AEOLUS PHARMACEUTICALS, INC.
Form 10-Q
February 14, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended December 31, 2013.

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

for the transition period from _____ to _____.

Commission File Number
0-50481

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

Delaware	56-1953785
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
26361 Crown Valley Parkway, Suite 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 þ NOo 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES þ NOo

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

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

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

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 February 1, 2014
Common Stock, par value $.01 per share	134,550,068 shares

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FORM 10-Q
For the Quarter Ended December 31, 2013
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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AEOLUS PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except per share data)

	December 31, 2013	September 30, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$534	$869
Accounts receivable	1,111	370
Deferred subcontractor cost	1,043	656
Prepaids and other current assets	38	39
Total current assets	2,726	1,935
Investment in CPEC LLC	32	32
Total assets	$2,758	$1,966
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$1,395	$579
Deferred revenue	1,085	682
Total current liabilities	2,480	1,261
Total liabilities	2,480	1,261
Commitments and contingencies (Note F)		
Stockholders' equity:		
Preferred stock, $.01 par value per share, 10,000,000 shares authorized:		
Series A nonredeemable convertible preferred stock, 1,250,000 shares authorized as of December 31, 2013 and September 30, 2013, respectively; no shares issued and outstanding as of December 31, 2013 and September 30, 2013, respectively	—	—
Series B nonredeemable convertible preferred stock, 1,600,000 shares authorized as of December 31, 2013 and September 30, 2013, respectively; 526,080 shares issued and outstanding as of December 31, 2013 and September 30, 2013, respectively	5	5
Common stock, $.01 par value per share, 200,000,000 shares authorized; 134,550,068 shares issued and outstanding as of December 31, 2013 and September 30, 2013, respectively	1,346	1,346
Additional paid-in capital	183,544	183,276
Accumulated deficit	(184,617)	(183,922)
Total stockholders' equity	278	705
Total liabilities and stockholders' equity	$2,758	$1,966

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

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AEOLUS PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended December 31,	
	2013	2012
Revenue:		
Contract revenue	$793	$1,342
Costs and expenses:		
Research and development	707	1,169
General and administrative	781	655
Total costs and expenses	1,488	1,824
Loss from operations	(695)	(482)
Non-cash financing charges and change in fair value of warrants	—	4,510
Net (loss) income	$(695)	$4,028
Net (loss) income per weighted share attributable to common stockholders:		
Basic	$(695)	$2,049
Diluted	$(695)	$(200)
Basic net (loss) income per common share	$(0.01)	$0.03
Diluted net (loss) income per common share	$(0.01)	$0.00
Weighted average common shares outstanding:		
Basic	134,550	62,732
Diluted	134,550	65,635

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)

	Three Months Ended December 31,	
	2013	2012
Cash flows from operating activities:		
Net (loss) income	$(695)	$4,028
Adjustments to reconcile net (loss) income to net cash used in operating activities:		
Stock-based compensation	268	72
Change in fair value of warrants	—	(4,510)
Change in assets and liabilities:		
Accounts receivable	(741)	(668)
Deferred subcontractor cost	(387)	—
Prepaid and other assets	1	7
Accounts payable and accrued expenses	816	792
Deferred revenue	403	—
Net cash used in operating activities	(335)	(279)
Net decrease in cash and cash equivalents	(335)	(279)
Cash and cash equivalents at beginning of period	869	281
Cash and cash equivalents at end of period	$534	$2

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

AEOLUS PHARMACEUTICALS, INC.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

A. Organization, Business and Summary of Significant Accounting Policies

Organization

The accompanying unaudited condensed consolidated financial statements include the accounts of Aeolus Pharmaceuticals, Inc. and its wholly-owned subsidiary, Aeolus Sciences, Inc. (collectively, "we," "us," "Company" or "Aeolus"). All significant intercompany accounts and transactions have been eliminated in consolidation. Aeolus is a Delaware corporation. The Company's primary operations are located in Mission Viejo, California.

Business

Aeolus is a biopharmaceutical company developing a platform of a new class of broad-spectrum, catalytic antioxidant compounds that protect healthy tissue from the damaging effects of oxidative stress. The principal endeavor of the Company is protecting against damaging effects of oxidative stress induced by radiation. Its first compound, AEOL 10150, is being developed as a medical countermeasure against the pulmonary effects of radiation exposure under a contract ("BARDA Contract") valued at up to $118.4 million with the Biomedical Advanced Research and Development Authority ("BARDA"), a division of the Department of Health and Human Services ("HHS"). Aeolus is in its third year under the BARDA Contract. Aeolus also receives development support from the National Institutes of Health ("NIH") for development of the compound as a medical countermeasure against radiation and exposure to chemical and nerve agents. Additionally, Aeolus is developing AEOL 10150 for oncology indications, where it is used in combination with radiation and chemotherapy. Aeolus' strategy is to leverage the substantial investment in toxicology, manufacturing, and preclinical and clinical studies made by U.S. government agencies in AEOL 10150, including the BARDA Contract, to efficiently develop the compound for use in oncology.

Basis of Presentation

All significant intercompany activity has been eliminated in the preparation of the unaudited 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 condensed 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 condensed balance sheet at September 30, 2013 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, 2013, filed with the Securities and Exchange Commission (the "SEC") on December 20, 2013.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company invests available cash in short-term bank deposits. Cash and cash equivalents include investments with maturities of three months or less at the date of purchase. The carrying value of cash and cash equivalents approximate their fair market value at December 31, 2013 and September 30, 2013 due to their short-term nature.

Significant customers and accounts receivable

For the three months ended December 31, 2013, the Company's primary customer was BARDA. For the three months ended December 31, 2013, revenues from BARDA comprised 100% of total revenues. As of December 31, 2013, the Company's receivable balances were comprised 100% from this customer. There was no unbilled accounts receivable, included in accounts receivable, as of December 31, 2013. Unbilled accounts receivable relates to work that has been performed, though invoicing has not yet occurred. All of the unbilled receivables are expected to be billed and collected within the next 12 months. Accounts receivable are stated at invoice amounts and consist primarily of amounts due from HHS as well as amounts due under reimbursement contracts with other government entities and non-government and philanthropic organizations. If necessary, the Company records a provision for doubtful receivables to allow for any amounts which may be unrecoverable. This provision is based upon an analysis of the Company's prior collection experience, customer creditworthiness and current economic trends. As of December 31, 2013 and September 30, 2013, an allowance for doubtful accounts was not recorded as the collection history from the Company's customer indicated that collection was probable.

Concentrations of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents with high quality financial institutions. Management believes that the financial risks associated with its cash and cash equivalents and investments are minimal. Because accounts receivable consist primarily of amounts due from the U.S. federal government agencies, management deems there to be minimal credit risk.

Revenue Recognition

Aeolus recognizes revenue in accordance with the authoritative guidance for revenue recognition. Revenue is recognized when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery (or passage of title) has occurred or services have been rendered, (iii) the seller's price to the buyer is fixed or determinable, and (iv) collectability is reasonably assured.

The BARDA Contract is classified as a "cost-plus-fixed-fee" contract. Aeolus recognizes government contract revenue in accordance with the authoritative guidance for revenue recognition including the authoritative guidance specific to federal government contracts. Reimbursable costs under the contract primarily include direct labor, subcontract costs, materials, equipment, travel, and indirect costs. In addition, we receive a fixed fee under the BARDA Contract, which is unconditionally earned as allowable costs are incurred and is not contingent on success factors. Reimbursable costs under the BARDA Contract, including the fixed fee, are generally recognized as revenue in the period the reimbursable costs are incurred and become billable.

Fair Value of Financial Instruments

The carrying amounts of Aeolus' short-term financial instruments, which include cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities approximate their fair values due to their short maturities.

Fair Value Measurements

The Company adopted Accounting Standards Codification ("ASC") Topic 820, Fair Value Measurements and Disclosures, for financial and non-financial assets and liabilities.

ASC Topic 820 discusses valuation techniques, such as the market approach (comparable market prices), the income approach (present value of future income or cash flow) and the cost approach (cost to replace the service capacity of an asset or replacement cost). The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation

techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.
Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
Level 3: Unobservable inputs that reflect the reporting entity's own assumptions.

Research and Development

Research and development costs are expensed in the period incurred.

Leases

The Company leases office space and office equipment under month to month operating lease agreements. For the three months ended December 31, 2013 and 2012, total rent expense was approximately $10,000 and $8,000, respectively.

Income Taxes

The Company recognizes liabilities or assets for the deferred tax consequences of temporary differences between the tax bases of assets or liabilities and their reported amounts in the financial statements. These temporary differences will result in taxable or deductible amounts in future years when the reported amounts of the assets or liabilities are recovered or settled. A valuation allowance is established when management determines that is more likely than not that all or a portion of a deferred tax asset will not be realized. Management evaluates the Company's ability to realize its net deferred tax assets on a quarterly basis and valuation allowances are provided, as necessary. During this evaluation, management reviews its forecasts of income in conjunction with other positive and negative evidence surrounding the Company's ability to realize its deferred tax assets to determine if a valuation allowance is required. Adjustments to the valuation allowance will increase or decrease the Company's income tax provision or benefit. Management also applies the relevant guidance to determine the amount of income tax expense or benefit to be allocated among continuing operations, discontinued operations, and items charged or credited directly to stockholders' equity (deficit).

A tax position must meet a minimum probability threshold before a financial statement benefit is recognized. The minimum threshold is a tax position that is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation process, based on the technical merits of the position. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense.

Net Income (Loss) Per Common Share

The Company computes net income attributable to common stockholders using the two-class method required for participating securities. Under the two-class method, securities that participate in dividends, such as the Company's outstanding preferred shares, preferred warrants, and most common stock warrants, are considered "participating securities." Our preferred shares, preferred warrants and common stock warrants are considered "participating securities" because they include non-forfeitable rights to dividends.

In applying the two-class method, (i) basic net income (loss) per share is computed by dividing net income (less any dividends paid on participating securities) by the weighted average number of shares of common stock and participating securities outstanding for the period and (ii) diluted earnings per share may include the additional effect of other securities, if dilutive, in which case the dilutive effect of such securities is calculated using the treasury stock method. The Company does have other securities with a dilutive effect outstanding, so the Company's basic net income (loss) per share uses the two-class method and diluted net income (loss) per share uses the treasury stock method.

Accounting for Stock-Based Compensation

The Company recognizes stock based compensation expense in the statement of operations based upon the fair value of the equity award amortized over the vesting period.

Segment Reporting

The Company currently operates in one segment.

B. Liquidity

In its audit opinion issued in connection with the Company's consolidated financial statements for the fiscal year September 30, 2013 and 2012, the Company's independent registered public accounting firm expressed substantial doubt about the Company's ability to continue as a going concern given the Company's recurring net losses, negative cash flows from operations and working capital deficiency. The Company had cash and cash equivalents of $534,000 on December 31, 2013, and $869,000 on September 30, 2013. The decrease in cash was primarily due to cash used in operating activities.

The Company has incurred significant losses since its inception. At December 31, 2013, the Company's accumulated deficit was $184,617,000. This raises substantial doubt about Aeolus' ability to continue as a going concern, which will be dependent on the Company's ability to generate sufficient cash flows to meet the Company's obligations on a timely basis, obtain additional financing and, ultimately, achieve operating profits through product sales or BARDA procurements. The Company intends to explore strategic and financial alternatives, which may include 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 the Company's 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. If the Company is unable to obtain additional financing to fund operations, 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 acceptable 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. Stockholders' Equity

Preferred Stock

The Certificate of Incorporation of Aeolus authorizes the issuance of up to 10,000,000 shares of Preferred Stock, at a par value of $.01 per share. The Board of Directors has the authority to issue Preferred Stock in one or more series, to fix the designation and number of shares of each such series, and to determine or change the designation, relative rights, preferences, and limitations of any series of Preferred Stock, without any further vote or action by the stockholders of the Company.

Of the 10,000,000 shares of total authorized shares of Preferred Stock, 1,250,000 shares are designated as Series A Convertible Preferred Stock and 1,600,000 shares are designated as Series B Stock. The Series B Stock is not entitled to vote on any matter submitted to the vote of holders of the common stock except that the Company must obtain the approval of a majority of the outstanding shares of Series B Stock to either amend the Company's Certificate of Incorporation in a manner that would adversely affect the Series B Stock (including by creating an additional class or series of stock with rights that are senior or pari passu to the Series B Stock) or change the rights of the holders of the Series B Stock in any other respect. Each share of Series B Stock is convertible at any time by the holder thereof into one share of the Company's common stock, provided that no conversion may be effected that would result in the holders of Series B Stock owning more than 9.9% of the Company's common stock on a fully converted to common stock basis. If the Company pays a cash dividend on its common stock, it must also pay the same dividend on an as converted basis on the Series B Stock. Upon a liquidation, dissolution, bankruptcy or winding up of the Company or the sale of all or substantially all of the Company's assets, the holders of Series B Stock will be entitled to receive, together with the holders of common stock, the assets of the Company in proportion to the number of shares of common stock held (assuming conversion of the Series B Stock into shares of common stock).

As of December 31, 2013, 526,080 shares of Series B Stock were outstanding, all of which were held by Elan. Each share of Series B Stock was convertible into one share of common stock as of December 31, 2013.

There were no shares of Series A Convertible Preferred Stock issued or outstanding as of December 31, 2013.

Common Stock

February/March 2013 Financing

On February 19, 2013 and March 4, 2013, the Company entered into Securities Purchase Agreements (the "Purchase Agreements") with certain accredited investors (the "Purchasers"). Under the terms of the agreements, the Company received approximately $3,616,000 in gross proceeds in exchange for the issuance of an aggregate of 14,462,000 units (the "Units"), consisting of 14,462,000 shares of common stock and 14,462,000 warrants, at a purchase price of $0.25 per unit. Each Unit consists of (i) one share of common stock (the "Common Shares") and (ii) a five-year warrant to purchase one share of the Company's common stock (the "Warrants"). The Warrants have an initial exercise price of $0.25 per share.

On February 19, 2013, the Company received $3,225,000 in gross proceeds in exchange for the issuance of an aggregate of 12,900,000 Units, which consisted of 12,900,000 shares of common stock and 12,900,000 warrants.

On March 4, 2013, the Company received approximately $390,000 in gross proceeds in exchange for the issuance of an aggregate of 1,562,000 Units, which consisted of 1,562,000 shares of common stock and 1,562,000 warrants.

Net cash proceeds from the February/March 2013 Financing, after deducting for expenses, were approximately $3,558,000. The Company also incurred non-cash expenses in the form of 365,000 warrants issued to consultants, at similar terms as the financing Warrants, for services provided. The Company issued a total of 14,827,000 warrants in connection with the February/March 2013 Financing.

The fair value of the February/March 2013 Financing warrants was estimated to be $4,791,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 154.84%, risk free interest rate of 0.87% and an expected life of five years. The proceeds from the February/March 2013 Financing were allocated based upon the relative fair values of the February/March 2013 Financing Warrants and the February/March 2013 Common Shares.

The February/March 2013 Financing contains a registration rights agreement with an arrangement for liquidated damages in the event of a failure to maintain the effectiveness with the SEC of a registration statement covering the February/March 2013 Financing Units. The Company must use its commercially reasonable efforts to maintain the registration statement continuously effective until the earlier to occur of (i) the date on which all securities covered by such registration statement have been sold, and (ii) the date on which all securities covered by such registration statement may be sold without volume restrictions pursuant to Rule 144 under the Securities Act of 1933, as amended. In the event the Company fails to meet this obligation, subject to certain exceptions, the Company will be required to make a cash payment of 0.5% of the aggregate amount invested to the Purchasers of the February/March 2013 Financing Units. The 0.5% payment equaling $18,000 would be due for every 30-day period in which the registration statement is not continuously effective. The maximum liability would be $108,000 and no damages would accrue after August 19, 2013, the date that is six months from the closing of the February/March 2013 Financing. The registration statement was declared effective by the SEC as of June 13, 2013. No liability was recorded as the registration statement was continuously effective through December 31, 2013.

Modification to rights of Security Holders

Effective February 19, 2013, the Company and each of Xmark JV Investment Partners, LLC, Xmark Opportunity Fund, Ltd. and Xmark Opportunity Fund, L.P. (collectively, the “Xmark Entities”) entered into a Warrant Repricing, Exercise and Lockup Agreement (the “Xmark Warrant Agreement”) pursuant to which the Company agreed to reduce the exercise price of outstanding warrants to purchase an aggregate of up to 59,149,999 shares of Common Stock held by the Xmark Entities (the “Xmark Warrants”) to $0.01 per share. In consideration for the reduction of the exercise price of the Xmark Warrants, each of the Xmark Entities agreed to immediately exercise all of the Xmark Warrants by cashless exercise. The Xmark Warrant Agreement also provides that the Xmark Entities will not transfer the shares issuable upon exercise of the Xmark Warrants (the “Xmark Warrant Shares”) until the Company either (i) declares a cash dividend on its common stock or otherwise makes a cash distribution or (ii) effects a Change of Control, subject in each case to the terms of the Xmark Warrant Agreement.

Modifying the exercise price of the warrants to a fixed amount of $0.01 eliminated the requirement for warrant liability accounting treatment and resulted in a charge of $2,084,000.

March 2012 Financing

On March 30, 2012 and April 4, 2012, the Company entered into Securities Purchase Agreements (the "Purchase Agreements") with certain accredited investors (the "Purchasers") and completed a financing (the "March 2012 Financing"). Under the terms of the Purchase Agreements, the Company received $660,000 in gross proceeds in exchange for the issuance of an aggregate of 2,200,166 units (the "March 2012 Units"), consisting of 2,200,166 shares of common stock and 1,650,126 warrants, at a purchase price of $0.30 per Unit. Each Unit consisted of (i) one share of common stock (the "March 2012 Common Shares") and (ii) a five-year warrant to purchase 0.75 of a share of the Company's common stock (the "March 2012 Warrants"). The March 2012 Warrants have an initial exercise price of $0.40 per share.

On March 30, 2012, the Company received $530,000 in gross proceeds in exchange for the issuance of an aggregate of 1,766,833 March 2012 Units, which consisted of 1,766,833 shares of common stock and 1,325,126 warrants.

On April 4, 2012, the Company received $130,000 in gross proceeds in exchange for the issuance of an aggregate of approximately 433,333 March 2012 Units, which consisted of 433,333 shares of common stock and 325,000 warrants.

Net cash proceeds from the March 2012 Financing, after deducting for expenses, were $642,000. The Company also incurred non-cash expenses in the form of 12,501 warrants issued to consultants, at similar terms as the March 2012 Warrants, for services provided. Pursuant to the warrants, the Company is obligated to issue up to a total of 1,662,627 shares of common stock as of September 30, 2012 in connection with the March 2012 Financing.

The fair value of the March 2012 Warrants issued on March 30, 2012 was estimated to be $363,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 150.74%, risk free interest rate of 1.04% and an expected life of five years. The proceeds from the March 2012 Financing were allocated based upon the relative fair values of the March 2012 Warrants and the March 2012 Common Shares.

The fair value of the March 2012 Warrants issued on April 4, 2012 was estimated to be $84,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 149.36%, risk free interest rate of 1.05% and an expected life of five years. The proceeds from the March 2012 Financing were allocated based upon the relative fair values of the March 2012 Warrants and the March 2012 Common Shares.

Dividends

The Company has never paid a cash dividend on its common stock and does not anticipate paying cash dividends on its common stock in the foreseeable future. If the Company pays a cash dividend on its common stock, it also must pay the same dividend on an as converted basis on its outstanding Series B Stock.

Warrants

As of December 31, 2013, warrants to purchase an aggregate of 17,879,627 shares of common stock were outstanding with a weighted average exercise price of $0.30 per share. Details of the warrants for common stock outstanding at December 31, 2013 are as follows:

Number of Shares	Exercise Price	Expiration Date
100,000	$ 0.50	May 2014
100,000	$ 1.00	May 2014
100,000	$ 1.50	May 2014
125,000	$ 0.51	June 2014
125,000	$ 1.00	June 2014
20,000	$ 0.39	September 2014
15,000	$ 0.50	September 2014
15,000	$ 0.60	September 2014

50,000	$ 0.38	April 2015
50,000	$ 0.50	May 2016
50,000	$ 0.50	July 2016
50,000	$ 1.00	July 2016
50,000	$ 1.50	July 2016
50,000	$ 2.00	July 2016
50,000	$ 2.50	July 2016
1,337,627	$ 0.40	March 2017
325,000	$ 0.40	April 2017
300,000	$ 0.258	June 2017
140,000	$ 0.35	October 2017
13,085,000	$ 0.25	February 2018
1,742,000	$ 0.25	March 2018
17,879,627	$ 0.30	

As of December 31, 2013, one warrant to purchase an aggregate of 896,037 shares of preferred stock was outstanding. The warrant has an exercise price of $0.01 per share and expires in February 2016.

Below is a summary of warrant activity (“common and preferred”) for the three months ended December 31, 2013:

	Number of Shares	Weighted Average Exercise Price	Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at 9/30/2013	18,775,664	$0.29	4.05	$693,340
Granted	-	$-	-	$-
Exercised	-	$-	-	$-
Expired or Canceled	-	$-	-	$-
Forfeited	-	$-	-	$-
Vested	-	$-	-	$-
Outstanding at 12/31/2013	18,775,664	$0.29	3.80	$197,128

D. Stock-Based Compensation

Below is a summary of stock option activity for the three months ended December 31, 2013:

	Number of Shares	Weighted Average Exercise Price	Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at 9/30/2013	11,214,898	$0.52	6.67	$3,825
Granted	-	$-	-	$-
Exercised	-	$-	-	$-
Expired or Canceled	(62,856)	$2.93	-	$-
Forfeited	-	$-	-	$-
Vested (RSAs)	-	$-	-	$-
Outstanding at 12/31/2013	11,152,042	$0.51	6.45	$-

For the three months ended December 31, 2013, all stock options were granted 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 for the three months ended December 31, 2013 were as follows:

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number Outstanding at December 31, 2013	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Number Exercisable At December 31, 2013	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)
$0.23-$0.30	1,612,500	$ 0.29	6.05	1,612,500	$ 0.29	6.05
$0.31-$0.40	6,501,500	$ 0.39	7.57	5,873,378	$ 0.39	7.40
$0.41-$0.50	502,000	$ 0.45	7.99	366,583	$ 0.45	7.49
$0.51-$0.60	963,750	$ 0.59	5.39	963,750	$ 0.59	5.39
$0.61-$0.70	66,500	$ 0.68	2.63	66,500	$ 0.68	2.63
$0.71-$0.80	382,250	$ 0.75	3.41	382,250	$ 0.75	3.41
$0.81-$0.90	697,091	$ 0.88	2.76	697,091	$ 0.88	2.76
$0.91-$1.00	44,500	$ 0.94	1.74	44,500	$ 0.94	1.74
$1.01-$1.50	81,500	$ 1.13	1.31	81,500	$ 1.13	1.31
$1.51-$5.00	300,451	$ 2.73	0.65	300,451	$ 2.73	0.65

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

	For the three months ended December 31,	
	2013	2012
Research and Development Expenses	$6	$4
General and Administrative Expenses	262	68
	$268	$72

The total deferred compensation expense for outstanding and unvested stock options for the three months ended December 31, 2013 was $209,000. The weighted average remaining recognition period for the total deferred compensation expense is approximately three months. The fair value of the options associated with the above compensation expense was determined at the date of the grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	For the three months ended December 31,	
	2013	2012
Dividend yield	0 %	0 %
Expected volatility	156.27 %	143.05 %
Risk-free interest rate	0.86 %	0.72 %
Expected term	5.27 years	5.14 years

E. Net Income (Loss) Per Common Share

The Company computes basic net income (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 income (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 outstanding 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 did not include any incremental shares for the three months ended December 31, 2013 and included incremental shares of approximately 2,903,000 shares for the three months ended December 31, 2012 issuable upon the exercise or conversion of convertible debt, stock options to purchase common stock, convertible preferred stock and warrants to purchase common stock. Diluted weighted average common shares excluded incremental shares of approximately 2,292,000 and 58,565,000, respectively, for the fiscal year 2013 and 2012, due to their anti-dilutive effect.

	For three months ended December 31,	
	2013	2012
Numerator:		
Net income	$ (695)	$ 4,028
Net income attributable to participating securities	—	(1,979)
Net income attributable to common stockholders – basic	$ (695)	$ 2,049
Net income	$ (695)	$ 4,028
Less gain on warrant liability for participating common warrants	—	4,228
Net loss attributable to common stockholders – diluted	$ (695)	$ (200)
Denominator:		
Weighted-average shares used in computing net income per share attributable to common stockholders – basic	134,550	62,732
Effect of potentially dilutive securities:		
Common stock warrants	—	2,903
Convertible preferred warrants	—	—
Convertible preferred stock	—	—
Common stock options	—	—
Non-participating common stock warrants	—	—
Weighted-average shares used in computing net income (loss) per share attributable to common stockholders – diluted	134,550	65,635
Basic net income per common share	$ (0.01)	$ 0.03
Diluted net income (loss) per common share	$ (0.01)	$ 0.00

F. Commitments

The Company acquires assets still in development and enters into research and development arrangements with third parties that often 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. Because of the contingent nature of these payments, they are not included in the table of contractual obligations. No milestones have been met, nor have any payments been paid, as of December 31, 2013.

We are also obligated to pay patent filing, prosecution, maintenance and defense costs, if any, for the intellectual property we have licensed from National Jewish Health, National Jewish Medical and Research Center and Duke University.

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 our product candidates and funding options, as well as our proprietary technologies and uncertainties and other factors that may cause our 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 (and obtaining) funding for pre-clinical and clinical trials and operations, the scope and validity of intellectual property protection for our product candidates, proprietary technologies and their uses, new accounting and Securities and Exchange Commission ("SEC") requirements and competition from other biopharmaceutical companies. Certain of these factors and others are more fully described in our filings with the SEC, including, but not limited to, our Annual Report on Form 10-K for the fiscal year ended September 30, 2013, filed with the SEC on December 20, 2013. 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

Business

We are a biopharmaceutical company developing a new class of broad-spectrum, catalytic antioxidant compounds based on technology discovered and researched at Duke University, the University of Colorado and National Jewish Health, developed by Drs. Irwin Fridovich, Brian Day and others. Dr. Day is our Chief Scientific Officer.

These compounds, known as metalloporphyrins, scavenge reactive oxygen species ("ROS") at the cellular level, mimicking the effect of the body's own natural antioxidant enzyme, Superoxide Dismutase ("SOD"). While the benefits of antioxidants in reducing oxidative stress are well-known research with our compounds indicates that metalloporphyrins can be used to affect signaling via ROS at the cellular level. In addition, there is evidence that high-levels of ROS can affect gene expression and this may be modulated through the use of metalloporphyrins. We believe this could have a profound beneficial impact on people who have been exposed, or are about to be exposed, to high-doses of radiation, whether from cancer therapy or a nuclear event.

Our lead compound, 10150, is a metalloporphyrin specifically designed to neutralize reactive oxygen and nitrogen species. The neutralization of these species reduces oxidative stress, inflammation, and subsequent tissue damage-signaling cascades resulting from radiation or chemical exposure. We are developing 10150 as a MCM for national defense and for use in oncology.

Our primary development program is the advanced development of 10150 for Lung-ARS and DEARE. On February 11, 2011, we signed a five-year, cost-plus contract with BARDA for the development of 10150 as a MCM against Lung-ARS (the "BARDA Contract"). BARDA is the government agency responsible for the advanced development and purchase of medical countermeasures for chemical, biological, radiological and nuclear threats. The contract fully funds the advanced development of 10150 through approval by the FDA under 21 CFR Part 314 Subpart I and Part 601 Subpart H (the "Animal Rule.") The Animal Rule allows for approval of drugs using only animal studies when human clinical trials cannot be conducted ethically.

Pursuant to the BARDA Contract we were awarded approximately $10.4 million for the base period of the contract (from February 2011 to April 2012). On April 16, 2012, we announced that BARDA had exercised two options under the BARDA Contract worth approximately $9.1 million. On September 17, 2013, we announced that BARDA had exercised $6.0 million in additional contract options, bringing the total exercised contract value to date to approximately $25.5 million. We may receive up to an additional $92.9 million in options exercisable over the remaining years of the BARDA Contract. Options are exercised based on the progress of the development program, including the completion of clinical trials or manufacturing tasks under previously exercised options. The final goal of the contract is to achieve FDA approval for 10150 and the development of commercial manufacturing capability. In order to achieve these goals, we believe it will be necessary to exercise the majority of the options in the contract. We also believe that BARDA is likely to continue to exercise options as long as 10150 continues to demonstrate efficacy and safety in animal testing for Lung-ARS. In the event we begin sales to the U.S. government under an Emergency Use Authorization (“EUA”), we believe that BARDA is highly likely to exercise the majority of the remaining options under the contract. One of the requirements of an EUA is that the development program continue towards the goal of FDA approval. If all of the options are exercised by BARDA, the total value of the contract would be approximately $118.4 million.

There are no existing treatments for Lung-ARS or DEARE and we are not aware of any compounds in development that have shown efficacy when administered after exposure to radiation. 10150 has demonstrated efficacy in two animal models (mouse and non-human primate) when administered after exposure to radiation. The U.S. government's planning scenario for a radiation incident is a 10 kiloton detonation of a nuclear device in a major American city. It is estimated that several hundred thousand civilians would be exposed to high doses of radiation in this scenario.

The BARDA Contract is designed to complete the work necessary for 10150 to be purchased for the US Strategic National Stockpile (the "SNS"). BARDA currently acquires drugs for the SNS through a Special Reserve Fund (the "SRF") created under Project BioShield and reauthorized under the Pandemic All-Hazards Preparedness Reauthorization Act of 2013. Although the final goal of the contract is full FDA approval under the Animal Rule, BARDA, based on historical purchases from other suppliers, may purchase product prior to FDA approval under an EUA.

Pursuant to the Statement of Work in the BARDA Contract, we expect to provide the data necessary for filing an application for an EUA in the second half of 2014. An EUA would make it possible for BARDA to begin procuring 10150 for the strategic national stockpile. If approved under an EUA, procurements from BARDA could result in a significant increase in revenues for Aeolus and potential profitability.

We are also developing 10150 as a treatment for GI-ARS with grant funding from NIH-NIAID. Unlike contract funding, grant funding is paid directly to research facilities and does not flow through our financial statements. The NIH-NIAID funding for GI-ARS is provided in the context of a larger grant program for ARS MCM development and is not currently tied to a defined development program like the BARDA Contract for Lung-ARS contract. Generally, we believe that the continuation of grant funding for this indication will be dependent on continuing evidence of efficacy in animal trials. There are no existing treatments for GI-ARS and current standard of care is limited to supportive measures, although there are other drugs being developed by other companies for this indication with BARDA funding. If we are able to successfully develop 10150 for use in GI-ARS, we would have an additional argument for its procurement by BARDA for the SNS.

We also benefit from research funded by grants from the NIH CounterACT program for the development of 10150 as a MCM for the effects of nerve gas (e.g., sarin and soman) and chemical vesicant gasses (e.g., mustard gas, phosgene gas and chlorine gas) exposure. Like the funding for GI-ARS, funding for this indication is provided directly to the research facility and does not flow through our financial statements. Continued funding is generally dependent on continuing evidence of efficacy in animal trials. There are no existing treatments for exposure to chemical vesicants. In October 2011, we announced that National Jewish Health was awarded a $12.5 million grant from NIH CounterACT to continue the development of 10150 as a MCM against chlorine gas exposure. Also included in the grant is support for research in looking at tissue plasminogen activator (TPA) and Silabilin as MCMs against sulfur mustard gas exposure. The ultimate objective of the sulfur mustard and chlorine gas work at National Jewish Health will be to complete all work necessary to initiate pivotal efficacy studies in animals for both indications. This would include: running efficacy studies in the rat model for higher doses of sulfur mustard and chlorine gas; establishing endpoints, optimal dosing and duration of treatment for pivotal efficacy studies; and characterizing the natural history from sulfur mustard and chlorine gas damage. We plan to meet with the FDA in early 2014 to discuss filing with the FDA an investigational new drug application (an "IND") for the sulfur mustard indication under the Animal Rule and to present the design of a pivotal study in a rat model developed under the NIH CounterACT program.

We are also funded by grant money from the NIH CounterACT program and the National Institute of Neurological Disorders and Stroke ("NINDS") for the development of 10150 as a MCM for the effects of nerve gas (e.g., sarin and soman) exposure. NIH-CounterACT awarded a contract on September 24, 2011 worth approximately $735,000, to the University of Colorado to develop 10150 as a MCM against nerve agents. Work performed with this initial funding

has demonstrated that 10150 significantly improves survival when administered with current treatment in a pilocarpine model for nerve gas exposure. In September 2013, we announced that Dr. Manisha Patel at the University of Colorado had been awarded a $4.3 million grant from NINDS to develop as a MCM for exposure to sarin gas and other nerve agents.

Until February 2011, the Lung-ARS program was principally funded by us and the work was performed at Duke University and the University of Maryland. Since February 11, 2011, substantially all of the costs for the Lung-ARS program have been funded by the BARDA Contract. To date, the GI-ARS development program has been funded by NIH-NIAID through programs at the University of Maryland and Epistem, Ltd., and the chlorine, phosgene, mustard gas and nerve agent programs have been funded by NIH-CounterACT and NINDS through programs at National Jewish Health, the University of Colorado, and the United States Army Medical Research Institute for Chemical Defense ("USAMRICD").

We are also developing 10150 for use in oncology where it would be used in combination with radiation and chemotherapy as both a therapeutic and prophylactic drug. Pre-clinical studies at Duke University have demonstrated that 10150 does not interfere with the benefit of radiation therapy or chemotherapy in prostate and lung cancer. These studies also demonstrated that 10150 displays anti-tumor activity.

Upon the successful completion of an additional Phase I study in healthy normal volunteers funded under the BARDA contract and approval of a protocol by the FDA and the appropriate Institutional Review Boards ("IRBs"), we expect to begin a Phase II study in cancer radiation therapy patients. The Company is considering several potential indications, including prostate cancer, esophageal cancer, head and neck cancer and non-small cell lung cancer.

10150 has been tested in two human Phase I safety studies where it was well-tolerated and no adverse events were observed. Efficacy has been demonstrated in validated animal models for Lung-ARS, GI-ARS, chlorine gas exposure, phosgene gas exposure, sulfur mustard gas exposure (lungs and skin) and nerve gas exposure. In both mouse and non-human primate ("NHP") studies for Lung-ARS, 10150 treated groups showed significantly reduced weight loss, inflammation, oxidative stress, lung damage, and most importantly, mortality. Therapeutic efficacy has been demonstrated when 10150 is administered 24 hours after exposure to radiation, a requirement for consideration as a radiation MCM for the SNS.

Following the events at the Fukushima nuclear plant in Japan in 2011, we ran murine studies at the request of Japanese researchers to demonstrate the alternative effects of administering leukocyte growth factors ("LGF") used to treat the hematopoietic or bone marrow syndrome of ARS ("H-ARS"). Data showed that 10150 does not interfere with the efficacy of LGF (in this case Amgen's Neupogen®). Additionally, the study demonstrated that administration of Neupogen®, the current standard of care for H-ARS, increased damage to the lungs. When 10150 was administered with Neupogen® this damage was significantly reduced. We believe that this finding may have important implications for the potential procurement of 10150 for the SNS. In September 2013, BARDA announced that it had entered into a procurement and inventory management agreement with Amgen to provide Neupogen® for the SNS.

We have an active Investigational New Drug Application ("IND") on file with the FDA for AEOL 10150 as a potential treatment for amyotrophic lateral sclerosis ("ALS"). At this time, we do not have any plans to continue development of 10150 for ALS. We expect to file an IND for 10150 for Lung-ARS with the Division of Medical Imaging Products during the first half of 2014. We also plan to file separate INDs for 10150 for cancer with the oncology division of the FDA, and for sulfur mustard gas in 2014. We have already completed two Phase I safety studies in 50 humans demonstrating that 10150 is safe and well tolerated. CMC work has been completed, pilot lots have been prepared and production is being scaled up under the BARDA Contract.

We have two programs underway for the development of several other drug candidates, AEOL 11207, AEOL1114B and AEOL11203, for the treatment of epilepsy and Parkinson's disease. These programs are being funded, in part, by private foundations, including the Michael J. Fox Foundation, CURE and government grants. In February 2012, data was published in the Journal Neurobiology of Disease from the CURE study indicating AEOL 11207 significantly reduced both the frequency and duration of spontaneous seizures in a pre-clinical epilepsy model. Additionally, the study showed an increase in average life span, protection against neuronal death and no difference in seizure severity.

Two other compounds Ethyl and Hexyl are the subject of a $20 million research grant from NIH-NIAID, for development as a potential MCM for ARS. In general, this research is at an earlier stage of development than 10150. Neither Ethyl nor Hexyl have been tested in humans and no IND is on file for either drug. A significant amount of pre-clinical work would be required to bring either compound into clinical testing. Because this is grant funding, it is paid directly to the research institutions and does not flow through our financial statements.

BARDA Contract

On February 11, 2011, we signed a five-year, cost-plus contract with BARDA for the development of 10150 as a MCM against Lung-ARS (the "BARDA Contract"). BARDA is the government agency responsible for the advanced development and purchase of medical countermeasures for chemical, biological, radiological and nuclear threats. The contract fully funds the advanced development of 10150 through approval by the FDA under 21 CFR Part 314 Subpart I and Part 601 Subpart H (the "Animal Rule.") The Animal Rule allows for approval of drugs using only animal studies when human clinical trials cannot be conducted ethically.

We were awarded approximately $10.4 million in the base period of the contract. On April 16, 2012, we announced that BARDA had exercised two options under the BARDA Contract worth approximately $9.1 million. On September 17, 2013, we announced that BARDA had exercised $6.0 million in additional contract options, bringing the total exercised contract value to date to approximately $25.5 million. We may receive up to an additional $92.9 million in options exercisable over the remaining years of the contract. If all of the options are exercised by BARDA, the total value of the contract would be approximately $118.4 million.

Pursuant to the Statement of Work in the BARDA Contract, we expect to provide the data necessary for filing an application for an EUA in the second half of 2014. An EUA would make it possible for BARDA to begin procuring 10150 for the strategic national stockpile. Procurements from BARDA may result in a significant increase in revenues, and potential profitability, for Aeolus.

Activities under the contract to date include animal efficacy studies, animal model development with radiation survival curve studies, dosing studies, bulk drug manufacturing, bulk drug and final drug product manufacturing, validation testing, compliance studies, stability studies and the filing of an orphan drug status application and a fast track designation application with the FDA.

Following the commencement of the BARDA Contract, we entered into a series of agreements with various parties in furtherance of our efforts under the BARDA Contract, which are described below.

On February 18, 2011, we entered into a Research and Manufacturing Agreement with Johnson Matthey Pharmaceutical Materials, Inc. (d/b/a Johnson Matthey Pharma Services) ("JMPS"), pursuant to which we engaged JMPS to, among other things, assess and develop a reliable separations or manufacturing process for certain chemical compounds as required by us and to perform such additional work as may be required or agreed upon by the parties and to manufacture compounds for us. Each project performed by JMPS under the agreement will have a detailed project description and separate fee agreement based on the nature and duration of the project and the specific services to be performed by JMPS. The term of the agreement with JMPS will continue until February 16, 2016 or the date on which all projects under the agreement have been completed or terminated.

On March 16, 2011, we and the Office of Research and Development of the University of Maryland, Baltimore ("UMB") entered into a Sub-award Agreement, pursuant to which we engaged UMB to, among other things, develop a whole thorax lung irradiation model for use in studies supporting the licensure of 10150. The Sub-award Agreement is a fixed fee agreement inclusive of all direct and indirect costs. As a result of the contract modification and no-cost extension with BARDA mentioned below, the term of the Sub-award Agreement will continue through at least June 30, 2014.

On February 14, 2012, the Aeolus team presented the results and deliverables that had been produced during the first twelve months under the base period of the BARDA Contract at an "In-Progress Review" meeting with BARDA, and requested the exercise of additional contract options, which contain additional key items required in the advanced development of 10150.

On February 15, 2012, we announced that we entered into a contract modification and no-cost extension with BARDA. The modification and extension allowed us to continue operating under the base period of the contract awarded in February 2011, and restructured the timing and components of the options that could be awarded under the remaining four years of the agreement. The changes did not impact the total potential value of the contract, which remains at approximately $118.4 million. The contract restructure was driven by our ability to generate cost savings in the base year contract, and to allow BARDA to better manage contract options to expedite development program.

On April 16, 2012, we announced that BARDA had exercised two contract options worth approximately $9.1 million. BARDA's exercise of the options was in response to the presentation of the deliverables and progress made under the contract at the meeting on February 14, 2012. Among the key items in the options BARDA exercised are animal efficacy studies, mechanism of action research and manufacturing and process validation work. All of these items build off of work successfully completed during the first twelve months of the contract base period. The contract is designed to produce the data necessary for an approval under the FDA “Animal Rule” and for a potential Emergency Use Authorization (EUA). An approval or EUA would allow the federal government to buy 10150 for the Strategic National Stockpile under Project Bioshield. Project Bioshield is designed to accelerate the research, development, purchase and availability of effective medical countermeasures for the Strategic National Stockpile.

On November 7, 2012, we and the Office of Research and Development of the University of Maryland, Baltimore (“UMB”) entered into a Sub-award Agreement, pursuant to which we engaged UMB to, among other things, perform mouse studies supporting the licensure of 10150. Prior to this agreement, our mouse studies had been conducted at Duke University. In 2012, the research team at Duke responsible for conducting the studies moved to UMB. The Sub-award Agreement is a fixed fee agreement inclusive of all direct and indirect costs. As a result of the contract modification and no-cost extension with BARDA mentioned above, the term of the Sub-award Agreement will continue through at least June 30, 2014.

On July 29, 2013, Aeolus presented the results and deliverables that had been produced during the first 28 months of the contract at an "In-Progress Review" meeting with BARDA, and requested the exercise of additional contract options.

On September 17, 2013 we announced that BARDA had exercised $6.0 million in additional options under the contract. The options that BARDA exercised will fund our IND filing for AEOL-10150 as a treatment for Lung-ARS, additional animal efficacy studies designed to optimize timing and duration of dosing and the continued development of large-scale GMP manufacturing capability to meet potential future demand. When combined with our ongoing studies in non-human primates and our completed work in GMP manufacturing development, these options will help Aeolus meet the requirements for a pre-EUA filing for AEOL-10150 in 2014.

As of December 31, 2013, the total contract value exercised by BARDA under the BARDA Contract is $25.5 million. From inception of the BARDA Contract, we have billed BARDA approximately $17.9 million.

Duke Licenses

Pursuant to our license agreements with Duke, we have obtained exclusive worldwide rights from Duke to products using antioxidant technology and compounds developed by Dr. Irwin Fridovich and other scientists at Duke. The license from Duke covers, among other items, AEOL11203, AEOL11207 and some of the intellectual property related to 10150. We are obligated under the licenses to pay Duke royalties ranging in the low single digits of net product sales during the term of the Duke licenses, and we must make payments upon the occurrence of certain development milestones in an aggregate amount of up to $2,000,000. In addition, we are obligated under the Duke licenses to pay patent filing, prosecution, maintenance and defense costs. The Duke licenses are terminable by Duke in the event of breach by us and otherwise expire when the last licensed patent expires.

National Jewish Medical and Research Center and National Jewish Health

We have obtained an exclusive worldwide license from the National Jewish Medical and Research Center (“NJMRC”) to develop, make, use and sell products using proprietary information and technology developed under a previous Sponsored Research Agreement within the field of antioxidant compounds and related discoveries. The license from NJMC covers, among other items, the composition of matter for 10150 and some use patents related to alkylating and

vesicant agents. We must make milestone payments to the NJMRC in an aggregate amount of up to $250,000 upon the occurrence of certain development milestones. Our royalty payment obligations to the NJMRC under this license agreement are in the low single digits of net product sales. We are also obligated to pay patent filing, prosecution, maintenance and defense costs. This NJMRC license agreement is terminable by the NJMRC in the event of breach and otherwise expires when the last licensed patent expires.

In 2009, we obtained an additional exclusive worldwide license from National Jewish Health to develop, make, use and sell products using proprietary information and technology developed at NJH related to certain compounds as an MCM against mustard gas exposure. Under this license agreement, we must make milestone payments to NJH in an aggregate amount of up to $500,000 upon the occurrence of certain development milestones. In addition, we must make royalty payments to NJH under this license agreement ranging in the low-single digits as a percentage of all sublicensing fees, milestone payments and sublicense royalties that we receive from sublicenses granted by us pursuant to this license agreement. We are also obligated to pay patent filing, prosecution, maintenance and defense costs. This NJH license agreement is terminable by NJH in the event of breach and otherwise expires when the last licensed patent expires.

February/March 2013 Financing

On February 19, 2013 and March 4, 2013, we entered into Securities Purchase Agreements (the "Purchase Agreements") with certain accredited investors (the "Purchasers"). Under the terms of the agreements, we received $3,616,000 in gross proceeds in exchange for the issuance of an aggregate of approximately 14,462,000 units (the "Units"), consisting of 14,462,000 shares of common stock and 14,462,000 warrants, at a purchase price of $0.25 per unit. Each Unit consists of (i) one share of common stock (the "Common Shares") and (ii) a five-year warrant to purchase one share of our common stock (the "Warrants"). The Warrants have an initial exercise price of $0.25 per share.

On February 19, 2013, we received $3,225,000 in gross proceeds in exchange for the issuance of an aggregate of 12,900,000 Units, which consisted of 12,900,000 shares of common stock and 12,900,000 warrants.

On March 4, 2013, we received $390,000 in gross proceeds in exchange for the issuance of an aggregate of approximately 1,562,000 Units, which consisted of 1,562,000 shares of common stock and 1,562,000 warrants.

Net cash proceeds from the February/March 2013 Financing, after deducting for expenses, were approximately $3,558,000. We also incurred non-cash expenses in the form of 365,000 warrants issued to consultants, at similar terms as the financing Warrants, for services provided. We issued a total of 14,827,000 warrants as of June 30, 2013 in connection with the February/March 2013 Financing.

The fair value of the February/March Financing warrants was estimated to be $4,791,000 using the Black-Scholes option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 154.84%, risk free interest rate of 0.87% and an expected life of five years. The proceeds from the February/March 2013 Financing were allocated based upon the relative fair values of the February/March 2013 Financing Warrants and the February/March 2013 Common Shares.

Results of Operations

Three months ended December 31, 2013 versus three months ended December 31, 2012

We had net loss of $695,000 and net income of $4,028,000 (including a non-cash adjustment for decreases in valuation of warrants of $4,510,000), and cash outflows from operations of $335,000 and $279,000 for the three months ended December 31, 2013 and December 31, 2012, respectively.

Revenue for the three months ended December 31, 2013 was $792,000, which compares to $1,342,000 for the three months ended December 31, 2012. The revenue is from the collaboration with BARDA announced on February 11, 2011. Since being awarded the BARDA Contract, we generate contract revenue from a cost-plus fee arrangement. Revenues on reimbursable contracts are recognized as costs are incurred, generally based on allowable costs incurred during the period, plus any recognizable earned fee. We consider fixed fees under cost-plus fee contracts to be earned

in proportion to the allowable costs incurred in performance of the contract.

Research and Development ("R&D") expenses decreased $462,000, or 40%, to $707,000 for the three months ended December 31, 2013 from $1,169,000 for the three months ended December 31, 2012. The decrease is primarily attributable to work related to the BARDA Contract.

General and administrative ("G&A") expenses increased $126,000, or 19%, to $781,000 for the three months ended December 31, 2013 from $655,000 for the three months ended December 31, 2012. Stock based compensation increased by $193,000 as a result of increased grant activity.

Liquidity and Capital Resources

We had cash and cash equivalents of $534,000 on December 31, 2013, and $869,000 on September 30, 2013. The decrease in cash was primarily due to cash provided by operating activities.

We had net loss of $695,000 for the three months ended December 31, 2013. We had cash outflows from operations of $335,000. We expect to incur additional losses and negative cash flow from operations during the remainder of fiscal year 2014 and for several more years.

On February 11, 2011, we were awarded the BARDA Contract to fund the development of AEOL 10150 as a medical countermeasure for Lung-ARS from its current status to FDA approval in response to Special Instructions Amendment 4 to a Broad Agency Announcement (BAA-BARDA-09-34) for advanced research and development of medical countermeasures for chemical, biological, radiological and nuclear threats. The contract value could be up to $118.4 million depending on options exercised by BARDA and the requirements for approval by the FDA. Under the BARDA Contract, substantially all of the costs of the development of AEOL 10150 as a medical countermeasure for pulmonary injuries resulting from an acute exposure to radiation from a radiological/nuclear accident or attack, particularly injuries associated with ARS or Delayed Effects of Acute Radiation Exposure would be paid for by the U.S. government through BARDA funding. We recognized $793,000 in revenue during the quarter ended December 31, 2013 related to the BARDA Contract. The BARDA Contract includes provisions to cover some, but not all, general corporate overhead as well as a small provision for profit. The net impact of the BARDA Contract on our liquidity is that our projected cash burn has been reduced. Certain costs, typically those of being a public company, like legal costs associated with being a public company, Investor Relations/Public Relations costs and patent-related costs, are not included in overhead reimbursement in the BARDA Contract. In order to fund on-going operating cash requirements or to accelerate or expand our oncology and other programs we may need to raise significant additional funds.

We do not have any revenues from product sales and, therefore, we rely on investors, grants, collaborations and licensing of our compounds to finance our operations. We generate limited revenue from reimbursable, cost-plus R&D contracts and grants. Revenues on reimbursable contracts are recognized as costs are incurred, generally based on allowable costs incurred during the period, plus any recognizable earned fee. We consider fixed fees under cost-plus fee contracts to be earned in proportion to the allowable costs incurred in performance of the contract.

We have incurred significant losses from operations to date. Our ongoing future cash requirements will depend on numerous factors, particularly the progress of our catalytic antioxidant program, potential government procurements for the national stockpile, clinical trials and/or ability to negotiate and complete collaborative agreements or out-licensing arrangements. In addition, we might sell additional shares of our stock and/or debt and explore other strategic and financial alternatives, including a merger or joint venture with another company, the sale of stock and/or debt, 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 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.

Critical Accounting Policies and Estimates

Revenue Recognition

We do not currently generate revenue from product sales, but do generate revenue from the BARDA Contract. We recognize revenue from the BARDA Contract in accordance with the authoritative guidance for revenue recognition. Revenue is recognized when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery (or passage of title) has occurred or services have been rendered, (iii) the seller's price to the buyer is fixed or determinable, and (iv) collectability is reasonably assured. We also comply with the authoritative guidance for revenue recognition regarding arrangements with multiple deliverables.

The BARDA Contract is classified as a "cost-plus-fixed-fee" contract. We recognize government contract revenue in accordance with the authoritative guidance for revenue recognition, including the authoritative guidance specific to federal government contracts. Reimbursable costs under the BARDA Contract primarily include direct labor, subcontract costs, materials, equipment, travel and indirect costs. In addition, we receive a fixed fee under the BARDA Contract, which is unconditionally earned as allowable costs are incurred and is not contingent on success factors. Reimbursable costs under this BARDA Contract, including the fixed fee, are generally recognized as revenue in the period the reimbursable costs are incurred and become billable.

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 Statements of Operations or Cash Flows for the three months ended December 31, 2012. We do not have any foreign currency or other derivative financial instruments.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). In designing and evaluating our disclosure controls and procedures, our management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q because of the material weakness

discussed below.

In connection with the preparation of our Quarterly Report on Form 10-Q for the quarter ended December 31, 2012, we determined that our basic and diluted net income (loss) per share calculations should have been prepared using the "two-class method." Under the two-class method, securities that participate in dividends are considered "participating securities." Our preferred shares, preferred warrants and most of our common stock warrants are considered "participating securities" because they include non-forfeitable rights to dividends.

Additionally, we determined that the diluted net income (loss) per share calculations did not include the net income effect of changes in fair value related to dilutive, liability classified warrants.

Application of the two-class method and, for dilutive earnings per share, including the effect of changes in fair value for liability classified warrants resulted in a modification to our previously reported basic and diluted net income (loss) per share for the fiscal years ended September 30, 2012 and 2011, and the quarterly periods included therein.

On February 12, 2013, the Audit Committee of our Board of Directors concluded, based on the recommendation of management, that the consolidated statements of operations for the fiscal years ended September 30, 2012 and 2011, and the consolidated statements of operations for the quarterly periods in the years ended September 30, 2012 and 2011 (collectively, the "Prior Financial Statements"), should no longer be relied upon because of the incorrect calculation of earnings per share. Management and the Audit Committee discussed the matters relating to the restatements with Grant Thornton LLP, our independent registered public accountants.

We filed a Current Report on Form 8-K on February 19, 2013 to reflect the revisions to our Annual Report on Form 10-K for the year ended September 30, 2012 described above. On May 14, 2013, we filed an amendment to our Annual Report on Form 10-K/A for the year ended September 30, 2012 to reflect the revisions set forth above, and we also included these revisions in our post-effective amendment to registration statement on Form S-1 (File No. 333-181409) filed on February 20, 2013. We do not intend to amend our previously filed Quarterly Reports on Form 10-Q for the periods ended December 31, 2010, March 31, 2011, June 30, 2011, December 31, 2011, March 31, 2012 or June 30, 2012, or our Annual Report on Form 10-K for the year ended September 30, 2011, to reflect the revisions described above.

A material weakness is a significant deficiency, or combination of deficiencies, in internal control over financial reporting that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As a result of the determination that our diluted net income (loss) per share calculations did not include the net income effect of changes in fair value related to dilutive, liability classified warrants for the fiscal years ended September 30, 2012 and 2011, and the quarterly periods included therein, management has determined that a material weakness existed as of December 31, 2013.

Management believes the material weakness is due to a deficiency in technical resources over financial reporting. As a result of the material weakness, management is evaluating mitigating controls to minimize the potential for incorrect calculations of earnings per share in our future financial statements.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended December 31, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

As of December 31, 2013, there have not been any material changes from the risk factors previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the fiscal year ended September 30, 2013, which was filed with the SEC on December 20, 2013.

Item 6. Exhibits

Exhibit #	Description
2.1 (1)	

		Agreement and Plan of Merger and Reorganization dated September 16, 2003 between Incara, Inc. and Incara Pharmaceuticals Corporation
3.1	(2)	Amended and Restated Certificate of Incorporation
3.2	(3)	Bylaws
4.1	(4)	Form of Common Stock Certificate
4.2	(1)	Form of Series B Preferred Stock Certificate
4.3	(5)	Form of Warrant to Purchase Common Stock dated June 5, 2006.

4.4	(6)	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.
4.5	(7)	Registration Rights Agreement dated October 6, 2009 by and among the Company and the investors whose names appear on the signature pages thereof.
4.6	(6)	Form of Warrant to Purchase Common Stock dated May 22, 2007.
4.7	(7)	Form of Warrant to Purchase Common Stock
4.8	(1)	Registration Rights Agreement dated September 16, 2003 among Incara Pharmaceuticals Corporation, Incara, Inc. and Goodnow Capital, L.L.C.
4.9	(8)	Registration Rights Agreement dated August 11, 2010 by and among Aeolus Pharmaceuticals, Inc. and the investors listed therein
4.10	(9)	Registration Rights Agreement dated March 4, 2013 by and among Aeolus Pharmaceuticals, Inc. and the investors listed therein
4.11	(9)	Form of Warrant to Purchase Common Stock dated March 4, 2013
4.12	(10)	Warrant Repricing, Exercise and Lockup Agreement dated February 19, 2013 by and among the Company, Xmark JV Investment Partners, LLC and affiliates
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 Interim Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a).
32.1		Certification by the Chief Executive Officer and Interim Chief Financial Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	+	XBRL Instance Document
101.SCH	+	XBRL Taxonomy Extension Schema Document
101.CAL	+	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	+	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	+	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	+	XBRL Taxonomy Extension Presentation Linkbase Document

(1) Incorporated herein by reference to the Registrant's Registration Statement on Form S -4 filed with the SEC on 09/19/03.

(2) Incorporated herein by reference to the Registrant's Annual Report on Form 10-K filed with the SEC on 12/31/12.

(3) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 10/27/05.

(4) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 08/11/04.

(5) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 06/06/06.

(6) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 5/23/07.

(7) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 10/06/09.

(8) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 8/12/10.

(9) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 3/6/13.

(10) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on 2/19/13.

+ Attached as Exhibit 101 to this report are documents formatted in XBRL (Extensible Business Reporting Language).

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: February 14, 2014

By /s/ John L. McManus_____
John L. McManus
President and Chief Executive Officer
(Principal Executive Officer)

By /s/ David Cavalier_____
David Cavalier
Chairman, Chief Financial Officer and Secretary
(Principal Financial and Accounting Officer)