AEOLUS PHARMACEUTICALS, INC.
Form 10-Q
July 31, 2009

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, 2009.

_____ 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.)
26361 Crown Valley Parkway #150 Mission Viejo, California (Address of Principal Executive Offices)	92691 (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 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES [X] NO [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer or a small reporting company. See definition of “large accelerated filer”, “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] 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 [ ] 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 30, 2009
Common Stock, par value $.01 per share	37,467,855 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, 2008), 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, 2008, filed with the SEC on December 12, 2008.

AEOLUS PHARMACEUTICALS, INC.

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

	June 30, 2009 (Unaudited)		September 30, 2008	
ASSETS				
Current assets:				
Cash and cash equivalents	$	1,179	$	399
Prepaids and other current assets		122		156
Total current assets		1,301		555
Marketable investments (Note D)		-		440
Other investments		32		125
Total assets	$	1,333	$	1,120
LIABILITIES AND STOCKHOLDERS' DEFICIT				
Current liabilities:				
Accounts payable and accrued expenses	$	744	$	991
Margin loan (Note E)		-		366
Current maturity of long-term note payable (Note E)		-		534
Total current liabilities		744		1,891
Senior convertible notes to related parties, net (redemption value of $1,000,000 and $625,000 as of June 30, 2009 and September 30, 2008, respectively (Note E))		546		266
Long-term note payable (Note E)		578		-
Total liabilities		1,868		2,157
Commitments and contingencies (Note H)				
Stockholders' deficit:				
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, 2009 and September 30, 2008		5		5
Common stock, $.01 par value per share, 200,000,000 shares authorized; 37,467,855 shares issued and outstanding at June 30, 2009 and				
		375		320

31,952,749 shares issued and outstanding at September 30, 2008				
Additional paid-in capital		159,535		157,573
Unrealized losses on investments, available for sale		-		(36)
Accumulated deficit		(160,450)		(158,899)
Total stockholders' deficit		(535)		(1,037)
Total liabilities and stockholders' deficit	$	1,333	$	1,120

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, 2009	Three Months Ended June 30, 2008	Nine Months Ended June 30, 2009	Nine Months Ended June 30, 2008
Revenue				
Grant income	$-	$-	$-	$-
Costs and expenses:				
Research and development	130	210	469	732
General and administrative	315	360	903	1,138
Total costs and expenses	445	570	1,372	1,870
Loss from operations	(445)	(570)	(1,372)	(1,870)
Interest income (expense), net	(114)	(10)	(322)	1
Other (expense) income, net	133	-	144	(49)
Net loss	$(426)	$(580)	$(1,550)	$(1,918)
Net loss per weighted share attributable to common stockholders:				
Basic and Diluted	$(0.01)	$(0.02)	$(0.05)	$(0.06)
Weighted average common shares outstanding:				
Basic and Diluted	37,468	31,952	33,865	31,952

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, 2009	Nine Months Ended June 30, 2008
Cash flows from operating activities:		
Net loss	$ (1,550)	$ (1,918)
Adjustments to reconcile net loss to net cash used in operating activities:		
Noncash compensation	193	272
Change in fair value of trading securities	(49)	-
Noncash consulting expense	25	-
Noncash interest and financing costs	366	40
Other than temporary impairment charge	-	49
Gain on sale of investments	(133)	-
Change in assets and liabilities:		
Prepaids and other assets	5	5
Accounts payable and accrued expenses	(247)	169
Net cash used in operating activities	(1,390)	(1,383)
Cash flows from investing activities:		
Sales (purchases) of marketable securities and investments	751	(525)
Net cash provided by (used in) financing activities	751	(525)
Cash flows from financing activities:		
Repayment of short term note payable	(368)	(6)
Proceeds from short term note payable	3	368
Proceeds from the issuance of common stock and warrants	1,500	-
Proceeds from issuance of Senior Convertible Notes	375	-

Costs related to the issuance of common stock and warrants		(91)		-
Net cash provided by financing activities		1,419		362
Net increase (decrease) in cash and cash equivalents		780		(1,546)
Cash and cash equivalents at beginning of period		399		1,727
Cash and cash equivalents at end of period	$	1,179	$	181

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 initial target indications are a countermeasure for exposure to radiation, mustard gas and chlorine gas, and an adjunct to cancer radiation therapy and a treatment for amyotrophic lateral sclerosis, also known as "ALS" or "Lou Gehrig's disease." The Company has reported positive safety results from two Phase I clinical trials of AEOL 10150, our lead drug candidate, with no serious adverse events noted. However, further development of AEOL 10150 for the treatment of ALS and cancer radiation therapy, if any, will be dependent upon future specific financing for this development or a partnership and the results of our ongoing studies of AEOL 10150 as a countermeasure for mustard gas, chlorine gas and radiation exposure.

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, 2009, Aeolus also owned a 35.0% interest in CPEC LLC, a Delaware limited liability company ("CPEC"). The Company's primary operations are located in Mission Viejo, 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, 2008 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, 2008. 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.

New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued SFAS No. 168, "The FASB Accounting Standards Codification and Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162" ("SFAS 168"). SFAS 168 establishes the FASB Standards Accounting Codification ("Codification") as the source of authoritative U.S. generally accepted accounting principles ("GAAP") recognized by the FASB to be applied to nongovernmental entities and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification will supersede all the existing non-SEC accounting and reporting standards upon its effective date and subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. SFAS 168 also replaces FASB Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles" given that once in effect, the Codification will carry the same level of authority. The Company does not anticipate that the adoption of this statement will have a material impact on its consolidated financial statement footnote disclosures.

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events" ("SFAS 165"). SFAS 165 establishes general standards for accounting for and disclosure of events that occur after the balance sheet date but before financial statements are available to be issued ("subsequent events"). More specifically, SFAS 165 sets forth the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition in the financial statements, identifies the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements and the disclosures that should be made about events or transactions that occur after the balance sheet date. SFAS 165 provides largely the same guidance on subsequent events which previously existed only in auditing literature. SFAS 165 is effective for financial statements issued for interim periods ending after June 15, 2009. The Company does not anticipate that the adoption of this statement will have a material impact on its consolidated financial statements.

In April 2009, the FASB issued the FASB Staff Position on FAS 107-1 and APB 28-1, "Interim Disclosures About Fair Value of Financial Instruments" ("FSP FAS 107-1 and APB 28-1"). FSP FAS 107-1 and APB 28-1 requires disclosures about fair value of financial instruments in interim reporting periods of publicly-traded companies that were previously only required to be disclosed in annual financial statements. The Company does not anticipate that the adoption of this statement will have a material impact on its consolidated financial statement footnote disclosures.

In June 2008, the FASB ratified EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" ("EITF 07-5"). Equity-linked instruments (or embedded features) that otherwise meet the definition of a derivative as outlined in SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), are not accounted for as derivatives if certain criteria are met, one of which is that the instrument (or embedded feature) must be indexed to the entity's own stock. EITF 07-5 provides guidance on how to determine if equity-linked instruments (or embedded features) such as warrants to purchase our stock and convertible notes are considered indexed to our stock. The Company will adopt EITF 07-5, effective October 1, 2009, and apply its provisions to outstanding instruments as of that date. The Company is evaluating the effect of adoption of EITF 07-5.

In May 2008, the FASB issued FSP APB 14-1, "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)." This FSP applies to convertible debt instruments that may be settled in cash, or other assets, upon conversion and are not addressed by APB Opinion No. 14 "Accounting for Convertible Debt Instruments and Debt Issued with Stock Purchase Warrants." If the embedded conversion option is required to be separately accounted for as a derivative, then such convertible debt instruments should be accounted for under FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" and this FSP does not apply .This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. This FSP is not expected to have a material impact on the Company's financial position, results of operations or liquidity.

B. Liquidity

The Company has incurred significant losses from operations of $1,372,000 and $2,517,000, and cash outflows from operations of $1,390,000 and $1,813,000, for the nine months ended June 30, 2009 and for the fiscal year ended September 30, 2008, respectively. The Company expects to incur additional losses and negative cash flow from operations during the remainder of fiscal year 2009 and for several more years.

Management believes the Company has adequate financial resources to conduct operations into the first quarter of fiscal year 2010. 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 profits.

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 and/or convertible debentures, 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 and/or debt 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 first quarter of fiscal year 2010, 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. Potential common shares consist of stock options, convertible debt, warrants and convertible preferred stock using the treasury stock method and are excluded if their effect is anti-dilutive. Diluted weighted average common shares excluded incremental shares of approximately 36,585,000 as of June 30, 2009 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. Diluted weighted average common shares excluded incremental shares of approximately 18,439,000 as of June 30, 2008 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. Investments

In fiscal year 2008, the Company invested in auction-rate securities with a par value of $525,000. Liquidity for these securities has historically been provided by an auction process that resets the applicable interest rate at pre-determined intervals for up to 35 days. In the past, the auction process has generally allowed investors to obtain immediate liquidity if so desired by selling the securities at their face amounts. However, disruptions in the credit markets adversely affected the auction market for these types of securities. From February 26, 2008 to January 2, 2009, all auctions scheduled with respect to the Company's auction-rate securities failed to close.

In October 2008, the Company entered into an agreement (the "UBS Agreement") with UBS Financial Services, Inc. ("UBS") for which the Company received the right ("Put Option") to sell all four of the auction rate securities back to UBS at par, at its sole discretion, anytime during the period from January 2, 2009 through January 4, 2011, and gave UBS the right to purchase these auction rate securities or sell them on the Company's behalf at par anytime after the execution of the Agreement through January 4, 2011. The Put Option is not transferable, tradable or marginable, and will not be listed or quoted on any securities exchange or any electronic communications network. Since the UBS Agreement is a legally enforceable firm commitment, the Put Option was recognized as a financial asset at fair value in the financial statements, and accounted for separately from the associated securities as a noncurrent asset. Since the Company intended to and subsequently exercised the Put Option on January 2, 2009, the Company did not have the intent to hold the associated auction rate securities until recovery or maturity. Therefore, the Company classified these securities as trading pursuant to Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS 115"). SFAS 115 requires changes in the fair value of these securities to be recorded in current period earnings. As a result of this transfer, the Company recognized in the Statement of Operations a change in market value of $65,000, reflecting a reversal of the related temporary valuation allowance that was previously recorded in other comprehensive loss.

Prior to entering into the UBS Agreement, the Company recorded the auction rate securities as investments available-for-sale. The Company recorded unrealized gains and losses on the available-for-sale debt securities in accumulated other comprehensive income in the shareholders' equity section of the balance sheets. Such an unrealized loss did not reduce net income for the applicable accounting period.

The Company elected to measure the Put Option under the fair value option of SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities", recorded income of approximately $114,000 and recorded a corresponding long term investment during the first quarter of fiscal year 2009.

Following the reclassification of the auction rate securities to trading, the Company recorded an additional charge to the Statement of Operations of $16,000 to reduce the value of the auction rate securities, offset by the gain on the Put Option of $16,000.

On January 2, 2009, the Company exercised its rights under the Put Option and sold its four auction rate securities for their par value of $525,000 to UBS.

During April 2009, the Company sold its 23,377 shares of Arca Discovery, Inc. generating net proceeds of $226,000 and a net gain of $133,000.

E. Notes Payable

Senior Convertible Notes to Related Parties

On August 1, 2008, the Company entered into a Securities Purchase Agreement (the "SCN Purchase Agreement") with two accredited institutional investors (the "Investors") pursuant to which the Company agreed to sell to the Investors units comprised of senior unsecured convertible notes of the Company (the "Notes"), in an aggregate principal amount of up to $5,000,000, which shall bear interest at a rate of 7% per year and mature on the 30-month anniversary of their date of issuance, and warrants to purchase up to an aggregate of 10,000,000 additional shares of Common Stock (the "Warrant Shares"), each with an initial exercise price of $0.50 per share, subject to adjustment pursuant to the warrants (the "Warrants") (collectively the “SCN Financing”). Each unit (collectively, the "Units") is comprised of $1,000 in Note principal and Warrants to purchase up to 2,000 shares of the Company's common stock, par value $0.01 per share (the "Common Stock"), and has a purchase price of $1,000.

On August 1, 2008, the Company sold and issued to the Investors 500 Units comprised of Notes in the aggregate principal amount of $500,000 and Warrants to purchase up to 1,000,000 shares of Common Stock for an aggregate purchase price of $500,000 (the "Financing").

On each of September 4, 2008, October 1, 2008, November 3, 2008 and December 1, 2008, the Company sold and issued to the Investors 125 Units comprised of Notes in the aggregate principal amount of $125,000 and Warrants to purchase up to 250,000 shares of Common Stock for an aggregate purchase price of $125,000 (the "Subsequent Financings").

The Notes issued in the Financing and the Subsequent Financings have an initial conversion price of $0.35 per share, subject to adjustment pursuant to the Notes. In addition, the Investors have the option to purchase up to an additional 4,000 Units, in one or more closings (each, an "Election Closing"), and at their sole option at any time on or before December 31, 2013. The additional Units sold at an Election Closing would also be sold by the Company at a purchase price of $1,000 per Unit, except that the initial conversion price of the Notes issued in an Election Closing will equal the volume weighted average closing sale price for the Common Stock for the sixty consecutive trading day period ending on the trading day immediately preceding such Election Closing, provided that such initial conversion price may not be less than $0.20 per share or greater than $0.75 per share, in each case subject to adjustment pursuant to the Note.

The Notes will be convertible, at the Investors' sole election, into shares of Common Stock at any time and from time to time. As of June 30, 2009, the Notes would be convertible into 2,857,000 shares of Common Stock with a fair value of $1,114,000. The conversion price of the Notes (including the $0.20 floor and $0.75 ceiling price with respect to Notes issued at Election Closings) and the exercise price of the Warrants are subject to adjustment in the event of a stock dividend or split, reorganization, recapitalization or similar event. Additionally, the exercise price of the Warrants may be reduced in the event the Company issues securities at a price per share lower than the then current exercise price of the Warrants. The Notes are due and payable in cash at the aggregate principal value plus accrued interest 30 months from the date of issuance if not converted earlier by the Investors.

Interest on the Notes accrues at the rate of 7.0% per annum from the date of issuance, and is payable semi-annually, on January 31 and July 31 of each year. Interest shall be payable, at the Company's sole election, in cash or shares of Common Stock, to holders of Notes on the record date for such interest payments, with the record dates being each January 15 and July 15 immediately preceding an interest payment date.

The Warrants are exercisable for a five year period from the date of issuance and contain a "cashless exercise" feature that allows the Investors to exercise the Warrants without a cash payment to the Company under certain circumstances.

The net proceeds to the Company from the sale of 1,000 Units in the Financing and Subsequent Financing, after deducting for expenses, were approximately $844,000. The Company used the net proceeds to fund the development of AEOL 10150 and to fund ongoing operations of the Company. Offering costs of the private placement were $156,000 and were allocated to the Notes and Warrants based upon their respective fair values. The offering costs attributed to the Notes in the amount of $100,000 were capitalized as Debt Issuance Costs and are included in Prepaid and other current assets in the Condensed Consolidated Balance Sheet. The Debt Issuance Costs are being amortized over the 30-month life of the Notes in the Financing.

As of June 30, 2009, the carrying value of the Notes was $546,000 and the redemption value was $1,000,000. In connection with the Financing and the Subsequent Financings, the Company recorded a note discount in the amount of $365,000 based on the relative fair value of the warrants issued in connection with the Notes. In addition, the Company determined that the Notes contained an embedded beneficial conversion feature with a computed value of $347,000 which was also recorded as a discount to the Notes. The note discounts are being amortized to interest expense over the thirty-month term of the Notes. The effective interest rate of the Note including the effect of the amortization of the embedded conversion feature and the note discount is 39.4 percent.

The maturity of the Notes may be accelerated upon the occurrence of an event of default, which includes, subject to certain grace periods, exceptions and qualifications as set forth in the Notes, the failure by the Company to maintain the listing of the Common Stock, the failure of the Company to deliver shares Common Stock in a timely manner following a conversion, the failure of the Company to have reserved a sufficient number shares of Common Stock to issue upon conversion of the Notes, the failure by the Company to make payments on the Notes in a timely manner, payment defaults by the Company or any of its significant subsidiaries on debt or other obligations in excess of

$100,000, the occurrence of certain bankruptcy events with respect to the Company or its significant subsidiaries, judgments rendered against the Company or its significant subsidiaries in excess of $100,000 and breaches of material representations, warranties or covenants by the Company under the Amended Purchase Agreement or the Notes. Upon the occurrence of an event of default related to a bankruptcy of the Company, the Notes shall immediately become due and payable. Upon the occurrence of any event default other than a bankruptcy event of default, any holder of the Notes, in its sole discretion, may declare this Note to be immediately due and payable and the Company shall pay to the holder in cash the sum of all outstanding principal multiplied by 115%, plus accrued and unpaid interest and late charges, if any, thereon. The Notes are unsubordinated obligations of the Company and all payments due under the Notes rank pari passu with the Elan Note and shall not be subordinated to any other Indebtedness of the Company.

The Notes also provide that the Company shall not issue any equity securities other than certain exempt securities as defined in the Notes, incur any indebtedness other than certain exempt indebtedness as defined in the Notes, allow the incurrence of any liens on its assets, repay any indebtedness other than the Notes, pay a dividend on its common stock or make an investment other than ordinary investing activities without the consent of the holders of Notes representing a majority of the then-outstanding principal subject to the Notes.

Affiliates of Xmark Opportunity Partners, LLC are the sole investors in the SCN Financing. Together with its affiliates, Xmark Opportunity Partners, LLC beneficially owned approximately 52% of the Company's outstanding common stock prior to the SCN Financing. Xmark Opportunity Partners, LLC is the sole manager of Goodnow Capital, L.L.C. and possesses sole power to vote and direct the disposition of all securities of the Company held by Goodnow. Goodnow has the right to designate up to two directors for election to the Company's Board of Directors pursuant to the terms of a purchase agreement between Goodnow and the Company. David C. Cavalier, a current director of the Company, is President of Goodnow. The transaction was evaluated by Management and the Board of Directors for fairness to ensure the terms were reasonable given the related party nature of the SCN Financing by providing an option for non-related party investors to participate in the transaction.

Elan Note Payable

In August 2002, Aeolus borrowed from Elan Corporation, plc. ("Elan") $638,000. The note payable accrued 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 a rate of $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 two-year note payable in the amount of $453,000 under substantially the same terms as the original note. In February 2009, the Company and Elan agreed to amend the note payable to extend the maturity date of the convertible promissory note from February 7, 2009 to February 7, 2011 and increased the interest rate of the convertible promissory note from 10% to 11% effective February 7, 2009. As of the date of the Amendment, an aggregate of $553,000 in principal and interest was outstanding under the convertible promissory note. In the event of an event of default under the convertible promissory note, Elan may demand immediate payment of all amounts outstanding under the note. For purposes of the note, an event of default includes, among other items, a default in the payment of the note principal or interest when due and payable, an uncured breach by the Company of its obligations to Elan pursuant the agreements under which the convertible promissory note was issued, an inability of the Company to pay its debts in the normal course of business, the cessation of business activities by the Company (other than as a result of a merger or consolidation with a third party) without Elan's prior written consent and the appointment of a liquidator, receiver, administrator, examiner, trustee or similar officer of the Company or over all or substantially all of its assets under the law.

During the term of the note payable, Elan has the option to convert the note into shares of Series B Preferred Stock at a rate 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, 2009, the outstanding balance, including interest, on the note payable to Elan was $578,000.

Margin Loan with UBS

During fiscal year 2008, Aeolus entered into a secured credit agreement (the "Margin Agreement") with UBS and subsequently drew $367,000 under the Margin Agreement. The Margin Agreement bears interest at the per annum rate of LIBOR plus 0.25 percent. The Company repaid the loan in full on January 2, 2009.

F. Stockholders' Deficit

Common Stock

On March 30, 2009, Aeolus entered into a Securities Purchase Agreement (the "Purchase Agreement") with two accredited institutional investors (the "March 2009 Investors") pursuant to which the Company sold and issued to the March 2009 Investors in a private placement an aggregate of 5,357,143 units (the "March 2009 Units"), comprised of an aggregate of 5,357,143 shares of Common Stock of the Company (the "Shares") and warrants to purchase up to an aggregate of 13,392,857 additional shares of Common Stock (the "March 2009 Warrants"), with an initial exercise price of $0.35 per share, subject to adjustment pursuant to the March 2009 Warrants, with each March 2009 Unit representing one share of Common Stock and a March 2009 Warrant to purchase two-and-one-half shares of Common Stock, at a purchase price of $0.28 per March 2009 Unit for aggregate gross proceeds of $1,500,000 (collectively, the " March 2009 Financing"). The March 2009 Warrants are exercisable for a five year period from their date of issuance; contain a "cashless exercise" feature that allows the holder to exercise the March 2009 Warrants without a cash payment to the Company under certain circumstances; contain a dividend participation right which allows the holder to receive any cash dividends paid on the Common Stock without exercising the March 2009 Warrant and contain a provision that provides for the reduction of the exercise price to $0.01 in the event of any such payment of cash dividends by the Company; and contain standard anti-dilution provisions that provide for the adjustment of the exercise price and the number of shares of common stock that can be purchased in the event of a financing at a price per share below the exercise price, a stock dividend or split, dividend payment or other issuance, reorganization, recapitalization or similar event.

The fair value of the March 2009 Warrants was estimated to be $4,129,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; risk free interest rate of 1.7%; expected volatility of 164%; and an expected life of five years.

In connection with the March 2009 Financing, the Company also entered into a Registration Rights Agreement (the "Rights Agreement") with the March 2009 Investors. Pursuant to the Rights Agreement, the Company agreed to file one or more registration statements (collectively, the "Registration Statements") with the Securities and Exchange Commission (the "SEC") covering the resale of the Shares and all shares of common stock issuable upon exercise of the March 2009 Warrants (together with the Shares, the "Registrable Securities") upon demand of the holders of a majority of the Registrable Securities (a "Demand Registration"). Such holders have the right to two (2) Demand Registrations; provided, however, that the Company is not obligated to effect more than one (1) Demand Registration within any period of 12 consecutive months, subject to certain exceptions. In the event the holders exercise their right to a Demand Registration, the Company has agreed to file a Registration Statement to register the resale of the Registrable Securities within a certain numbers of days after the request and to use commercially reasonable efforts to cause the Registration Statement to be declared effective by the SEC as soon as practicable after the filing thereof. The Company also agreed to use its commercially reasonable efforts to keep the Registration Statements effective for a specified period.

Offering costs of the private placement were $91,000 resulting in net proceeds to the Company from the March 2009 Financing, after deducting for expenses, of approximately $1.4 million. The Company intends to use the net proceeds from the March 2009 Financing to finance the development of AEOL 10150 and to fund ongoing operations of the Company.

Affiliates of Xmark Opportunity Partners, LLC are the sole investors in the Financing. Together with its affiliates, Xmark Opportunity Partners, LLC beneficially owned approximately 57% of the Company's outstanding common stock prior to the March 2009 Financing.

Warrants

As a result of the March 2009 Financing, the Company was required to lower the exercise price of 4,687,000 warrants previously issued in November 2005 and May 2007 to $0.28 per share, the purchase price of the March 2009 Units issued in the March 2009 Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in the value of $38,000 which was charged to the statement of operations.

In connection with the SCN Financing (Note E), Aeolus issued warrants to purchase 2,000,000 shares at an exercise price of $0.50 per share with a five year term. The fair value of the warrants issued on August 1, 2008 was estimated to be $282,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 128% risk free interest rate of 3.2%; and an expected life of five years. The fair value of the warrants issued on September 4, 2008 was estimated to be $53,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 130% risk free interest rate of 3.0%; and an expected life of five years. The fair value of the warrants issued on October 1, 2008 was estimated to be $93,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 133% risk free interest rate of 2.9%; and an expected life of five years. The fair value of the warrants issued on November 3, 2008 was estimated to be $76,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 139% risk free interest rate of 2.7%; and an expected life of five years. The fair value of the warrants issued on December 1, 2008 was estimated to be $75,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%; expected volatility of 138% risk free interest rate of 1.7%; and an expected life of five years.

In addition, as a result of the SCN Financing, the Company was required to lower the exercise price of 4,687,000 warrants previously issued in the November 2005 Financing and in the 2007 Financing to $0.35 per share, the conversion price of the Notes issued in the SCN Financing. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in the value of $118,000 which was charged to the statement of operations during the fourth quarter of fiscal year 2008.

As of June 30, 2009, warrants to purchase 27,329,525 shares of common stock were outstanding. Details of the warrants for common stock outstanding at June 30, 2009 were as follows:

Number of Shares	Exercise Price	Expiration Date
2,500,000	$ 0.28	November 2010
2,186,668	$ 0.28	May 2012
13,392,857	$ 0.35	March 2014
50,000	$ 0.50	May 2011
1,000,000	$ 0.50	August 2013
250,000	$ 0.50	September 2013
250,000	$ 0.50	October 2013
250,000	$ 0.50	November 2013
250,000	$ 0.50	December 2013
7,000,000	$ 0.75	June 2011
50,000	$ 1.00	May 2011
50,000	$ 1.50	May 2011
50,000	$ 2.00	May 2011
50,000	$ 2.50	May 2011
27,329,525	$ 0.46	

G. Stock-Based Compensation

Below is a summary of Aeolus stock option activity during the nine month period ended June 30, 2009:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at September 30, 2008	4,235,290	$ 2.50	6.7 years	$ 46
Granted	1,624,000	$ 0.32	9.8 years	122
Exercised	---	$ ---		
Forfeited	---	$ ---		
Outstanding at June 30, 2009 (unaudited)	5,859,290	$ 1.90	7.0 years	$ 143
Exercisable at June 30, 2009 (unaudited)	4,441,772	$ 2.40	6.1 years	$ 31

For the nine months ended June 30, 2009 and 2008, 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, 2009 were as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at June 30, 2009	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Number Exercisable at June 30, 2009	Weighted Average Exercise Price
$0.29 - 0.40	1,999,000	$ 0.32	9.6 years	598,149	$ 0.34
$0.44 - $0.60	526,050	$ 0.55	7.9 years	509,383	$ 0.55
$0.68 - $0.80	464,161	$ 0.75	7.0 years	464,161	$ 0.75
$0.81 - $0.90	780,085	$ 0.88	6.9 years	780,085	$ 0.88
$0.91 - $1.45	224,500	$ 1.04	6.8 years	224,500	$ 1.04
$1.50	1,256,019	$ 1.50	4.1 years	1,256,019	$ 1.50
$1.52 - $12.85	461,420	$ 4.24	4.6 years	461,420	$ 4.24
$14.50 - $31.88	99,256	$ 25.97	1.4 years	99,256	$ 25.97
$50.9375	2,999	$ 50.94	0.8 years	2,999	$ 50.94
$51.25	45,800	$ 51.25	0.8 years	45,800	$ 51.25
$0.29 - $51.25	5,859,290	$ 1.90	7.0 years	4,441,772	$ 2.40

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

	For the nine months June 30, 2009	2008
Research and development expenses	$ 34	$ 43
General and administrative expenses	159	229
Total stock-based compensation expense	$ 193	$ 272

The total deferred compensation expense for outstanding and unvested stock options was $336,000 as of June 30, 2009. The weighted average remaining recognition period for the total deferred compensation expense is ten months. The fair value of the options associated with the above compensation expense for the nine months ended June 30, 2009 and 2008, 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, 2009	2008
Dividend yield	0%	0%
Expected volatility	96% - 209%	197%
Risk-free interest rate	2.6% - 3.8%	3.8% - 4.6%
Expected option life after shares are vested	10 years	10 years

Effective April 1, 2009, the Company began to use a peer group to determine an expected volatility rate for stock option valuation. Prior to April 1, 2009, the Company used its historical stock price to calculate volatility. In addition, the Company changed its method of amortization of stock based compensation from the multiple attribute method to straight line for grants made subsequent to April 1, 2009. There was no material impact on the financial statements as a result of these changes as of April 1, 2009. The Company believes the use of the peer group and straight line amortization results in a better estimate of stock based compensation expense for the Company.

H. Commitments

The Company has acquired assets still in development and entered into research and development arrangements with third parties that may require milestone and royalty payments to the third party contingent upon the occurrence of certain future events linked to the success of the asset in development. Milestone payments may be required, contingent upon the successful achievement of an important point in the development life-cycle of the pharmaceutical product (e.g., approval of the product for marketing by a regulatory agency). If required by the arrangement, the Company may have to make royalty payments based upon a percentage of the sales of the pharmaceutical product in the event that regulatory approval for marketing is obtained.

These arrangements may be material individually, and in the unlikely event that milestones for multiple products covered by these arrangements were reached in the same period, the aggregate charge to expense could be material to the results of operations in any one period. In addition, these arrangements often give Aeolus the discretion to unilaterally terminate development of the product, which would allow Aeolus to avoid making the contingent payments; however, Aeolus is unlikely to cease development if the compound successfully achieves clinical testing objectives.

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, 2008. 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 will be the use of our catalytic antioxidants as a countermeasure to exposure to radiation, mustard gas and chlorine gas, as an adjunct to cancer radiation therapy and a treatment for amyotrophic lateral sclerosis, also known as "ALS" or "Lou Gehrig's disease." However, further development of AEOL 10150 in radiation therapy and ALS, if any, will be dependent upon future specific financing for this development or a partnership and the results of our ongoing studies of AEOL 10150 as a countermeasure for exposure to radiation, mustard gas and chlorine gas. We have reported positive safety results from two Phase I clinical trials of AEOL 10150 in patients diagnosed with ALS with no serious adverse events noted.

We do not have any revenue 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 into the first quarter of fiscal year 2010, but in order to fund on-going operating cash requirements beyond the first quarter of fiscal year 2010, 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, 2009 versus three months ended June 30, 2008

We had a net loss of $426,000 for the three months ended June 30, 2009 versus a net loss of $580,000 for the three months ended June 30, 2008.

Research and development ("R&D") expenses decreased $80,000, or 38%, to $130,000 for the three months ended June 30, 2009 from $210,000 for the three months ended June 30, 2008. The lower level of R&D expenses during the current quarter is a result of a decline in research expenses. While the Company's research activities have increased, most of the research underway is being funded by government grants whereas during the prior year quarter, the Company was funding the majority of the research activities. Research expenses during the three month ended June 30, 2009 was $44,000 compared to $114,000 for the three months ended June 30, 2008. The Company currently has seven studies under way; the study of its drug candidates as a potential countermeasure against the effects of mustard gas on the lung and skin, as a protectant against the effects of radiation on the lungs and on the gastro-intestinal tract, as a countermeasure against the effects of chlorine gas; as a potential treatment for epilepsy and for the potential treatment for Parkinson's disease.

R&D expenses for our antioxidant program have totaled $35,319,000 from inception through June 30, 2009. 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 $45,000, or 13%, to $315,000 for the three months ended June 30, 2009 from $360,000 for the three months ended June 30, 2008. G&A expenses were lower during the three months ended June 30, 2009 versus June 30, 2008 due to a decline in Board of Directors expense and legal fees. Board of Directors expense decreased by $34,000 as the Board of Directors adopted a stock based compensation plan in July 2008 whereas during the quarter ended June 30, 2008, the Board of Directors received cash and stock based compensation. Legal fees declined by $34,000 due to management's continued efforts to reduce costs by performing regulatory and compliance activities in-house.

We incurred net interest expense of $114,000 for the three months ended June 30, 2009 compared to $10,000 for the three months ended June 30, 2008. The increase in interest expense was a result of the issuance of the Senior Convertible Notes which bear interest at a rate of 7% as well as the related amortization of debt issuance costs and note issuance discounts related to warrant issuances and beneficial conversion features. Interest expense also increased as a result of a higher average balance of our note payable with Elan. Interest income on our investments also decreased due to a lower level of interest rates during the current quarter.

During the three months ended June 30, 2009, we recorded a gain on the sale of our holdings of Arca Discovery, Inc. common stock of $133,000.

Nine months ended June 30, 2009 versus nine months ended June 30, 2008

We had a net loss of $1,550,000 for the nine months ended June 30, 2009, versus a net loss of $1,918,000 for the nine months ended June 30, 2008.

R&D expenses decreased $263,000, or 36%, to $469,000 for the nine months ended June 30, 2009 from $732,000 for the nine months ended June 30, 2008. The lower level of R&D expenses during the current period reflects a lower amount of manufacturing and research expenses. During the nine months ended June 30, 2008, we were in the process of manufacturing small quantities of our drug candidates to support our development program whereas during the current year we had no manufacturing underway and were only running stability studies on existing drug supplies resulting in a decrease of $88,000 in manufacturing expenses. Research expenses also declined during the current period as more of the Company's research programs were funded by external grants during the current nine month period. During the nine months ended June 30, 2009, outside research expenses were $142,000 compared to $334,000 during the nine months ended June 30, 2008.

G&A expenses decreased $235,000, or 21%, to $903,000 for the nine months ended June 30, 2009 from $1,138,000 for the nine months ended June 30, 2008. G&A expenses were lower during the nine months ended June 30, 2009 versus the nine months ended June 30, 2008 due to a decline in stock based compensation expense, Board of Directors expense and legal fees. Stock based compensation expense decreased by $70,000 as a result of a lower valuation assigned to our stock option grants in the current period when compared to the prior year period. Board of Directors expense decreased by $101,000 as the Board of Directors adopted a stock based compensation plan in July 2008 whereas during the nine months ended June 30, 2008, the Board of Directors received cash and stock based compensation. Legal fees declined by $88,000 due to management's continued efforts to reduce costs by performing regulatory and compliance activities in-house.

We incurred net interest expense of $322,000 for the nine months ended June 30, 2009 compared to net interest income of $1,000 for the nine months ended June 30, 2008. The change reflects higher interest expense as a result of the issuance of our Senior Convertible Notes as well as the related amortization of debt issuance costs and note issuance discounts. Interest expense also increased as a result of a higher average balance of our note payable with Elan and interest on our margin loan with UBS Financial Services, Inc. which was outstanding during the first quarter of fiscal year 2009. Interest income on our investments also decreased due to a lower level of interest rates during the current year period.

During the nine months ended June 30, 2009 as a result of our March 2009 Financing, we were required to lower the exercise price of 4,687,000 warrants previously issued in November 2005 and May 2007 to $0.28 per share, the purchase price of the March 2009 Units issued on March 30, 2009. As a result of the change in the exercise price, these warrants were revalued resulting in an increase in the value of $38,000 which was charged to the statement of operations.

We recorded a gain of $49,000 related to the net increase in the market value of our trading securities during the nine months ended June 30, 2009. While during the nine months ended June 30, 2008, we recorded an "other-than-temporary" impairment charge of $49,000 based upon reduced market values of our auction-rate securities.

During the nine months ended June 30, 2009, we recorded a gain on the sale of our holding of Arca Discovery, Inc. common stock of $133,000.

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, 2009, we had $1,179,000 of cash, an increase of $780,000 from September 30,

2008. The increase in cash was primarily due to the March 2009 Financing and the SCN Financing which generated net proceeds of $1.8 million offset by our $1,390,000 loss from operations for the nine months ended June 30, 2009. We believe we have adequate financial resources to conduct operations into the first quarter of fiscal year 2010, 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 $1,372,000 and $2,517,000, and cash outflows from operations of $1,390,000 and $1,813,000, for the nine months ended June 30, 2009 and for the fiscal year ended September 30, 2008, 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.

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 three and nine months ended June 30, 2009. We do not have any foreign currency or other derivative financial instruments. Our debt bears interest at a fixed rate.

ITEM 4T. Controls and Procedures.

(a) As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer (the Company's Principal Executive Officer) and Chief Financial Officer (the Company's Principal Financial and Accounting Officer), of the effectiveness of the Company's disclosure controls and procedures required by Exchange Act Rule 13a-15. Based upon that evaluation, the Company's Principal Executive Officer and Principal Financial and Accounting Officer have concluded that the Company's disclosure controls and procedures were not effective as of June 30, 2009 to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms because of the material weakness discussed below.

As a result of the lack of segregation of duties, management has determined that a material weakness in internal control over financial reporting related to the segregation of duties existed as of June 30, 2009, and based on the criteria set forth by by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), concluded that the Company's internal control over financial reporting was not effective as of June 30, 2009.

A "material weakness," as defined by the Public Company Accounting Oversight Board (PCAOB) is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. This material weakness has not resulted in an adjustment or misstatements to the financial statements.

To address the material weakness, management has established mitigating controls to minimize the potential for material misstatements in the financial statements. Management has determined that given the Company's size, level of operations and financial resources, it is not practicable for the Company to eliminate the segregation of controls weakness and therefore management has established mitigating controls to minimize the impact of the lack of segregation of duties.

(b) During the most recent fiscal quarter, there were no significant changes in the Company's internal control over financial reporting or in other factors that materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

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
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: 2009	July 31,	By:	/s/ John L. McManus John L. McManus President and Chief Executive Officer (Principal Executive Officer)
Date: 2009	July 31,	By:	/s/ Michael P. McManus Michael P. McManus

Chief Financial Officer, Treasurer and Secretary
(Principal Financial and Accounting Officer)