anti-dilution adjustments be lower than the "Floor Price" which is $0.20 per share.

The number of shares of Common Stock that may be issued to the lender pursuant to a conversion of this Note, combined with an exercise of the Warrant, shall not exceed a cap determined by (a) dividing the sum of (i) the face amount of this Note, plus (ii) an amount equal to all interest that would accrue under this Note during its term (assuming no payments of principal or interest are made prior to the Maturity Date), by (b) a price per share of Common Stock equal to $0.20 (the Floor Price).

The Company Note also contains other standard adjustment features for stock splits, recapitalizations and similar occurrences. The Company Note contains standard events of default related to payment, performance of certain covenants and bankruptcy events. We have granted the Investor a security interest in the Trust Notes under the terms of the Security Agreement. The sole collateral for the Company's payment and performance obligation under the

Company Note is the Trust Notes. The Warrant entitles the Investor to purchase 3,636,364 shares of common stock at an exercise price of $0.231 per share. The Warrant contains "anti-dilution" protection, such that if we issue and sell common stock, or securities convertible into or exercisable for common stock of the Company, at a price per share that is less than the price, then the price is adjusted downward to match such lower issuance price. The Warrant also contains other standard adjustment features for stock splits, recapitalizations and similar occurrences.

We recorded a debt discount of $890,000 based on the estimated fair value of the derivative liabilities associated with the warrants and embedded conversion feature which was amortized using the effective interest method over the term of the note.

On June 28, 2011, we entered into a Termination Agreement with Tonaquint under which both parties agreed to terminate the warrant to prevent continuing dilution of our common stock and to eliminate confusion or disagreement as to the number of shares of common stock available for issuance under the warrant in the future. Accordingly, under the Termination Agreement we issued 3,599,913 shares of common stock upon the final exercise of the warrant, whereupon the warrant was terminated and is of no further force or effect. The Termination Agreement also provides for a "Common Stock Sale Limitation" on all of our common stock held by Tonaquint, Inc. Under the "Common Stock Sale Limitation", the daily limitation on the number of shares of common stock which Tonaquint, Inc. may sell into the market on any trading day is limited to the greater of (i) $5,000 of sales amount, or (ii) 10% of the Average Daily Volume of our common stock sold on the Over The Counter Bulletin Board, where the Average Daily Volume shall mean the average daily volume for the prior three month period as reported on each trading day on Yahoo Finance with respect to our common stock. Under the terms of the Termination Agreement, Tonaquint, Inc. has waived and released us from any obligation to pay or perform any fees, penalties, costs, or assessments that were or are due, or would have become due, under the convertible note, the warrant and the note purchase agreement. In consideration of the termination of the warrant, the waiving of all fees, penalties, the creation of the selling program and other factors, we agreed to issue an unsecured non-convertible promissory note (the "New Note") in the principal amount of $360,185, which provides for annual interest at a rate of 6%, payable monthly in either cash or our stock, at our option. The New Note originally had a maturity date of April 30, 2012 and was subsequently extended to July 31, 2013. At September 30, 2012, the balance of this note was $262,114 and interest payable totaled $2,054 (see Note 4).

SEPTEMBER 2010 10% CONVERTIBLE NOTES

On September 3, 2010, we entered into a Subscription Agreement with three accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of $1,430,000. The initial closing under the Subscription Agreement resulted in the issuance and sale of (i) convertible promissory notes in the aggregate principal amount of $743,600, (ii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of $0.31125 per share, and (iii) five-year warrants to purchase an aggregate of 3,718,000 shares of our common stock at an exercise price of $0.43575 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of ten percent (10%) and matured on September 3, 2011. The aggregate gross cash proceeds were $650,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not be more than $0.30 nor less than $0.20. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

The following conversions of the September 2010 10% Convertible Note have taken place during the fiscal year ended March 31, 2012 and the six months ended September 30, 2012:

	Six Months	Fiscal Year

	Ended September 30, 2012	Ended March 31, 2012
Principal converted	$ 30,000	$405,500
Accrued interest converted	$ 64,164	$19,255

At September 30, 2012, the remaining principal balance of $308,100 was in default and interest payable on these notes totaled $29,285 and we are recording interest at the default rate of 15%.

APRIL 2011 10% CONVERTIBLE NOTES

In April 2011, we entered into a Subscription Agreement with two accredited investors (the “Purchasers”) providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of $385,000. The closing under the Subscription Agreement resulted in the issuance and sale by us of (i) convertible promissory notes in the aggregate principal amount of $385,000, (ii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of $0.125 per share, and (iii) five-year warrants to purchase an aggregate of 4,004,000 shares of our common stock at an exercise price of $0.175 per share. The convertible promissory notes bear interest compounded monthly at the annual rate of ten percent (10%) and matured on April 1, 2012. The aggregate gross cash proceeds to us were $350,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to eighty percent (80%) of the average of the three lowest closing bid prices of the common stock as reported by Bloomberg L.P. for the principal market on which the common stock trades or is quoted for the ten (10) trading days preceding the proposed conversion date. Subject to adjustment as described in the notes, the conversion price may not be more than $0.20 nor less than $0.10. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

In addition, we issued (i) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of $0.125 per share, and (ii) five-year warrants to purchase an aggregate of 812,500 shares of our common stock at an exercise price of $0.175 per share to the Purchasers. These warrants were issued as an antidilution adjustment under certain common stock purchase warrants held by the Purchasers that were acquired from us in September 2010.

At September 30, 2012, the outstanding principal balance was $400,400 and was in default and interest payable on these notes totaled $70,070 and we are recording interest at the default rate of 15%.

JULY & AUGUST 2011 10% CONVERTIBLE NOTES

During the three months ended September 30, 2011, we raised $357,656 in 10% convertible notes. Those notes had a fixed conversion price of $0.09 per share and carried an interest rate of 10%. The convertible notes matured in July and August 2012. We also issued those investors five year warrants to purchase 3,973,957 shares of common stock at $0.125 per share.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a $257,926 discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note.

Effective July 14, 2011 holders of three notes totaling $100,000 agreed to extend the expiration date of their notes to July 13, 2013.

At September 30, 2012, the outstanding principal balance was $357,655, of which $257,655 was in default and interest payable on these notes totaled $44,380. Following the expiration of the maturity dates on the $257,655 of notes that are now in default, we began to accrue interest at the default interest rate of 15%.

SEPTEMBER 2011 CONVERTIBLE NOTES

On September 23, 2011, we entered into a Subscription Agreement with two accredited investors (the "Purchasers") providing for the issuance and sale of convertible promissory notes and corresponding warrants in the aggregate principal amount of $253,760. The warrants carried a five-year term to purchase an aggregate of 3,625,143 shares of our common stock at an exercise price of $0.10 per share. The convertible promissory notes do not bear an interest rate and mature on September 23, 2012. The aggregate net cash proceeds to us were $175,000, the balance of the principal amount representing a due diligence fee and an original issuance discount. The convertible promissory notes are convertible at the option of the holders into shares of our common stock at a price per share equal to $0.07. Subject to adjustments as described in the notes, the conversion price may not be more than $0.07. There are no registration requirements with respect to the shares of common stock underlying the notes or the warrants.

We measured the fair value of the warrants and the beneficial conversion feature of the notes and recorded a $168,804 discount against the principal of the notes. We amortized this discount using the effective interest method over the term of the note.

In March 2012, following the six month anniversary of the note funding, one of the note holders converted $15,000 of principal into common stock and in the six months ended September 30, 2012, that note holder converted an additional $30,000 of principal into common stock.

At September 30, 2012, the outstanding principal balance was $208,760 and was in default and there was no accrued interest as these notes do not bear interest.

NOVEMBER 2011 CONVERTIBLE NOTES

In November 2011, we raised $525,000 in 5% Original Issue Discount Unsecured Convertible Debentures from five accredited investors pursuant to which the investors purchased an aggregate principal amount of $525,000 for an aggregate purchase price of $500,000. The debentures bear interest at 20% per annum and matured on April 20, 2012. The debentures will be convertible at the option of the holders at any time into shares of our common stock, at a conversion price equal to $0.0779, subject to adjustment. In connection with the debentures, the purchasers received warrants to purchase 3,369,706 shares of our common stock. The warrants are exercisable for a period of five years from the date of issuance at an exercise price of $0.11, subject to adjustment.

Until December 31, 2012, upon any proposed issuance by us of our common stock or equivalents (or a combination thereof as defined in the subscription agreement) for cash consideration, the purchasers may elect, in their sole discretion, to exchange all or some of the debentures then held by such purchaser for any securities issued in a subsequent financing on a $1.00 for $1.00 basis, provided, however , this right shall not apply with respect to (i) an Exempt Issuance (as defined in the debenture) or (ii) an underwritten public offering of our common stock.

A Financial Industry Regulatory Authority (FINRA) registered broker-dealer was engaged as placement agent in connection with the transaction. We paid the placement agent a cash fee in the amount of $50,000 (representing a 8% sales commission and a 2% unaccountable expense allowance) and issued the placement agent or its designees warrants to purchase an aggregate of 808,729 shares of common stock at $0.11 per share. The warrants issued to the placement agent may be exercised on a cashless basis. In the event the placement agent exercises the warrants on a cashless basis, we will not receive any proceeds.

During the six months ended September 30, 2012, all of the outstanding principal balances on these notes and all related accrued interest of $53,803 were converted into common stock.

FEBRUARY 2012 CONVERTIBLE NOTES

In February 2012, we entered into a subscription agreement with five accredited investors (the “Purchasers”) pursuant to which the Purchasers purchased an aggregate principal amount of $525,000 of 5% Original Issue Discount Unsecured Convertible Debentures for an aggregate purchase price of $500,000 (the “Debenture”). These subscriptions represent the completion of the $1,000,000 securities offering that was initiated and priced in November 2011 (see above).

The Debentures bear interest at 20% per annum and matured on April 20, 2012. The Debentures will be convertible at the option of the holders at any time into shares of our common stock, at a conversion price equal to $0.0779, subject to adjustment. In connection with the subscription agreement, the Purchasers received warrants to purchase 3,369,707 shares of our common stock (the “Warrants”). The Warrants are exercisable for a period of five years from the date of issuance at an exercise price of $0.11 per share, subject to adjustment. Each Purchaser may exercise such Purchaser’s Warrant on a cashless basis if the shares of common stock underlying the Warrant are not then registered pursuant to an effective registration statement. In the event the Purchasers exercise the Warrants on a cashless basis, we will not receive any proceeds. The conversion price of the Debenture and the exercise price of the Warrants are subject to customary adjustment provisions for stock splits, stock dividends, recapitalizations and the like.

Until December 31, 2012, upon any proposed issuance by us of our Common Stock or Common Stock Equivalents (or a combination thereof as defined in the subscription agreement) for cash consideration (the “Subsequent Financing”), a Purchaser may elect, in its sole discretion, to exchange all or some of the Debenture then held by such Purchaser for any securities issued in a Subsequent Financing on a $1.00 for $1.00 basis, provided, however, this right shall not apply with respect to (i) an Exempt Issuance (as defined in the Debenture) or (ii) an underwritten public offering of our common stock.

Each Purchaser has contractually agreed to restrict its ability to exercise the Warrant and convert the Debenture such that the number of shares of our common stock held by the Purchaser and its affiliates after such conversion or exercise does not exceed 4.99% of our then issued and outstanding shares of common stock.

The full principal amount of the Debenture is due upon a default under the terms of the Debenture. The Debenture is a general unsecured debt obligation of ours arising other than in the ordinary course of business which constitutes a direct financial obligation of the Company.

A FINRA registered broker-dealer was engaged as placement agent in connection with the transaction. We paid the placement agent a cash fee in the amount of $50,000 (representing an 8% sales commission and a 2% unaccountable expense allowance) and issued the placement agent or its designees warrants to purchase an aggregate of 815,774 shares of common stock at $0.11 per share. The warrants issued to the placement agent may be exercised on a cashless basis. In the event the placement agent exercises the warrants on a cashless basis, we will not receive any proceeds.

During the six months ended September 30, 2012, all of the outstanding principal balances on these notes and all related accrued interest of $55,432 were converted into common stock.

LAW FIRM NOTE

On March 22, 2012, we entered into a Promissory Note with our corporate law firm for the amount of $75,000, which represented the majority of the amount we owed to that firm. The Promissory Note has a maturity date of December 31, 2012 and bears interest at five percent per annum. The note is convertible at the option of the holder into shares of our common stock at a 10% discount to the market price of the common stock on the date prior to conversion with a floor price on such conversions of $0.08 per share. This ability of the holder to convert became exercisable upon the amendment of the Articles of Incorporation increasing the authorized shares of our common stock to a number greater than 250,000,000. As that increase in the authorized number of shares of our common stock was approved by our stockholders at a Special Stockholders Meeting on June 4, 2012, this note was reclassified to a convertible note as of June 30, 2012 (see Note 4).

At September 30, 2012, the outstanding principal balance on this note was $75,000 and the interest payable on this note totaled $1,979.

NOTE 6. EQUITY TRANSACTIONS

On April 5, 2012, we completed a unit subscription agreement with one accredited investor (the “Purchaser”) pursuant to which the Purchaser purchased $200,000 of units (the "Units" and each a "Unit"), with each Unit consisting of (i) one share of Common Stock, par value $0.001 per share (the “Common Stock”) at a price per share of $0.08 and (ii) a warrant to purchase such number of shares of Common Stock as shall equal (a) fifty percent of the Subscription Amount *divided by* (b) $0.08 (the "Warrant Shares") at an exercise price of $0.125 per Warrant Share, (each, a “Warrant” and collectively, the “Warrants”). Based on the foregoing, Units consisting of 2,500,000 shares of Common Stock and Warrants to purchase 1,250,000 shares of Common Stock were issued on April 5, 2012.

The Warrants are exercisable for a period of seven years from the date of issuance at an exercise price of $0.125, subject to adjustments for stock splits, stock dividends, recapitalizations and the like. The Purchaser may exercise the Warrant on a cashless basis if the shares of common stock underlying the Warrant are not then registered pursuant to an effective registration statement. In the event the Purchaser exercises the Warrant on a cashless basis, we will not receive any proceeds. There are no registration rights with respect to the Warrants or the Warrant Shares.

On June 19, 2012, we completed a unit subscription agreement with seven accredited investors (the "Purchasers") pursuant to which the Purchasers purchased $592,000 of units (the "Units" and each a "Unit"), with each Unit consisting of (i) one share of Common Stock at a price per share of $0.072 and (ii) a warrant to purchase such number of shares of Common Stock as shall equal (a) fifty percent of the Subscription Amount *divided by* (b) $0.072 (the "Warrant Shares") at an exercise price of $0.108 per Warrant Share.

On June 26, 2012, we completed a unit subscription agreement with one accredited investor pursuant to which the Purchaser purchased $10,000 of units (the "Units" and each a "Unit"), with each Unit consisting of (i) one share of Common Stock at a price per share of $0.072 and (ii) a warrant to purchase such number of shares of Common Stock as shall equal (a) fifty percent of the Subscription Amount *divided by* (b) $0.072 (the "Warrant Shares") at an exercise price of $0.107 per Warrant Share.

On August 29, 2012, we completed a unit subscription agreement with seven accredited investors (the "Purchasers") pursuant to which the Purchasers purchased an aggregate of $271,000 (the "Subscription Amount") of restricted Common Stock at a price of $0.08 per share. The Common Stock purchase price under the Subscription Agreement was determined to be 80% of the average closing price of the our Common Stock for the five-day period immediately preceding the date of the Subscription Agreement, resulting in the issuance of 3,387,500 shares of Common Stock.

Each Purchaser also received one Common Stock Purchase Warrant for each two shares of Common Stock purchased under the Subscription Agreement. The Warrant exercise price was calculated to be $0.12 per share based upon 120% of the average of the closing prices of our Common Stock for the five-day period immediately preceding the parties entering into the Subscription Agreement.

The Warrants are exercisable for a period of seven years from the date of issuance at an exercise price of $0.12, subject to adjustments for stock splits, stock dividends, recapitalizations and the like. The Purchasers may exercise the Warrants on a cashless basis if the shares of Common Stock underlying the Warrants are not then registered pursuant to an effective registration statement. In the event that a Purchaser exercises the Warrant on a cashless basis, we will not receive any proceeds. There are no registration rights with respect to the Warrants or the Common Stock underlying the Warrants.

During the six months ended September 30, 2012, we issued 20,308,316 shares of restricted common stock to holders of notes issued by the Company in exchange for the partial or full conversion of principal and interest of several notes payable in an aggregate amount of $1,515,163 at an average conversion price of $0.07 per share based upon the conversion formulae in the respective notes.

During the six months ended September 30, 2012, we issued 116,000 shares of restricted common stock to settle past due accrued interest that we recorded as non-cash interest expense of $11,846.

During the six months ended September 30, 2012, we issued 1,553,803 restricted shares of common stock to service providers for investor relations and business development services valued at $139,182 based upon the fair value of the shares issued. The average issuance price on the restricted share issuances was approximately $0.09 per share.

In July 2012, we filed a registration statement on Form S-8 for the purpose of registering 5,000,000 common shares issuable under the 2010 Stock Plan under the Securities Act of 1933.

On July 24, 2012, we expanded our Board of Directors by an additional two seats and appointed two new outside directors to fill those seats.

In July 2012, our Board of Directors approved a new Board Compensation Program (the “New Program”), which modifies and supersedes the 2005 Directors Compensation Program (the “2005 Program”) that was previously in effect. Under the New Program, in which only non-employee Directors may participate, an eligible Director will receive a grant of $15,000 worth of options to acquire shares of Common Stock, with such grant being valued at the exercise price based on the average of the closing bid prices of the Common Stock for the five trading days preceding the first day of the fiscal year; however for the new non-employee directors, the exercise price for this initial grant, $0.076 per share, is based on the average of the closing bid prices of the Common Stock for the five trading days preceding the date of their appointment (July 24, 2012). These options will have a term of ten years and will be fully vested upon grant. In addition, each existing eligible Director will receive the same grant of $15,000 worth of options to acquire shares of Common Stock, with such grant being valued at the exercise price based on the average of the closing bid prices of the Common Stock for the five trading days preceding the first day of the fiscal year; provided however that for this current grant only, all of such grants shall be made at an exercise price of $0.076 per share based on the average of the closing bid prices of the Common Stock for the five trading days preceding the date (July 24, 2012) of the appointment of two new directors to our Board of Directors.

At the beginning of each fiscal year, each Director eligible to participate in the New Program also will receive a grant of $20,000 worth of options valued at the exercise price based on the average of the closing bid prices of the Common Stock for the five trading days preceding the first day of the fiscal year. In addition, under the New Program eligible Directors will receive cash compensation equal to $500 for each committee meeting attended and $1,000 for each formal Board meeting attended.

The New Program eliminates the following features of the 2005 Program: (1) the annual payment of $10,000 in cash compensation and (2) the granting of options to Directors based on a percentage of our issued and outstanding common stock.

NOTE 7. ACCRUED LIQUIDATED DAMAGES

We account for contingent obligations to make future payments or otherwise transfer consideration under a registration payment arrangement separately from any related financing transaction agreements, and any such contingent obligations are recognized only when it is determined that it is probable that we will become obligated for future payments and the amount, or range of amounts, of such future payments can be reasonably estimated.

We have entered into registration payment arrangements in connection with certain financing arrangements, pursuant to which we raised an approximate aggregate amount of $2,020,000, that require us to register the shares of common stock underlying the convertible debt and warrants issued in these financing transactions. Under these agreements we are liable for liquidated damages to the investors if we fail to file and/or maintain effective registration statements covering the specified underlying shares of common stock as noted below:

- With respect to a $1,000,000 financing agreement – damages accrue at a rate of 1% - 1.5% per month until such time as the underlying shares of common stock would have been eligible for sale under Rule 144.
- With respect to financing agreements totaling $715,000 – damages accrue at a rate of 2% per month, subject to an aggregate maximum liquidated damages amount of $150,000.
- With respect to equity investments totaling $305,000 – damages accrue at a rate of 2% per month until the expiration dates of warrants issued in connection with this financing, which range from December 31,2010 through February 8, 2011 and are payable in common stock.

Since we have either failed to file, or failed to maintain the registration obligations under these agreements, as of September 30, 2012 and March 31, 2012, we have accrued estimated aggregate liquidated damages of $437,800 in connection with the liquidated damage provisions of these agreements, which we believe represents our maximum exposure under these provisions. Accordingly, we do not expect to accrue any further liquidated damages in connection with these agreements. The actual amount of liquidated damages paid, if any, may differ from our estimates as it is our intention to negotiate with the investors the settlement of liquidated damages due and, as such, the ultimate amounts we may actually pay may be less than the amount currently accrued.

NOTE 8. OTHER CURRENT LIABILITIES

At September 30, 2012 and March 31, 2012, our other current liabilities were comprised of the following items:

	September 30, 2012	March 31, 2012
Accrued interest	$840,866	$725,616
Accrued legal fees	179,465	179,465
Deferred rent	6,175	5,607
Other	106,763	220,533
Total other current liabilities	$1,133,269	$1,131,221

As of the date of this report, various promissory and convertible notes payable in the aggregate principal amount of $2,291,916 (as identified in Notes 4 and 5 above) have reached maturity and are past due. We are continually reviewing other financing arrangements to retire all past due notes. At September 30, 2012, we had accrued interest in the amount of $787,267 associated with these defaulted notes in accrued liabilities payable (see Notes 4 and 5).

NOTE 9. FAIR VALUE MEASUREMENTS

We follow FASB ASC 820, "FAIR VALUE MEASUREMENTS AND DISCLOSURES" ("ASC 820") in connection with assets and liabilities measured at fair value on a recurring basis subsequent to initial recognition. The guidance applies to our derivative liabilities. We had no assets or liabilities measured at fair value on a non-recurring basis for any period reported.

ASC 820 requires that assets and liabilities carried at fair value will be classified and disclosed in one of the following three categories: We measure the fair value of applicable financial and non-financial assets based on the following fair value hierarchy:

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 hierarchy noted above requires us to minimize the use of unobservable inputs and to use observable market data, if available, when determining fair value.

The fair value of our recorded derivative liabilities is determined based on unobservable inputs that are not corroborated by market data, which is a Level 3 classification. We record derivative liabilities on our balance sheet at fair value with changes in fair value recorded in our consolidated statements of operations.

Our fair value measurements at the September 30, 2012 reporting date are classified based on the valuation technique level noted in the table below (there were no transfers in or out of level 3 for all periods presented):

Description	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Derivative Liabilities	$3,194,394	$ –	$ –	$ 3,194,394
Total Assets	$3,194,394	$ –	$ –	$ 3,194,394

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The following outlines the significant weighted average assumptions used to estimate the fair value information presented, in connection with our warrant and embedded conversion option derivative instruments utilizing the Binomial Lattice option pricing model:

	Six Months Ended September 30, 2012
Risk free interest rate	0.09% - 0.60%
Average expected life	0.02 – 4.2 years
Expected volatility	76.0% - 102.0%
Expected dividends	None

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the six months ended September 30, 2012:

	April 1, 2012	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	September 30, 2012
Derivative liabilities	$3,588,615	$ –	($361,462)	($ 32,759)	$3,194,394

The table below sets forth a summary of changes in the fair value of our Level 3 financial instruments for the six months ended September 30, 2011:

	April 1, 2011	Recorded New Derivative Liabilities	Change in estimated fair value recognized in results of operations	Reclassification of Derivative Liability to Paid in capital	September 30, 2011
Derivative liabilities	2,002,896	$1,107,940	($1,521,502)	(247,608)	$1,341,726

The fair value of derivative liabilities that we recorded in the six months ended September 30, 2011 was related to our April 2011 convertible note, July & August 2011 10% convertible notes and the September 2011 convertible note offerings (see Note 5) and was based upon an independent valuation report.

NOTE 10. STOCK COMPENSATION

The following table summarizes share-based compensation expenses relating to shares and options granted and the effect on basic and diluted loss per common share during the three and six months ended September 30, 2012 and 2011:

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Six Months Ended September 30, 2012	Six Months Ended September 30, 2011
Total share-based compensation expense	$ 226,196	$ 224,031	$ 395,495	$ 448,062
Total share-based compensation expense included in net loss	$ 226,196	$ 224,031	$ 395,495	$ 448,062
Basic and diluted loss per common share	$ (0.00)	$ (0.00)	$ (0.00)	$ (0.01)

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The following table breaks out the components of our share-based compensation expenses relating to shares and options granted and the effect on basic and diluted loss per common share during the three and six months ended September 30, 2012 and 2011.

Three Months Ended September 30, 2012	Three Months Ended	Six Months Ended	Six Months Ended