AEOLUS PHARMACEUTICALS, INC.
Form 10-Q
July 30, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2007.

_____ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
for the transition period from _____ to _____.

Commission File Number
0-50481

AEOLUS PHARMACEUTICALS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	56-1953785 (I.R.S. Employer Identification No.)
23811 Inverness Place Laguna Niguel, California (Address of Principal Executive Offices)	92677 (Zip Code)

(Registrant's Telephone Number, Including Area Code)
949-481-9825

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 [ ]

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

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding as of July 27, 2007
Common Stock, par value $.01 per share	31,952,749 shares

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AEOLUS PHARMACEUTICALS, INC.

PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements.

Statement Regarding Financial Information

The condensed consolidated financial statements of Aeolus Pharmaceuticals, Inc. and its wholly-owned subsidiary, Aeolus Sciences, Inc. (collectively the "Company"), included herein have been prepared by management, without audit (except for the Consolidated Balance Sheet as of September 30, 2006), pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information normally included in the consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States has been condensed or omitted pursuant to such rules and regulations. However, the Company believes that the disclosures are adequate to make the information presented not misleading. The Company recommends that you read the consolidated financial statements included herein in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006, filed with the SEC on December 15, 2006.

AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except shares and per share data)

	June 30, 2007 (Unaudited)	September 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,173	$ 3,324
Prepaids and other current assets	298	104
Total current assets	2,471	3,428
Investment in CPEC LLC	126	126
Total assets	$ 2,597	$ 3,554
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 163	$ 868
Accrued expenses	5	23
Current maturity of long-term note payable	-	956
Total current liabilities	168	1,847
Long-term note payable	471	-
Total liabilities	639	1,847
Commitments and contingences		
Stockholders' equity:		
Preferred stock, $.01 par value per share, 10,000,000 shares authorized:		
Series B nonredeemable convertible preferred stock, 600,000 shares authorized; 475,087 shares issued and outstanding at June 30, 2007 and September 30, 2006	5	5
Common stock, $.01 par value per share, 150,000,000 shares authorized; 31,952,749 and 29,265,249 shares issued and outstanding at June 30, 2007 and September 30, 2006, respectively	320	293
Additional paid-in capital	156,537	154,311
Accumulated deficit	(154,904)	(152,902)
Total stockholders' equity	1,958	1,707
Total liabilities and stockholders' equity	$ 2,597	$ 3,554

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

AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006
Revenue				
Grant income	$ -	$ -	$ -	$ 92
Costs and expenses:				
Research and development	192	419	869	2,677
General and administrative	320	524	1,396	1,571
Total costs and expenses	512	943	2,265	4,248
Loss from operations	(512)	(943)	(2,265)	(4,156)
Interest income (expense), net	3	(10)	38	(29)
Equity in income of CPEC LLC	-	-	-	433
Other income	-	17	225	53
Increase in fair value of common stock warrants	-	(2,216)	-	(1,815)
Net loss	(509)	(3,152)	(2,002)	(5,514)
Preferred stock dividend accreted	-	(26)	-	(81)
Net loss attributable to common stockholders	$ (509)	$ (3,178)	$ (2,002)	$ (5,595)
Net loss per weighted share attributable to common stockholders:				
(basic and diluted)	$ (0.02)	$ (0.17)	$ (0.07)	$ (0.36)
Weighted average common shares outstanding:				
Basic and diluted	30,429	18,234	29,661	15,450

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

AEOLUS PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine Months Ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net loss	$ (2,002)	$ (5,514)
Adjustments to reconcile net loss to net cash used in operating activities:		
Noncash compensation	471	264
Noncash interest and financing costs	40	66
Noncash licensing fee	-	12
Forgiveness of note payable	(225)	-
Equity income of CPEC LLC	-	(433)
Decrease in fair value of common stock warrants	-	1,815
Change in assets and liabilities:		
Accounts receivable, prepaids and other assets	(194)	(20)
Accounts payable and accrued expenses	(723)	(337)
Net cash used in operating activities	(2,633)	(4,147)
Cash flows from financing activities:		
Payment of note payable	(300)	-
Proceeds from dividend from CPEC LLC	-	315
Net proceeds from issuance of Series A Preferred Stock	-	2,413
Net proceeds from issuance of common stock	1,761	4,754
Proceeds from exercise of stock options	21	42
Net cash provided by financing activities	1,482	7,524
Net decrease in cash and cash equivalents	(1,151)	3,377
Cash and cash equivalents at beginning of period	3,324	626
Cash and cash equivalents at end of period	$ 2,173	$ 4,003

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

AEOLUS PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

A. Organization and Business and Basis of Presentation

Aeolus Pharmaceuticals, Inc. is biopharmaceutical company that is developing a new class of catalytic antioxidant compounds for diseases and disorders of the central nervous system, respiratory system, autoimmune system and oncology. The Company's target applications are for cancer radiation therapy, Parkinson's Disease and amyotrophic lateral sclerosis, also known as "ALS" or "Lou Gehrig's disease." The Company reported positive safety results from two Phase I clinical trials of AEOL 10150, our lead drug candidate, with no serious adverse events noted. The Company plans on initiating a clinical trial for AEOL 10150 as a protector of healthy normal cells in radiation therapy upon securing additional financial resources. Further development of AEOL 10150 for the treatment of ALS, if any, will be dependent upon future specific financing for this development or a partnership. The Company is planning additional pre-clinical and other studies for AEOL 11207 to prepare for the filing of a Investigational New Drug Application ("IND") with the United States Food and Drug Administration. We expect to develop AEOL 11207 for the treatment of patients with Parkinson's Disease.

The "Company" or "Aeolus" refers collectively to Aeolus Pharmaceuticals, Inc., a Delaware corporation ("Aeolus"), and its wholly owned subsidiary, Aeolus Sciences, Inc., a Delaware corporation. As of June 30, 2007, Aeolus also owned a 35.0% interest in CPEC LLC, a Delaware limited liability company ("CPEC"). The Company's primary operations are located in Laguna Niguel, California.

All significant intercompany activity has been eliminated in the preparation of the condensed consolidated financial statements. The unaudited condensed consolidated financial statements have been prepared in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X. Some information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to those rules and regulations. In the opinion of management, the accompanying unaudited consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations and cash flows of the Company. The consolidated balance sheet at September 30, 2006 was derived from the Company's audited financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2006. The unaudited condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements and the notes thereto included in that Annual Report on Form 10-K and in the Company's other SEC filings. Results for the interim period are not necessarily indicative of the results for any other period.

B. Liquidity

The Company has incurred significant losses from operations of $2,265,000 and $5,604,000, and cash outflows from operations of $2,633,000 and $4,867,000, for the nine months ended June 30, 2007 and for the fiscal year ended September 30, 2006, respectively. The Company expects to incur additional losses and negative cash flow from operations during the remainder of fiscal year 2007 and for several more years.

Management believes the Company has adequate financial resources to conduct operations through the second quarter of fiscal year 2008. This raises substantial doubt about our ability to continue as a going concern, which will be dependent on our ability to generate sufficient cash flows to meet our obligations on a timely basis, to obtain additional financing and, ultimately, to achieve operating profit.

The Company intends to explore strategic and financial alternatives, including a merger or acquisition with or by another company, the sale of shares of stock, the establishment of new collaborations for current research programs that include initial cash payments and on-going research support and the out-licensing of our compounds for development by a third party. The Company believes that without additional investment capital it will not have sufficient cash to fund its activities in the near future, and will not be able to continue operating. As such, the Company's continuation as a going concern is dependent upon its ability to raise additional financing. The Company is actively pursuing additional equity financing to provide the necessary funds for working capital and other planned activities.

If the Company is unable to obtain additional financing to fund operations beyond the second quarter of fiscal year 2008, it will need to eliminate some or all of its activities, merge with another company, sell some or all of its assets to another company, or cease operations entirely. There can be no assurance that the Company will be able to obtain additional financing on favorable terms or at all, or that the Company will be able to merge with another Company or sell any or all of its assets.

C. Net Loss Per Common Share

The Company computes basic net loss per weighted average share attributable to common stockholders using the weighted average number of shares of common stock outstanding during the period. The Company computes diluted net loss per weighted average share attributable to common stockholders using the weighted average number of shares of common and dilutive potential common shares outstanding during the period. Diluted weighted average common shares excluded incremental shares of approximately 17,874,000 as of June 30, 2007 issuable upon the exercise or conversion of stock options to purchase common stock, convertible preferred stock, convertible debt and warrants to purchase common stock. These shares were excluded due to their antidilutive effect as a result of the Company's net losses.

D. Note Payable

In August 2002, Aeolus borrowed from Elan Corporation, plc. ("Elan") $638,000. The note payable accrues interest at 10% compounded semi-annually. The note was convertible at the option of Elan into shares of the Company's Series B non-voting convertible preferred stock ("Series B Stock") at $43.27 per share. The original note matured on December 21, 2006. However, in February 2007, the Company and Elan terminated the note, the Company paid $300,000 in cash to Elan, Elan forgave $225,000 of the note payable and Elan and the Company entered into a new note payable in the amount of $453,000 for a period of two years under substantially the same terms as the original note.

The remaining principal plus accrued interest will be due and payable in two years. During the term of the note payable, Elan has the option to convert the note to shares of Series B Preferred Stock at a value of $9.00 per share. Upon the maturity of the note payable, Aeolus has the option to repay the note either in cash or in shares of Series B Stock and warrants having a then fair market value of the amount due; provided that the fair market value used for calculating the number of shares to be issued will not be less than $13.00 per share. As of June 30, 2007, the outstanding balance on the note payable to Elan was $471,000.

D. Stockholders' Equity

Common Stock

On May 22, 2007, Aeolus Pharmaceuticals, Inc. entered into a Securities Purchase Agreement with certain accredited investors (the "Investors") pursuant to which the Company sold to the Investors an aggregate of 2,666,667 shares of the Company's common stock (the "Shares") at a purchase price of $0.75 per share for aggregate gross proceeds of $2,000,000 and issued to the Investors warrants (the "Investor Warrants") to purchase up to an aggregate of 2,000,001 shares of common stock of the Company with an exercise price of $0.75 per share (collectively, the "May 2007 Private Placement"). The Investor Warrants are exercisable until May 22, 2012. In addition, we issued to a placement agent a warrant to purchase up to an aggregate of 186,667 shares of common stock with an exercise price of $0.75 per share.

The aggregate net proceeds to the Company from the May 2007 Private Placement, after deducting for expenses related to finders fees, legal and accounting fees, were approximately $1,761,000. The Company intends to use the net proceeds from the May 2007 private placement to finance the clinical development of AEOL 10150 and AEOL 11207 and to fund ongoing operations of the Company.

The fair value of the Investor Warrants on May 22, 2007 was estimated to be $1,428,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; risk free interest rate of 4.8%; expected volatility of 132%; and an expected life of five years.

Pursuant to the terms of the Subscription Agreement, the Company filed a registration statement which was declared effective on July 19, 2007. The subscription agreement further provides that if a registration statement is not filed,

declared effective within specified time periods or its effectiveness maintained, the Company is required to pay each holder an amount in cash, as liquidated damages, equal to 1.5% per month of the aggregate purchase price paid by such holder in the private placement for the common stock and warrants then held.

Warrants

As of June 30, 2007, warrants to purchase 14,025,427 shares of common stock were outstanding. Details of the warrants for common stock outstanding at June 30, 2007 were as follows:

Number of Shares	Exercise Price	Expiration Date
50,000	$ 0.50	May 2011
2,500,000	$ 0.50	November 2010
2,186,668	$ 0.75	May 2012
7,000,000	$ 0.75	June 2011
50,000	$ 1.00	May 2011
35,000	$ 1.00	July 2008
50,000	$ 1.50	May 2011
50,000	$ 2.00	May 2011
50,000	$ 2.50	May 2011
410,400	$ 2.50	April 2009
1,641,600	$ 4.00	April 2009
1,759	$ 19.90	October 2008
14,025,427	$ 1.15	

E. Stock-Based Compensation

Below is a summary of Aeolus stock option activity during the nine-month period ended June 30, 2007:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at September 30, 2006	3,071,806	$ 3.25	7.7 years	$ 22,000
Granted	748,000	$ 0.61		
Exercised	(20,833)	$ 1.00		
Forfeited	(477,356)	$ 0.64		
Outstanding at June 30, 2007 (unaudited)	3,321,617	$ 3.04	7.0 years	$ 119,000
Exercisable at June 30, 2007 (unaudited)	3,119,117	$ 3.19	6.9 years	$ 87,000

For the nine months ended June 30, 2007 and 2006, all stock options were issued with an exercise price at or above the fair market value of the Company's common stock on the date of grant.

The details of stock options outstanding at June 30, 2007 were as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	**Number Outstanding at June 30, 2007**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life**	**Number Exercisable at June 30, 2007**	**Weighted Average Exercise Price**
$0.38 - 0.75	592,461	$ 0.68	8.5 years	454,961	$ 0.69
$0.78 - $0.83	133,000	$ 0.80	9.0 years	125,500	$ 0.80
$0.85	335,744	$ 0.85	8.3 years	278,244	$ 0.85
$0.86 - $1.12	342,477	$ 0.95	8.2 years	342,477	$ 0.95
$1.13 - $1.45	52,450	$ 1.16	7.6 years	52,450	$ 1.16
$1.50	1,256,015	$ 1.50	6.1 years	1,256,015	$ 1.50
$1.52 - $5.00	374,556	$ 2.74	7.0 years	374,556	$ 2.74
$5.10 - $31.88	186,115	$ 18.84	4.0 years	186,115	$ 18.84
$50.9375	2,999	$ 50.94	2.8 years	2,999	$ 50.94
$51.25	45,800	$ 51.25	2.8 years	45,800	$ 51.25
$0.38 - $51.25	3,321,617	$ 3.04	7.0 years	3,119,117	$ 3.19

Stock-based compensation expense recognized in the statement of operations is as follows (in thousands):

	For the nine months June 30,	
	2007	2006
Research and development expenses	$ 161	$ 31
General and administrative expenses	283	191
Total stock-based compensation expense	$ 444	$ 222

The total deferred compensation expense for outstanding and unvested stock options was $34,000 as of June 30, 2007, which will be recognized over the next four months. The fair value of the options associated with the above compensation expense for the nine months ended June 30, 2007, was determined at the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	For the nine months June 30,	
	2007	2006
Dividend yield	0%	0%
Expected volatility	191 - 195%	187 – 190%
Risk-free interest rate	4.5% - 5.1%	4.4% - 5.2%
Expected option life after shares are vested	10 years	10 years

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Introduction

Unless otherwise noted, the terms "we," "our" or "us" refer collectively to Aeolus Pharmaceuticals, Inc. and our wholly owned subsidiary, Aeolus Sciences, Inc.

This report contains, in addition to historical information, statements by us with respect to expectations about our business and future results which are "forward-looking" statements under the Private Securities Litigation Reform Act of 1995. These statements and other statements made elsewhere by us or by our representatives, which are identified or qualified by words such as "likely," "will," "suggests," "expects," "might," "believe," "could," "should," "may," "estimates," "predict," "continue," "would," "anticipates," "plans," or similar expressions, are based on a number of assumptions that are subject to risks and uncertainties. Such statements include, but are not limited to, those relating to Aeolus' product candidates, as well as its proprietary technologies and uncertainties and other factors that may cause Aeolus' actual results to be materially different from historical results or from any results expressed or implied by such forward-looking statements. Important factors that could cause results to differ include risks associated with uncertainties of progress and timing of clinical trials, scientific testing, obtaining regulatory approval, the need to obtain funding for pre-clinical and clinical trails and operations, the scope and validity of intellectual property protection for Aeolus' product candidates, proprietary technologies and their uses, new accounting and SEC requirements and competition from other biopharmaceutical companies. Certain of these factors and others are more fully described in Aeolus' filings with the SEC, including, but not limited to, Aeolus' Annual Report on Form 10-K for the fiscal year ended September 30, 2006. All forward-looking statements are based on information available as of the date hereof, and we do not assume any obligation to update such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

Operations Summary

We are developing a series of catalytic antioxidant molecules to protect against the damaging effects of reactive oxygen derived molecules, commonly referred to as free radicals. Free radicals cause damage in a broad group of diseases and conditions. Our initial target applications are for cancer radiation therapy, Parkinson's Disease and amyotrophic lateral sclerosis, also known as "ALS" or "Lou Gehrig's disease." We reported positive safety results from two Phase I clinical trials of AEOL 10150, our lead drug candidate, with no serious adverse events noted. We plan on initiating a clinical trial for AEOL 10150 as a protector of healthy normal cells in radiation therapy upon securing additional financial resources. Further development of AEOL 10150 for the treatment of ALS, if any, will be dependent upon future specific financing for this development or a partnership. We are planning for additional pre-clinical and other studies for AEOL 11207 to prepare for the filing of a Investigational New Drug Application ("IND") with the United States Food and Drug Administration. We expect to develop AEOL 11207 for the treatment of patients with Parkinson's Disease.

We do not have any revenue, other than grant income, and therefore we must rely on public or private equity offerings, debt financings, collaboration arrangements or grants to finance our operations.

Need for Additional Funds

We believe we have adequate financial resources to fund our operations through the second quarter of fiscal year 2008, but in order to fund on-going operating cash requirements beyond the second quarter of fiscal year 2008, or to accelerate or expand our programs, we will need to raise significant additional funds. Our need for additional financing is discussed under "Liquidity and Capital Resources."

Results of Operations

Three months ended June 30, 2007 versus three months ended June 30, 2006

We had net losses attributable to common stockholders of $509,000 for the three months ended June 30, 2007, versus net losses attributable to common stockholders of $3,178,000 for the three months ended June 30, 2006.

Research and development ("R&D") expenses decreased $227,000, or 54%, to $192,000 for the three months ended June 30, 2007 from $419,000 for the three months ended June 30, 2006. R&D expenses were lower during the three months ended June 30, 2007 versus June 30, 2006 due to a decline of $65,000 in consulting expenses as our activities were limited to planning for our next clinical trail whereas during the three months ended June 30, 2006 our activities were focused on our Phase I multiple dose clinical trial for the treatment of ALS. In addition, preclinical expenses declined by $41,000 and patent fees declined by $40,000 during the three months ended June 30, 2007 when compared to the three months ended June 30, 2006.

R&D expenses for our antioxidant program have totaled $33,022,000 from inception through June 30, 2007. Because of the uncertainty of our research and development and clinical studies, we are unable to predict the level of spending and the anticipated program completion date, if any.

General and administrative ("G&A") expenses decreased $204,000, or 39%, to $320,000 for the three months ended June 30, 2007 from $524,000 for the three months ended June 30, 2006. G&A expenses were lower during the three months ended June 30, 2007 versus June 30, 2006 due to a decline of $125,000 in employee compensation and our efforts to decrease the level of services provided by consultants resulting in a decline of $43,000 in consulting expenses.

During the three months ended June 30, 2006 and in accordance with EITF 00-19, "Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled In a Company's Own Stock," and the terms of the warrants and the transaction documents, at the closing date, June 5, 2006, the fair value of the warrants issued in a Common Stock private placement were accounted for as a liability until such date in which a registration statement registering the shares underlying the warrants was declared effective. The warrant liability was revalued at each balance sheet date and changes in fair value were charged to the statement of operations. During the period from June 5, 2006 to June 30, 2006, the fair value of the warrant increased by $2,111,000 which was charged to the statement of operations. No such liability was required during the current quarter for the May 2007 financing. The warrant liability and revaluations did not have any impact on the Company's working capital, liquidity, or business operations.

In connection with the Private Placement in June 2006, we were required to reduce the exercise price of warrants to purchase 2,500,000 shares from $1.00 per share to $0.50 per share, the purchase price of the common stock issued in the Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in their value of $105,000 which was charged to the statement of operations.

Nine months ended June 30, 2007 versus nine months ended June 30, 2006

We had net losses attributable to common stockholders of $2,002,000 for the nine months ended June 30, 2007, versus net losses attributable to common stockholders of $5,595,000 for the nine months ended June 30, 2006.

In August 2003, we were awarded a Small Business Innovation and Research ("SBIR") grant from the National Cancer Institute, a division of the National Institutes of Health. Pursuant to the grant, we studied the antitumor and radiation-protective effects of our catalytic antioxidants. The study was a collaboration between us and the Department of Radiation Oncology at Duke University Medical Center. The grant ended in March 2006. We recognized zero and $92,000 of grant income during the nine months ended June 30, 2007 and 2006, respectively from our SBIR grant from the National Cancer Institute. We do not expect to earn further grant revenues as work under our SBIR grant has been completed.

R&D expenses decreased $1,808,000, or 68%, to $869,000 for the nine months ended June 30, 2007 from $2,677,000 for the nine months ended June 30, 2006. Clinical trial expenses for the nine months ended June 30, 2007 was $64,000 compared to $908,000 during the nine months ended June 30, 2006 as we completed our Phase I multiple dose clinical trail in ALS earlier in 2007. Preclinical expenses primarily related to the Aeolus Pipeline Initiative for the nine months ended June 30, 2007 was $39,000 compared to $491,000 for the nine months ended June 30, 2006. Patent fees also decreased by $643,000 during the current period as we were in the process of validating several patents internationally during the nine months ended June 30, 2006 while no such activity occurred during the current period. Offsetting these declines was an increase of $226,000 in contract manufacturing and chemistry costs.

G&A expenses decreased $175,000, or 11%, to $1,396,000 for the nine months ended June 30, 2007 from $1,571,000 for the nine months ended June 30, 2007. G&A expenses were lower during the nine months ended June 30, 2007 versus the nine months ended June 30, 2006 due to our efforts to decrease the level of services provided by consultants resulting in a decline of $180,000 in legal and professional fees and a decline of $42,000 in employee

compensation. Offsetting these decline were increased stock expenses in the amount of $92,000.

During the nine months ended June 30, 2006, CPEC LLC ("CPEC") received a milestone payment and equity consideration from ARCA Discovery, Inc., a privately held cardiovascular-focused company ("ARCA"). In 2003, CPEC, of which we own 35%, out-licensed all rights to a potential therapeutic compound referred to as "bucindolol" to ARCA. During the three months ended June 30, 2006, CPEC agreed to modify the license agreement between CPEC and ARCA Discovery, Inc. and received 400,000 shares of ARCA Discovery, Inc. common stock as consideration for the amendment. In addition, during the three months ended June 30, 2006, CPEC received a milestone payment of $1,000,000 as a result of ARCA Discovery, Inc. completing a financing. We recognized zero and $433,000 of income during the nine months ended June 30, 2007 and 2006, respectively as a result of our equity ownership of CPEC LLC.

During the nine months ended June 30, 2007, we recognized $225,000 in income as a result of the forgiveness of a portion of the principal balance of a note payable from Elan Corporation, plc. ("Elan"). In connection with the termination of a note payable and issuance of a new note payable, we paid $300,000 in cash to Elan, Elan and the Company entered into a new note payable in the amount of $453,000 for a period of two years under substantially the same terms as the original note and Elan forgave $225,000 of the original note payable.

In accordance with EITF 00-19, "Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled In a Company's Own Stock," and the terms of the warrants and the transaction documents in our November 2005 and June 2006 financings, at the closing dates, November 21, 2005 and June 5, 2006, the fair value of the warrants issued in the financings were initially accounted for as liabilities until such date in which a registration statement registering the shares underlying the warrants were declared effective. The warrant liabilities were revalued at each balance sheet date until the EITF 00-19 equity classification requirements were satisfied and changes in fair value were charged to the statement of operations. Between November 21, 2005 and March 31, 2006, the fair value of the November 2005 warrants decreased by $401,000 which was credited to the statement of operations. On March 1, 2006, the Securities and Exchange Commission declared the registration statement registering the shares underlying the warrants in the November 2005 financing effective and accordingly the warrant liability was reclassified to additional paid in capital. During the period from June 5, 2006 to June 30, 2006, the fair value of the warrant increased by $2,111,000 which was charged to the statement of operations. No such liability was required during the current quarter for the May 2007 financing. The warrant liability and revaluations have not and will not have any impact on the Company's working capital, liquidity, or business operations.

In connection with the Private Placement in June 2006, we were required to reduce the exercise price of warrants to purchase 2,500,000 shares from $1.00 per share to $0.50 per share, the purchase price of the common stock issued in the Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in their value of $105,000 which was charged to the statement of operations.

Liquidity and Capital Resources

We do not have any revenue and therefore we rely on investors, grants, collaborations and licensing of our compounds to finance our operations. At June 30, 2007, we had $2,173,000 of cash, a decrease of $1,151,000 from September 30, 2006. The decrease in cash was primarily due to the $2,265,000 loss from operations for the nine months ended June 30, 2007 and the payment of $300,000 to Elan in connection with the termination of a note payable offset by the May 2007 common stock financing which generated net proceeds of $1,761,000. We believe we have adequate financial resources to conduct operations through the second quarter of fiscal year 2008, but in order to fund on-going operating cash requirements beyond that point, or to further accelerate or expand our programs, we need to raise significant additional funds.

We incurred significant losses from operations of $2,265,000 and $5,604,000, and cash outflows from operations of $2,633,000 and $4,867,000, for the nine months ended June 30, 2007 and for the fiscal year ended September 30, 2006, respectively. Our ongoing future cash requirements will depend on numerous factors, particularly the progress of our catalytic antioxidant program and clinical trials and our ability to negotiate and complete collaborative agreements or out-licensing arrangements. In order to help fund our on-going operating cash requirements, we intend to seek new collaborations for our antioxidant research program that include initial cash payments and on-going research support. In addition, we might sell additional shares of our stock and explore other strategic and financial alternatives, including a merger with another company, the sale of stock, the establishment of new collaborations for current research programs, that include initial cash payments and ongoing research support and the out-licensing of our compounds for development by a third party.

There are significant uncertainties as to our ability to access potential sources of capital. We may not be able to enter into any collaboration on terms acceptable to us, or at all, due to conditions in the pharmaceutical industry or in the economy in general or based on the prospects of our catalytic antioxidant program. Even if we are successful in obtaining a collaboration for our antioxidant program, we may have to relinquish rights to technologies, product candidates or markets that we might otherwise develop ourselves. These same risks apply to any attempt to out-license our compounds.

Similarly, due to market conditions, the illiquid nature of our stock and other possible limitations on equity offerings, we may not be able to sell additional securities or raise other funds on terms acceptable to us, if at all. Any additional

equity financing, if available, would likely result in substantial dilution to existing stockholders.

Our forecast of the period of time through which our financial resources will be adequate to support our operations is forward-looking information, and actual results could vary.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. We do have operating leases, which are generally for office and laboratory space. In accordance with accounting principles generally accepted in the United States, operating leases are not reflected in the accompanying consolidated balance sheets. We do not have any capital leases.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk.

Our exposure to market risk is presently limited to the interest rate sensitivity of our cash and cash equivalents, which is affected by changes in the general level of U.S. interest rates. However, we believe that we are not subject to any material market risk exposure and do not expect that changes in interest rates would have a material effect upon our financial position. A hypothetical 10% change in interest rates would not have a material effect on our Statement of Operations or Cash Flows for the nine months ended June 30, 2007. We do not have any foreign currency or other derivative financial instruments. Our debt bears interest at a fixed rate.

ITEM 4. Controls and Procedures.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Accounting Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e)) pursuant to Rule 13a-15 of the Securities and Exchange Act of 1934 as amended. Based upon their evaluation, our Chief Executive Officer and Chief Accounting Officer have concluded that our disclosure controls and procedures are effective.

No change in our internal control over financial reporting occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Management is aware that there is a lack of segregation of duties due to the small number of employees and consultants addressing the Company’s general administrative and financial matters. However, management has determined that, considering the employees involved and the control procedures in place, risks associated with such lack of segregation are not significant and any potential benefits of adding employees or consultants to clearly segregate duties do not justify the expenses associated with such increases at this time.

PART II. - OTHER INFORMATION

ITEM 1. Legal Proceedings.

None.

ITEM 1A. Risk Factors.

None.

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

None.

ITEM 3. Defaults Upon Senior Securities.

None.

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

None.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits

Exhibit #	Description
4.1	Registration Rights Agreement dated May 22, 2007 by and among the Company and each of the Purchasers whose names appear on the Schedule attached thereto (incorporated by reference to Exhibit 4.1 to the Company's Form 8-K dated May 22, 2007).
10.1	Securities Purchase Agreement dated May 22, 2007 by and among the Company and the investors whose names appear on the signature pages thereof (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K dated May 22, 2007).
10.2	Form of Warrant to Purchase Common Stock dated May 22, 2007 (incorporated by reference to Exhibit 10.2 to the Company's Form 8-K dated May 22, 2007).
10.3	Letter Agreement dated April 30, 2007 by and between the Company and Rodman and Renshaw, LLC (incorporated by reference to Exhibit 10.3 to the Company's Form 8-K dated May 22, 2007).
10.4	Convertible Promissory Note dated February 7, 2007 issued by Aeolus Pharmaceuticals, Inc. to Elan Pharma International Ltd. (incorporated by reference to Exhibit 10.43 to the Company's Form S-1 dated June 4, 2007).
31.1	Certification of the Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a).
31.2	Certification of the Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a).
32.1	Certification by the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AEOLUS PHARMACEUTICALS, INC.

Date:	July 30, 2007	By:	/s/ John L. McManus John L. McManus President and Chief Executive Officer (Principal Executive Officer)
Date:	July 30, 2007	By:	/s/ Michael P. McManus Michael P. McManus Chief Financial Officer, Treasurer and Secretary (Principal Financial and Accounting Officer)