MEDICAL DISCOVERIES INC
Form 10QSB
August 14, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-QSB

(Mark One)

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

For the quarterly period ended June 30, 2006

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT**

For the transition period from __________ to __________

Commission file number 0-12627

MEDICAL DISCOVERIES, INC.

(Exact name of Small Business Issuer as specified in its charter)

Utah	87-0407858
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1388 S. Foothill Drive, #266, Salt Lake City, Utah 84108
(Address of principal executive offices)
(801) 582-9583
(Issuer s telephone number, including area code)
N/A
(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 No o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date: As of August 14, 2006, there were 117,922,148 shares of the issuer s Common Stock outstanding.

Transitional Small Business Disclosure Format (check one): Yes o No þ

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

The following financial statements are filed with this report:

Condensed Consolidated Balance Sheets as of June 30, 2006, (unaudited) and December 31, 2005 (unaudited)

Condensed Consolidated Statements of Operations for the three- and six-month periods ended June 30, 2006 (unaudited) and June 30, 2005 (unaudited), and from inception of the development stage on November 20, 1991 through June 30, 2006 (unaudited)

Condensed Consolidated Statements of Cash Flows for the six-month periods ended June 30, 2006 (unaudited) and June 30, 2005 (unaudited), and from inception of the development stage on November 20, 1991 through June 30, 2006 (unaudited)

Notes to Unaudited Condensed Consolidated Financial Statements

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
(A Development Stage Company)
Condensed Consolidated Balance Sheets
(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
CURRENT ASSETS		
Cash	$ 106,123	$ 654,438
Total Current Assets	106,123	654,438
Note receivable	319,475	296,050
Property and Equipment, Net	71,164	80,635
TOTAL ASSETS	$ 496,762	$ 1,031,123
LIABILITIES AND STOCKHOLDERS DEFICIT		
CURRENT LIABILITIES		
Accounts payable	$ 2,151,935	$ 2,608,783
Accrued interest payable	252,664	237,836
Notes payable	56,000	56,000
Convertible notes payable	193,200	193,200
Research and development obligation	638,950	592,100
Deferred revenue	192,825	
Financial instrument	1,979,516	2,859,596
Total Current Liabilities	5,465,090	6,547,515
NOTE PAYABLE	90,000	
TOTAL LIABILITIES	5,555,090	6,547,515
STOCKHOLDERS DEFICIT		
Preferred Stock undesignated, Series A, convertible; no par value; 50,000 shares authorized; 34,420 and 42,000 shares issued and outstanding,	514,612	523,334

respectively; (aggregate liquidation preference of $3,442,000 and $4,200,000, respectively)		
Common stock, no par value; 250,000,000 shares authorized; 117,922,148 and 107,679,724 shares issued and outstanding, respectively	15,220,617	15,211,895
Additional paid in capital	1,056,020	988,670
Deficit accumulated prior to the development stage	(1,399,577)	(1,399,577)
Deficit accumulated during the development stage	(20,450,000)	(20,840,714)
Total Stockholders Deficit	(5,058,328)	(5,516,392)
TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT	$ 496,762	$ 1,031,123

See notes to condensed consolidated financial statements

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
(A Development Stage Company)
Condensed Consolidated Statements of Operations
(Unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,		From Inception of the Development Stage on November 20, 1991 Through June 30,
	2006	2005	2006	2005	2006
REVENUES	$	$	$	$	$ 157,044
COST OF GOODS SOLD					14,564
GROSS PROFIT					142,480
OPERATING EXPENSES					
General and administrative	385,946	636,325	731,466	888,321	17,786,463
Research and development	234,659	118,520	327,242	1,670,506	6,048,441
Inventory write-down					96,859
Impairment loss					9,709
License fees					1,001,500
Total Expenses	620,605	754,845	1,058,708	2,558,827	24,942,972
LOSS FROM OPERATIONS	(620,605)	(754,845)	(1,058,708)	(2,558,827)	(24,800,492)
OTHER INCOME (EXPENSES)					
Unrealized gain on financial instrument	1,999,857	2,133,177	880,080	1,990,915	3,180,271
Interest income	565	9,346	1,776	14,910	57,074
Interest expense	(7,472)	(7,237)	(14,844)	(23,135)	(1,170,545)
Foreign currency transaction gain (loss)	(16,000)	40,900	(23,425)	60,800	33,055
Gain on debt restructuring	605,052	196,353	605,052	196,353	2,036,941
Other income	783		783		905,895

Total Other Income	2,582,785	2,372,539	1,449,422	2,239,843	5,042,691
NET INCOME (LOSS)	1,962,180	1,617,694	390,714	(318,984)	(19,757,801)
Preferred stock dividend from beneficial conversion feature					(692,199)
NET INCOME (LOSS) APPLICABLE TO COMMON SHAREHOLDERS	$ 1,962,180	$ 1,617,694	$ 390,714	$ (318,984)	$ (20,450,000)
BASIC EARNINGS (LOSS) PER SHARE	$ 0.02	$ 0.02	$	$	
DILUTED EARNINGS (LOSS) PER SHARE	$ 0.01	$ 0.01	$	$	

See notes to condensed consolidated financial statements

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
(A Development Stage Company)
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005	From Inception of the Development Stage on November 20, 1991 Through June 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income (Loss)	$ 390,714	$ (318,984)	$ (19,757,801)
Adjustments to reconcile net loss to net cash used by operating activities:			
Foreign currency transaction (gain) loss	23,425	(60,800)	(33,055)
Gain on debt restructuring	(605,052)	(196,353)	(2,036,941)
Common stock issued for services, expenses, and litigation		18,750	4,267,717
Commitment for research and development obligation		665,700	665,700
Depreciation	9,471	870	118,257
Reduction of escrow receivable from research and development			272,700
Unrealized gain on financial instrument	(880,080)	(1,990,915)	(3,180,271)
Stock options and warrants granted for services	67,350		4,878,603
Reduction of legal costs			(130,000)
Write-off of subscriptions receivable			112,500
Impairment of loss on assets			9,709
Loss on disposal of equipment			30,364
Write-off of accounts receivable			245,065
Note payable issued for litigation			385,000
Changes in operating assets and liabilities			
Increase in accounts receivable			(7,529)
Increase in accounts payable	238,204	162,889	2,702,390
Increase in accrued expenses	14,828	23,134	652,747
Increase in deferred revenue	192,825		192,825
Net Cash Used by Operating Activities	(548,315)	(1,695,709)	(10,612,020)
CASH FLOWS FROM INVESTING ACTIVITIES			
Increase in deposits			(51,100)
Purchase of equipment		(68,491)	(221,334)
Issuance of notes receivable			(313,170)
Payments received on notes receivable			130,000
Net Cash Used by Investing Activities		(68,491)	(455,604)

CASH FLOWS FROM FINANCING ACTIVITIES			
Issuance of common stock, preferred stock and warrants for cash		3,033,000	10,033,845
Contributed equity			131,374
Proceeds from notes payable			1,336,613
Payments on notes payable		(300,000)	(801,287)
Proceeds from convertible notes payable			571,702
Payments on convertible notes payable			(98,500)
Net Cash Provided by Financing Activities		2,733,000	11,173,747
NET INCREASE (DECREASE) IN CASH	(548,315)	968,800	106,123
CASH AT BEGINNING OF PERIOD	654,438	1,455,397	
CASH AT END OF PERIOD	$ 106,123	$ 2,424,197	$ 106,123

See notes to condensed consolidated financial statements

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
(A Development Stage Company)
Condensed Consolidated Statements of Cash Flows (Continued)
(Unaudited)

	For the Six Months Ended June 30, 2006	2005
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Initial valuation of financial instrument	$	$6,279,829
Conversion of preferred stock to common stock	$8,722	$

See notes to condensed consolidated financial statements

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MEDICAL DISCOVERIES, INC. AND SUBSIDIARIES
(A Development Stage Company)
Notes to the Unaudited Condensed Consolidated Financial Statements

Note 1 Basis of Presentation

Unaudited Interim Consolidated Financial Statements

The accompanying unaudited consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments and disclosures necessary for a fair presentation of these financial statements have been included. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s 2005 Annual Report on Form 10-KSB for the year ended December 31, 2005, as filed with the Securities and Exchange Commission. The results of operations for the three months and six months ended June 30, 2006 may not be indicative of the results that may be expected for the year ending December 31, 2006.

Earnings (Loss) Per Common Share

Basic earnings (loss) per share is computed by dividing net income (loss) applicable to common shareholders by the weighted-average number of shares outstanding during the period. Dilutive earnings (loss) per share reflects the potential dilution that could occur if all contracts to issue common stock were converted into common stock except for those that are anti-dilutive. The computation of earnings (loss) per share for the three and six months ended June 30, 2006 and 2005 is as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	$ 1,962,180	$ 1,617,694	$ 390,714	$ (318,984)
Basic weighted-average common shares outstanding	111,255,481	107,580,033	109,576,693	107,043,413
Convertible notes	128,671	128,671	128,671	
Convertible preferred stock	48,478,873	57,776,847	48,478,873	
Warrants	535,829	767,936	679,786	
Stock options	14,316,063	16,289,969	14,587,548	
Diluted weighted-average common shares outstanding	174,714,917	182,543,456	173,451,571	107,043,413
Basic net earnings (loss) per common share	$ 0.02	$ 0.02	$	$
Diluted net earnings (loss) per common share	$ 0.01	$ 0.01	$	$

For the three and six months ending June 30, 2006 and 2005, the Company had the following common stock equivalents outstanding that that were not included in the computation of diluted net loss per common share as their effect would have been anti-dilutive, thereby decreasing the net loss per common share:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Convertible notes				128,671

Convertible preferred stock				59,786,477
Warrants	38,567,161	38,567,161	38,567,161	40,923,861
Options	2,233,000	2,233,000	1,733,000	19,483,000
	40,800,161	40,800,161	40,300,161	120,322,009

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Potential common shares from convertible notes payable, preferred stock, warrants, and stock options for the six months ended June 30, 2005 have not been included as their effects are anti-dilutive.

Stock Based Compensation

Effective January 1, 2006 the Company adopted SFAS No. 123(R), Share-Based Payments (FAS 123(R)), an amendment of SFAS No. 123, Accounting for Stock Based Compensation , using the modified prospective transition method. Under this transaction method, compensation cost is recognized beginning with the effective date: (a) based on the requirements of FAS 123(R) for all share-based awards granted after the effective date and (b) based on the requirements of FAS 123 for all awards granted to employees prior to the effective date of FAS 123(R) that remain unvested on the effective date. Accordingly, we did not restate the results of prior periods. The most notable change with the adoption is that compensation expense associated with stock options is now recognized in our consolidated statement of operations, rather than being disclosed in pro forma footnote to our consolidated financial statements.

Prior to January 1, 2006, the Company accounted for stock options issued to directors, officers, and employees under Accounting Principals Board Opinion No. 25 and related interpretations (APB 25). The Company accounted for options and warrants issued to non-employees at their fair value in accordance with SFAS 123, Accounting for Stock-Based Compensation (SFAS 123). Share-based compensation was included as a pro forma disclosure in the financial statement footnotes for periods prior to January 1, 2006. The Company did not have any employee based options that vested during 2005.

As a result of adopting FAS 123(R), we recognized compensation expense related to options granted during the six months ended June 30, 2006 in the amount of $67,350, which was the fair value of the options issued during the six months ended June 30, 2006.

Note 2 Going Concern Considerations

The Company s recurring losses from development-stage activities in current and prior years raise substantial doubt about the Company s ability to continue as a going concern. The financial statements do not include any adjustments to reflect the possible effects on the recoverability and classification of assets or amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern. The Company is attempting to raise additional capital to fund research and development costs until it is able to consistently generate revenues and sustain profitable operations. However, there can be no assurance that these plans will be successful.

Note 3 Preferred Stock, Financial Instrument, and Options

During January 2006, the Company converted 200 shares of Series A Preferred Stock into 242,424 shares of common stock pursuant to the Subscription Agreement dated October 18, 2004. The conversion price was $.0825 per share. The preferred stock had an assigned value of $8,722 which was reclassed to common stock at the time of conversion.

During May 2006, the Company converted 7,380 shares of Series A Preferred Stock into 10,000,000 shares of Common Stock pursuant to the Subscription Agreement dated December 4, 2004. The conversion price was $.0738 per share. The preferred stock did not have any assigned value due to proceeds being assigned to the warrant liability.

The Company adjusted to market value the outstanding warrants as of June 30, 2006. The fair value of the financial instrument was $1,979,516. The Company used the Black Scholes model in calculating fair value with the following assumptions: volatility of 142%, risk-free interest rate of 5.18%, and an expected life of 1.5 years. The changes in fair market value have been recorded as adjustments in the line Unrealized gain on financial instrument in the financial statements.

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During the six months ended June 30, 2006, the Company granted a stock option to a former officer and director. The option is for 500,000 shares exercisable at $0.25 per share through December 31, 2010. The Company valued these options at $67,350 ($0.13 per share) using the Black-Scholes option pricing model with the following assumptions: risk-free rate of 4.3%, volatility of 152%, and an expected life of five years.

Note 4 Related Party Transactions

At June 30, 2006, the Company had accounts payable to current and former officers and directors totaling $1,088,886, respectively, for services performed and costs incurred in behalf of the Company, including $877,636 payable to the Company s President and CEO. Also at June 30, 2006, the Company had accounts payable to its controller of $73,000.

On July 15, 2005, the Company entered into an agreement to grant a shareholder a non-interest bearing loan in the amount of 500,000 (approximately $639,000 under current exchange rates) in exchange for the transfer of certain patents in relation to Savetherapeutics AG, and the performance of certain research activities. The loan is payable as follows, 100,000 upon closing, 150,000 after signature of consent to the transfer of patents, and 250,000 after performance and acceptance of certain research activities. As of June 30, 2006, the amount of the loan was 250,000 (approximately $319,000 under current exchange rates). Settlement of the loan shall take place by offsetting against profit claims, which accrue to the shareholder from his stake in the Company.

Subsequent to the transfer of the industrial property rights and applications, the Company shall grant to the aforementioned shareholder a 6% stake in MDI Oncology, Inc and to assign to him 6% of the shares. The Company deemed these shares to have no value because it is a start-up company, and its success is contingent on several different factors. The Company also entered into an employment contract with the shareholder for a period of 24 months. The shareholder will receive a fee of 120,000 per annum (approximately $153,000 using current exchange rates.)

Note 5 Other Significant Transactions

SaveCream Asset Purchase

On March 16, 2005, the Company completed the purchase of the intellectual property assets (the Assets) of Savetherapeutics AG, a German corporation in liquidation in Hamburg, Germany (SaveT). The Assets consist primarily of patents, patent applications, pre-clinical study data and clinical trial data concerning SaveCream, SaveT s developmental-stage topical aromatase inhibitor treatment for breast cancer. SaveCream never generated revenues for SaveT. The Company s analysis as to whether the intellectual property purchased constituted a business resulted in the conclusion that no such business had been acquired.

The purchase price of the Assets was 2,350,000 (approximately $3 million under current exchange rates), payable as follows: 500,000 at closing, 500,000 (approximately $665,700 on the date of transaction, $639,000 using the June 30, 2006 exchange rates) upon conclusion of certain pending transfers of patent and patent application rights from SaveT s inventors to the Company, and the remaining 1,350,000 (approximately $1.7 million at current exchange rates) upon successful commercialization of the Assets.

SaveT inventors have yet to assign the patent and application rights to the Company, management has deemed the assignment of the rights to be reasonably likely because the inventors are contractually bound to execute and deliver the assignments; therefore, the Company has recorded the second 500,000 payment as a current liability in these financial statements. At present it is undeterminable whether the intellectual property will ever be commercialized; therefore, the final 1,350,000 under this acquisition has not been accrued as a liability as of June 30, 2006. The Company determined the intellectual property purchased should be expensed as research and development costs.

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Debt Restructuring

On June 10, 2006, the Company entered into an agreement with a former vendo to forgive certain accrued expenses. The balance owed before the agreement was $226,356. Per the agreement, $3,975 was paid on the date of the agreement, another $3,975 will be paid by November 7, 2006, and $128,407 will be forgiven. The remaining balance of $90,000 will be due and payable immediately upon MDI s receipt of $1 million in cumulative license revenue for MDI s drug MDI-P in any human indication and has been recorded as Note Payable in the accompanying financial statement. Additionally, the company determined $476,645 of previously recorded payables has passed the statue of limitations for collection and are included in Gain on debt restructuring in the accompanying financial statements.

Licensing Agreement

On May 8, 2006, MDI Oncology, Inc. (MDIO), a wholly-owned subsidiary of Medical Discoveries, Inc., entered into a letter of intent with Eucodis Forschungs-und Entwicklungs GmbH (Eucodis). The agreement included a $192,825 exclusivity fee for the sixty day period ending July 8, 2006. The fee was received during the second quarter, however the revenue related to this fee was deferred and will be recorded in our third quarter when the exclusivity period expires.

On July 29, 2006, MDIO entered into a Definitive Master Agreement (the Agreement) with Eucodis. The agreement will give Eucodis the exclusive right and license to develop, manufacture, and commercialize the Formestane Cream in the European Union for use in breast cancer. According to the Agreement, MDIO will receive upfront license fees and milestone payments of approximately $2.4 million (at current exchange rates), plus royalties.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The purpose of this section is to discuss and analyze our condensed consolidated financial condition, liquidity and capital resources, and results of operations. This analysis should be read in conjunction with the condensed consolidated financial statements and notes thereto at pages 3 through 10 and Management s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-KSB for the year ended December 31, 2005 (the 2005 10-KSB).

This section contains certain forward-looking statements that involve risks and uncertainties, including statements regarding our plans, objectives, goals, strategies and financial performance. Our actual results could differ materially from the results anticipated in these forward-looking statements as a result of factors set forth under Cautionary Statement for Forward-Looking Information and Factors Affecting Future Results below and elsewhere in this report.

Overview

We are a developmental-stage bio-pharmaceutical company engaged in the research, validation, development and ultimate commercialization of two drugs: MDI-P and formestane cream (formeraly known as SaveCream). MDI-P is an anti-infective drug that we believe will be a useful and well-tolerated treatment for bacterial infections, viral infections and fungal infections. We further believe that MDI-P will be a useful treatment for cystic fibrosis. Formestane cream is a breast cancer medication that is applied topically to reduce breast cancer tumors. Both of these drugs are still in development and have not been approved by the U. S. Food and Drug Administration (FDA).

Our initial target indications for MDI-P are cystic fibrosis and HIV. On November 10, 2004 we filed an Investigational New Drug application (IND) with the FDA seeking permission to begin Phase I human clinical trials of MDI-P as a treatment for cystic fibrosis. The FDA placed the proposed Phase I clinical trials on clinical hold pending additional preclinical testing. We completed that preclinical testing and no significant toxicities were noted. We submitted that data to the FDA on March 16, 2006. On April 21, 2006, the FDA responded and continued the clinical hold pending the outcome of yet another battery of preclinical trials. We intend to complete those additional

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