BSD MEDICAL CORP
Form 10-Q
January 09, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended November 30, 2008

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 No. 001-32526

BSD Medical Corporation
(Exact Name of Registrant as Specified in Its Charter)

Delaware	75-1590407
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2188 West 2200 South
Salt Lake City, Utah 84119
(Address of principal executive offices, including zip code)

(801) 972-5555
(Registrant's telephone number, including area code)

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

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

Large accelerated filer o	Accelerated filer ý
Non-accelerated filer o	Smaller reporting company ý

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

As of January 9, 2009, there were 21,843,673 shares of the Registrant's common stock, $0.001 par value per share, outstanding.

BSD MEDICAL CORPORATION
FORM 10-Q

FOR THE QUARTER ENDED NOVEMBER 30, 2008

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

BSD MEDICAL CORPORATION
Condensed Balance Sheets
(Unaudited)

ASSETS	November 30, 2008	August 31, 2008
Current assets:		
Cash and cash equivalents	$ 243,209	$ 1,394,652
Investments	10,312,265	14,487,192
Accounts receivable, net of allowance for doubtful accounts of $20,000	737,166	439,739
Related party trade accounts receivable	399,344	737,483
Income tax receivable	1,001,438	1,409,996
Inventories, net	1,661,394	1,425,153
Other current assets	89,323	113,829
Total current assets	14,444,139	20,008,044
Property and equipment, net	1,428,117	1,441,524
Patents, net	35,646	37,330
	$ 15,907,902	$ 21,486,898
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 530,673	$ 221,605
Accrued liabilities	499,344	585,777
Customer deposits	307,948	427,677
Deferred revenue – current portion	38,578	41,885
Total current liabilities	1,376,543	1,276,944
Deferred revenue – net of current portion	49,094	54,094
Total liabilities	1,425,637	1,331,038
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $.001 par value; 10,000,000 shares authorized, no shares issued and outstanding	-	-

Common stock; $.001 par value, 40,000,000 shares authorized, 21,843,673 and 21,388,958 shares issued	21,844	21,389
Additional paid-in capital	27,716,033	27,565,373
Treasury stock, 24,331 shares at cost	(234)	(234)
Other comprehensive loss	(6,532,981)	(2,141,416)
Accumulated deficit	(6,722,397)	(5,289,252)
Total stockholders' equity	14,482,265	20,155,860
	$ 15,907,902	$ 21,486,898

See accompanying notes to condensed financial statements

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BSD MEDICAL CORPORATION
Condensed Statements of Operations
(Unaudited)

	Three Months Ended November 30,	
	2008	2007
Revenues:		
Sales	$ 1,208,396	$ 479,703
Sales to related parties	23,168	908,025
Total revenues	1,231,564	1,387,728
Operating costs and expenses:		
Cost of sales	600,480	162,981
Cost of related party sales	22,172	277,874
Research and development	507,223	337,353
Selling, general and administrative	1,510,307	1,393,947
Total operating costs and expenses	2,640,182	2,172,155
Loss from operations	(1,408,618)	(784,427)
Other income (expense):		
Interest and investment income	258,732	189,348
Other expense	(34,259)	(63,856)
Total other income (expense)	224,473	125,492
Loss before income taxes	(1,184,145)	(658,935)
(Provision) benefit for income taxes	(249,000)	43,000
Net loss	(1,433,145)	(615,935)
Other comprehensive loss – unrealized loss on investments, net of income tax	(4,391,565)	(368,600)
Net comprehensive loss	$ (5,824,710)	$ (984,535)
Loss per common share:		
Basic	$ (0.07)	$ (0.03)
Diluted	$ (0.07)	$ (0.03)
Weighted average number of shares outstanding:		
Basic	21,769,000	21,311,000
Diluted	21,769,000	21,311,000

See accompanying notes to condensed financial statements

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BSD MEDICAL CORPORATION
Condensed Statements of Cash Flows
(Unaudited)

	Three Months Ended November 30,	
	2008	2007
Cash flows from operating activities:		
Net loss	$ (1,433,145)	$ (615,935)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	33,276	26,373
Stock-based compensation	273,173	158,630
Stock issued for services	37,500	30,000
Decrease (increase) in:		
Receivables	40,712	(835,910)
Income tax receivable	249,000	(211,000)
Inventories	(236,241)	(92,436)
Deferred tax assets	-	168,000
Other current assets	24,506	7,227
Increase (decrease) in:		
Accounts payable	309,068	33,629
Accrued liabilities	(86,433)	(72,358)
Customer deposits	(119,729)	(131,573)
Deferred revenue	(8,307)	(7,722)
Net cash used in operating activities	(916,620)	(1,543,075)
Cash flows from investing activities:		
(Purchase) sale of investments	(216,638)	3,072,907
Purchase of property and equipment	(18,185)	(1,205,892)
Increase in patents	-	(20,967)
Net cash (used in) provided by investing activities	(234,823)	1,846,048
Cash flows from financing activities:		
Proceeds from the sale of common stock	-	12,000
Net (decrease) increase in cash and cash equivalents	(1,151,443)	314,973
Cash and cash equivalents, beginning of period	1,394,652	416,540
Cash and cash equivalents, end of period	$ 243,209	$ 731,513

See accompanying notes to condensed financial statements

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BSD MEDICAL CORPORATION
Notes to Condensed Financial Statements
(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited condensed balance sheets of BSD Medical Corporation (the "Company") as of November 30, 2008 and August 31, 2008, the related unaudited condensed statements of operations for the three months ended November 30, 2008 and 2007, and the related unaudited condensed statements of cash flows for the three months ended November 30, 2008 and 2007 have been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). The condensed financial statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. These condensed financial statements should be read in conjunction with the notes thereto, and the financial statements and notes thereto included in our annual report on Form 10-K for the year ended August 31, 2008.

All adjustments (consisting only of normal recurring adjustments) necessary for the fair presentation of our financial position as of November 30, 2008 and August 31, 2008, our results of operations for the three months ended November 30, 2008 and 2007, and our cash flows for the three months ended November 30, 2008 and 2007 have been included. The results of operations for the three months ended November 30, 2008 may not be indicative of the results for the year ending August 31, 2009.

Note 2. Net Income (Loss) Per Common Share

The computation of basic earnings per common share is based on the weighted average number of shares outstanding during the period. The computation of diluted earnings per common share is based on the weighted average number of shares outstanding during the period plus the weighted average common stock equivalents which would arise from the exercise of stock options outstanding using the treasury stock method and the average market price per share during the period.

The shares used in the computation of the Company's basic and diluted earnings per share are reconciled as follows:

	Three Months Ended November 30,	
	2008	2007
Weighted average number of shares outstanding – basic	21,769,000	21,311,000
Dilutive effect of stock options	-	-
Weighted average number of shares outstanding – diluted	21,769,000	21,311,000

No stock options are included in the computation of diluted weighted average number of shares for the three months ended November 30, 2008 and 2007 because the effect would be anti-dilutive. At November 30, 2008, the Company had outstanding options to purchase a total of 1,851,600 common shares of the Company that could have a future dilutive effect on the calculation of earnings per share.

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Note 3. Inventories

Inventories consist of the following:

	November 30, 2008	August 31, 2008
Parts and supplies	$ 999,047	$ 802,956
Work-in-process	648,541	608,391
Finished goods	53,806	53,806
Reserve for obsolete inventory	(40,000)	(40,000)
Inventories, net	$ 1,661,394	$ 1,425,153

Note 4. Property and Equipment

Property and equipment consist of the following:

	November 30, 2008	August 31, 2008
Equipment	$ 1,059,447	$ 1,048,061
Furniture and fixtures	298,576	298,576
Leasehold improvements	24,220	17,420
Building	956,000	956,000
Land	244,000	244,000
	2,582,243	2,564,057
Less accumulated depreciation	(1,154,126)	(1,122,533)
Property and equipment, net	$ 1,428,117	$ 1,441,524

Note 5. Related Party Transactions

During the three months ended November 30, 2008 and 2007, we had sales of $23,168 and $908,025, respectively, to an entity controlled by a significant stockholder and member of the Board of Directors. These related party transactions represent approximately 2% and 65% of total sales for each respective three-month period.

At November 30, 2008 and August 31, 2008, receivables included $399,344 and $737,483, respectively, from this entity.

Note 6. Stock-Based Compensation

We have both an employee and director stock option plan, which are described more fully in Note 10 in our 2008 Annual Report on Form 10-K. As of November 30, 2008, we had approximately 1,262,000 shares of common stock reserved for future issuance under the stock option plans.

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The Company accounts for stock-based compensation in accordance with SFAS No. 123(R), Share Based Payments. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the value of the award granted using the Black-Scholes option pricing model, and recognized over the period in which the award vests. The stock-based compensation expense for the three-month periods ended November 30, 2008 and 2007 has been allocated to the various categories of operating costs and expenses in a manner similar to the allocation of payroll expense as follows:

	Three Months Ended November 30,	
	2008	2007
Cost of sales	$ 18,429	$ 21,148
Research and development	42,329	25,495
Selling, general and administrative	212,415	111,987
Total	$ 273,173	$ 158,630

During the three months ended November 30, 2008, we granted 235,000 options to our directors and employees, 150,000 options with one fifth vesting each year for the next five years, and 85,000 options with one third vesting each year for the next three years. These grants account for $55,984 of the total stock-based compensation expense for the three months ended November 30, 2008.

Unrecognized stock-based compensation expense expected to be recognized over the estimated weighted-average amortization period of 3.64 years is approximately $3,088,000 at November 30, 2008.

Our weighted-average assumptions used in the Black-Scholes valuation model for equity awards with time-based vesting provisions granted during the three months ended November 30, 2008 are shown below:

Expected volatility	62.11%
Expected dividends	0%
Expected term	6.0 Years
Risk-free interest rate	3.35%

The expected volatility rate was estimated based on the historical volatility of our common stock. The expected term was estimated based on historical experience of stock option exercise and forfeiture. The risk-free interest rate is the rate provided by the U.S. Treasury for Daily Treasury Yield Curve Rates commonly referred to as “Constant Maturity Treasury” rate in effect at the time of grant with a remaining term equal to the expected option term.

The weighted-average grant-date fair value of stock options granted during the three months ended November 30, 2008 was $4.37.

A summary of the time-based stock option awards as of November 30, 2008, and changes during the three months then ended, is as follows:

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	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contract Term (Years)	Aggregate Intrinsic Value
Outstanding at August 31, 2008	2,182,629	$ 3.02		
Granted	235,000	7.32		
Exercised	(516,029)	0.94		
Forfeited or expired	(50,000)	7.04		
Outstanding at November 30, 2008	1,851,600	$ 4.09	7.56	
Exercisable at November 30, 2008	1,007,410	$ 2.67	6.43	$1,502,264

Note 7. Income Taxes

The income tax (provision) benefit consists of the following:

	Three Months Ended November 30,	
	2008	2007
Current	$ (20,000)	$ 211,000
Deferred	(229,000)	(168,000)
Total	$ (249,000)	$ 43,000

The current provision for income tax of $20,000 in the three months ended November 30, 2008 resulted from a decrease in our income tax receivable due to a change in the amount of taxable loss and tax credits that we can carry back to offset income taxes previously paid. The current income tax benefit of $211,000 in the three months ended November 30, 2007 represents an increase in our income tax receivable resulting from our ability to carry back our taxable loss in that period to offset income taxes previously paid.

The deferred income tax provision of $229,000 and $168,000 in the three months ended November 30, 2008 and 2007, respectively, resulted from our recording a valuation allowance against our deferred tax assets. In recording the valuation allowance, we were unable to conclude that it is more likely than not that our deferred tax assets, including our taxable loss and tax credit carry forwards, will be realized. In reaching this determination, we evaluated factors such as prior earnings history, expected future earnings and our ability to carry back reversing items within two years to offset income taxes paid.

Note 8. Supplemental Cash Flow Information

The Company paid no amounts for interest during the three months ended November 30, 2008 and 2007. The Company paid no amounts for income taxes during the three months ended November 30, 2008 and 2007.

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During the three months ended November 30, 2008, the Company had the following non-cash financing and investing activities:

- Increased other comprehensive loss and decreased investments by $4,391,565.
- Increased common stock and decreased additional paid-in capital by $450.
- Decreased income tax receivable and additional paid-in capital by $159,558.

During the three months ended November 30, 2007, the Company had the following non-cash financing and investing activities:

- Recorded an increase in additional paid-in capital of $115,027, a decrease in long-term deferred tax asset of $76,000 and an increase in income tax receivable of $191,027 related to the tax benefit from the exercise of stock options.
- Increased other comprehensive loss by $368,600, decreased investments by $156,600 and increased short-term deferred tax asset by $212,000.
- Increased common stock and decreased additional paid-in capital by $1.

Note 9. Recent Accounting Pronouncements

On May 9, 2008, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 162, The Hierarchy of Generally Accepted Accounting Principles. This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements in conformity with U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. The statement establishes that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. This statement is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. We do not believe the implementation of this statement will have a material impact on our financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, or our fiscal year beginning September 1, 2009, with early application encouraged. This statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

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In December 2007, the FASB issued SFAS No. 141(R) (revised 2007), Business Combinations. This statement replaces SFAS No. 141, Business Combinations and applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as "true mergers" or "mergers of equals" and combinations achieved without the transfer of consideration. This statement establishes principles and requirements for how the acquirer: a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, or our fiscal year beginning September 1, 2009. Earlier adoption is prohibited. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements. This statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, and amends Accounting Research Bulletin ("ARB") 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51's consolidation procedures for consistency with the requirements of SFAS No. 141(R) (revised 2007). This statement will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, or our fiscal year beginning September 1, 2009. Earlier adoption is prohibited. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of SFAS No. 159 apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities applies to all entities with available-for-sale and trading securities. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We adopted SFAS No. 159 on September 1, 2008, with no material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of their financial instruments according to a fair value hierarchy as defined in the standard. Additionally, companies are required to provide enhanced disclosure regarding financial instruments in one of the categories, including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. In February 2008, the FASB issued FASB Staff Position (FSP) No. FAS 157-2, which delays by one year the effective date of SFAS No. 157 for certain types of non-financial assets and non-financial liabilities. As a result, SFAS No. 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007 for financial assets and liabilities carried at fair value on a recurring basis, and for fiscal years beginning after November 15, 2008 for non-recurring non-financial assets and liabilities that are recognized or disclosed at fair value. In October 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active, or FSP 157-3. FSP 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued.

We adopted SFAS No. 157 for financial assets and liabilities carried at fair value on a recurring basis on September 1, 2008, with no material impact on our financial statements. We are currently unable to determine the impact on our financial statements of the application of SFAS No. 157 on September 1, 2009, for non-recurring non-financial assets

and liabilities that are recognized or disclosed at fair value.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this report contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can also be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looki statements are not guarantees of future performance and our actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to those discussed in the subsection entitled "Forward-Looking Statements" below. The following discussion should be read in conjunction with our financial statements and notes thereto included in this report. We assume no obligation to revise or update any forward-looking statements for any reason, except as required by law.

General

BSD Medical Corporation develops, manufactures, markets and services medical systems that deliver precision-focused radio frequency (RF) or microwave energy into diseased sites of the body, heating them to specified temperatures as required by a variety of medical therapies. Our business objectives are to commercialize our products developed for the treatment of cancer and to further expand our developments to treat other diseases and medical conditions. Our product line for cancer therapy has been created to offer hospitals and clinics a complete solution for thermal treatment of cancer as provided through microwave/RF systems. We consider our operations to comprise one business segment.

While our primary developments to date have been cancer treatment systems, we also pioneered the use of microwave thermal therapy for the treatment of symptoms associated with enlarged prostate, and we are responsible for much of the technology that has successfully created a substantial new medical industry addressing the needs of men's health. In accordance with our strategic plan, we subsequently sold our interest in TherMatrx, Inc., the company established to commercialize our technology to treat enlarged prostate symptoms, to provide substantial funding that we can utilize for commercializing our systems used in the treatment of cancer and in achieving other business objectives.

In spite of the advances in cancer treatment technology, nearly 40% of cancer patients continue to die from the disease in the United States. Commercialization of our systems used to treat cancer is our most immediate business objective. Our BSD-2000 and BSD-500 cancer treatment systems are used to treat cancer with heat while boosting the effectiveness of radiation through a number of biological mechanisms. Our MicroThermX-100 Microwave Ablation System is used to ablate soft tissue with heat alone. Current and targeted cancer treatment sites for our systems include cancers of the prostate, breast, head, neck, bladder, cervix, colon/rectum, esophagus, liver, brain, bone, stomach and lung. Our cancer treatment systems have been used to treat thousands of patients throughout the world, and have received much notoriety, including the Frost & Sullivan "Technology Innovation of the Year Award" for cancer therapy devices awarded for the development of the BSD-2000.

Our BSD-2000 systems are used to non-invasively treat cancers located deeper in the body, and are designed to be companions to the estimated 7,500 linear accelerators used to treat cancer through radiation and in combination with chemotherapy treatments. Our BSD-500 systems treat cancers on or near the body surface and those that can be approached through body orifices such as the throat, the rectum, etc., or through interstitial treatment in combination with interstitial radiation (brachytherapy). BSD-500 systems can be used as companions to our BSD-2000 systems and the estimated 2,500 brachytherapy systems installed.

Based on our management team's knowledge of the market, we believe that the fully saturated potential market for these developed cancer therapy systems is in excess of $5 billion. We also project an after-market opportunity based on service agreements that equates to approximately 15% of the purchase price of our systems per year. We believe

that the replacement cycle for our systems, based on advances in software, hardware and other components, will average 5-7 years. Our financial model in the higher production environment of established commercial sales is to achieve a 60% gross margin on systems and an 80% gross margin on service agreements and disposable applicators used with our MicroThermX-100 system.

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We have received United States Food and Drug Administration, or FDA, approval to market our commercial version of the BSD-500, and in March 2006, we completed a submission for FDA approval to sell the BSD-2000 in the United States. In August 2007, we successfully concluded a pre-approval and quality system inspection by the FDA. In December 2007, we received a letter from the FDA denying our application for pre-market approval of the BSD 2000 and providing guidance regarding amendments needed to make the BSD-2000 submission approvable. We have subsequently met with the FDA to clarify its requirements and are currently seeking to satisfy these requirements. In April 2008, we submitted a 510(k) premarket notification to the FDA for the MicroThermX-100 system, and in September 2008 we received FDA clearance to market the MicroThermX-100 thermal ablation system in the United States. We have designed our cancer therapy systems such that together they are capable of providing treatment for most solid tumors located virtually anywhere in the body.

Although we have not entered these markets, we also believe that our technology has application for a number of other medical purposes in addition to cancer.

Critical Accounting Policies and Estimates

The following is a discussion of our critical accounting policies and estimates that management believes are material to an understanding of our results of operations and which involve the exercise of judgment or estimates by management.

Revenue Recognition. Revenue from the sale of cancer treatment systems is recognized when a purchase order has been received, the system has been shipped, the selling price is fixed or determinable, and collection is reasonably assured. Most system sales are F.O.B. shipping point; therefore, shipment is deemed to have occurred when the product is delivered to the transportation carrier. Most system sales do not include installation. If installation is included as part of the contract, revenue is not recognized until installation has occurred, or until any remaining installation obligation is deemed to be perfunctory. Some sales of cancer treatment systems may include training as part of the sale. In such cases, the portion of the revenue related to the training, calculated based on the amount charged for training on a stand-alone basis, is deferred and recognized when the training has been provided. The sales of our cancer treatment systems do not require specific customer acceptance provisions and do not include the right of return, except in cases where the product does not function as warranted by us. We provide a reserve allowance for estimated returns. To date, returns have not been significant.

Revenue from manufacturing services is recorded when an agreement with the customer exists for such services, the services have been provided, and collection is reasonably assured. Revenue from training services is recorded when an agreement with the customer exists for such training, the training services have been provided, and collection is reasonably assured. Revenue from service support contracts is recognized on a straight-line basis over the term of the contract.

Our revenue recognition policy is the same for sales to both related parties and non-related parties. We provide the same products and services under the same terms to non-related parties as to related parties. Sales to distributors are recognized in the same manner as sales to end-user customers. Deferred revenue and customer deposits payable include amounts from service contracts as well as cash received for the sales of products, which have not been shipped.

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Investments. Investments with scheduled maturities greater than three months, but not greater than one year, are recorded as short-term investments. We have currently classified these investments as available-for sale. The short-term investments are recorded at fair value, with net unrealized gains and losses reported as other comprehensive income (loss) in stockholders' equity on our balance sheets. Realized gains and losses are included in our statements of operations.

Inventory Reserves. We periodically review our inventory levels and usage, paying particular attention to slower-moving items. If projected sales do not materialize or if our hyperthermia systems do not receive increased market acceptance, we may be required to increase the reserve for inventory impairment in future periods.

Product Warranty. We provide product warranties on our systems. These warranties vary from contract to contract, but generally consist of parts and labor warranties for one year from the date of installation. To date, expenses resulting from such warranties have not been material. We record a warranty expense at the time of each sale. This reserve is estimated based on prior history of service expense associated with similar units sold in the past.

Allowance for Doubtful Accounts. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. This allowance is a significant estimate and is regularly evaluated by us for adequacy by taking into consideration factors such as past experience, credit quality of the customer base, age of the receivable balances, both individually and in the aggregate, and current economic conditions that may affect a customer's ability to pay. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

Stock-based Compensation – We account for stock-based compensation in accordance with SFAS No. 123(R), which requires us to measure the compensation cost of stock options and other stock-based awards to employees and directors at fair value at the grant date and recognize compensation expense over the requisite service period for awards expected to vest. The grant date fair value of stock options is computed using the Black-Scholes valuation model, which model utilizes inputs that are subject to change over time, including the volatility of the market price of our common stock, risk free interest rates, requisite service periods and assumptions made by us regarding the assumed life and vesting of stock options and stock-based awards. As new options or stock-based awards are granted, additional non-cash compensation expense will be recorded by us.

Income Taxes – We account for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

We maintain valuation allowances where it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances are included in our income tax provision in the period of change. In determining whether a valuation allowance is warranted, we evaluate factors such as prior earnings history, expected future earnings and our ability to carry back reversing items within two years to offset income taxes previously paid.

To the extent that we have the ability to carry back current period taxable losses within two years to offset income taxes previously paid, we record an income tax receivable and a current income tax benefit.

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Results of Operations: Comparison of Three-Month Periods ended November 30, 2008 and 2007

Revenues – Total revenues for the three months ended November 30, 2008 were $1,231,564 compared to $1,387,728 for the three months ended November 30, 2007, a decrease of $156,164, or 11%. Our revenues can fluctuate significantly from period to period because our sales, to date, have been based upon a relatively small number of systems, the sales price of each being substantial enough to greatly impact revenue levels in the periods in which they occur. Sales of a few systems can cause a large change in our revenues from period to period.

Related Party Sales – We earned $23,168, or approximately 2%, of our revenues in the three months ended November 30, 2008 from sales to related parties as compared to $908,025 or approximately 65%, in the three months ended November 30, 2007. These sales for the three months ended November 30, 2008 and 2007 were to Medizin-Technik and decreased in the current fiscal year primarily due to a decrease in the number of systems sold. The sales consisted of sales of probes of $19,463 and other revenues of $3,705 in the three months ended November 30, 2008, and product sales of $879,512, probes of $8,700 and other revenues of $19,813 in the three months ended November 30, 2007. Sales to Medizin-Technik may fluctuate significantly from period to period because our sales, to date, have been based upon a relatively small number of systems, the sales price of each being substantial enough to greatly impact revenue levels in the periods in which they occur. Sales of a few systems can cause a large change in our revenue from period to period.

Non-Related Party Sales – In the three months ended November 30, 2008, we earned $1,208,396, or 98%, of our revenues from sales to unrelated parties, as compared to $479,703, or 35%, in the three months ended November 30, 2007, with the increase due primarily to more systems sold in the current fiscal year. These sales for the three months ended November 30, 2008 consisted of product sales of $1,179,040, service of $15,641, probes of $2,402 and consulting and other revenue of $11,313. By comparison, these sales for the three months ended November 30, 2007 consisted of product sales of $435,000, service of $15,371, probes of $13,847 and other revenue of $15,485.

Cost of Sales – Cost of sales in the three months ended November 30, 2008 was $600,480 compared to $162,981 in the three months ended November 30, 2007, an increase of $437,499, or 268%. This increase resulted primarily from increased product sales in the current fiscal year. We also have experienced a modest increase in our manufacturing costs in the current fiscal year, primarily from increased labor costs. Cost of sales as a percentage of sales will fluctuate from period to period depending on the mix of revenues for the period, the product configuration, pricing and other factors. Cost of sales to related parties in the three months ended November 30, 2008 decreased to $22,172 from $277,874 in the three months ended November 30, 2007 primarily due to the decrease in related party product sales. All of the related party cost of sales were attributable to sales to Medizin-Technik.

Gross Profit – Gross profit in the three months ended November 30, 2008 was $608,912 or 49% of total sales, as compared to $946,873 or 68% of total sales in the three months ended November 30, 2007. The increase in non-related party product sales in the current year resulted in a lower gross margin than in the first quarter of the prior fiscal year as a result of pricing with certain products. The decrease in related party product sales in the current year also contributed to the decrease in the overall gross margin. The gross margin percentage will fluctuate from period to period depending on the mix of revenues for the period, the product configuration, pricing and other factors.

Research and Development Expenses – Research and development expenses were $507,223 for the three months ended November 30, 2008, as compared to $337,353 for the three months ended November 30, 2007, an increase of $137,223, or approximately 50%. The increase in research and development expenses in the current fiscal year is due primarily to the development of new products and an increase in fees to outside consultants used in support of these development efforts.

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Selling General and Administrative Expenses – Selling, general and administrative expenses for the three months ended November 30, 2008 were $1,510,307, as compared to $1,393,947 for the three months ended November 30, 2007, an increase of $116,360, or approximately 8%. The increase in selling, general and administrative expenses in the current fiscal year is due primarily to an increase in our non-cash stock option expense and board compensation due to the addition of one new director.

Interest and Investment Income – Interest and investment income increased to $258,732 for the three months ended November 30, 2008, as compared to $189,348 for the three months ended November 30, 2007, due to losses on the liquidation of investments realized in the prior fiscal year.

(Provision) Benefit for Income Taxes – The provision for income taxes in the three months ended November 30, 2008 was $249,000 comprised of a current provision of $20,000 and a deferred provision of $229,000. By comparison, the income tax benefit for the three months ended November 30, 2007 was $43,000, comprised of a current benefit of $211,000, partially offset by a deferred provision of $168,000.

The current provision for income tax of $20,000 in the three months ended November 30, 2008 resulted from a decrease in our income tax receivable due to a change in the amount of taxable loss and tax credits that we can carry back to offset income taxes previously paid. The current income tax benefit of $211,000 in the three months ended November 30, 2007 represents an increase in our income tax receivable resulting from our ability to carry back our taxable loss in that period to offset income taxes previously paid.

The deferred income tax provision of $229,000 and $168,000 in the three months ended November 30, 2008 and 2007, respectively, resulted from our recording a valuation allowance against our deferred tax assets. In recording the valuation allowance, we were unable to conclude that it is more likely than not that our deferred tax assets, including our taxable loss and tax credit carry forwards, will be realized. In reaching this determination, we evaluated factors such as prior earnings history, expected future earnings and our ability to carry back reversing items within two years to offset income taxes paid.

Net Loss – During the three months ended November 30, 2008 we had a net loss of $1,433,145, after recording a provision for income taxes of $249,000 as compared to a net loss of $615,935, after recording a tax benefit of $43,000 in the three months ended November 30, 2007. The increase in the net loss in the current fiscal year is due primarily to the decrease in total revenues, increase in total operating costs and expenses, and increase in the provision for income taxes as discussed above.

Liquidity and Capital Resources

Since inception through November 30, 2008, we have generated an accumulated deficit of $6,722,297. We have historically financed our operations through cash from operations, research grants, licensing of technological assets, issuance of common stock and sale of investments in spinoff operations. As of November 30, 2008, we had cash, cash equivalents and investments totaling $10,555,474 as compared to cash, cash equivalents and investments totaling $15,881,844 as of August 31, 2008. The recorded value of our investments at November 30, 2008 has been reduced by an unrealized loss of $6,532,981.

During the three months ended November 30, 2008, we used cash of $916,620 in operating activities, primarily as a result of our net loss of $1,433,145, increase in inventories of $236,241, decrease in accrued liabilities of $86,433, and decrease in customer deposits of $119,729, partially offset by a decrease in income tax receivable of $249,000 and an increase in accounts payable of $309,068. By comparison, net cash used in operating activities was $1,543,075 during the three months ended November 30, 2007, which included an increase in accounts receivable of $835,910, increase in income tax receivable of $211,000, increase in inventories of $92,436, decrease of accrued liabilities of $72,358,

and decrease in customer deposits of $131,573, partially offset by a decrease in deferred tax assets of $168,000 and an increase in accounts payable of $33,629.

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Net cash used in investing activities for the three months ended November 30, 2008 was $234,823, consisting of the net purchase of investments of $216,638 and the purchase of property and equipment of $18,185. For the three months ended November 30, 2007, net cash provided by investing activities was $1,846,048, resulting from the net sale of investments of $3,072,907, partially offset by the purchase of property and equipment of $1,205,892 and the increase in patents of $20,967.

No net cash was provided by financing activities for the three months ended November 30, 2008. Net cash provided by financing activities consisted of proceeds from the sale of common stock through the exercise of stock options of $12,000 in the three months November 30, 2007.

We expect to incur additional expenses related to the commercial introduction of our systems, due to additional participation at trade shows, expenditures on publicity, additional travel, increased sales salaries and commissions and other related expenses. In addition, we anticipate that we will incur increased expenses related to seeking governmental and regulatory approvals for our products and continued expenses related to corporate governance and compliance with the Sarbanes-Oxley Act of 2002, during the remainder of fiscal 2009.

We believe we can cover any cash requirements with cost cutting or available cash. If we cannot cover any such cash shortfall with cost cutting or available cash, we would need to obtain additional financing. Due to recent turmoil in the global financial markets, we cannot be certain that any financing will be available when needed or will be available on terms acceptable to us. If we raise equity capital our stockholders will be diluted. Insufficient funds may require us to delay, scale back or eliminate some or all of our programs designed to facilitate the commercial introduction of our systems or entry into new markets.

As of November 30, 2008, we have no significant commitments for the purchase of property and equipment.

We believe that our current cash and cash equivalents, investments, income tax refunds receivable, and expected cash provided from operating activities will be sufficient to fund our operations for the next twelve months. If the global credit market continues to deteriorate, our investment portfolio may be impacted and we could determine some of our investments have experienced other-than-temporary declines in fair value, which could adversely impact our financial results and decrease the amount of the investments available to fund our operations.

The Company has no off balance sheet arrangements as of November 30, 2008.

Recent Accounting Pronouncements

On May 9, 2008, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 162, The Hierarchy of Generally Accepted Accounting Principles. This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements in conformity with U.S. generally accepted accounting principles (GAAP) for nongovernmental entities. The statement establishes that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. This statement is effective 60 days following the SEC’s approval of the Public Company Accounting Oversight Board Auditing amendments to AU Section 411, The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles. We do not believe the implementation of this statement will have a material impact on our financial statements.

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In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities. This statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, or our fiscal year beginning September 1, 2009, with early application encouraged. This statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

In December 2007, the FASB issued SFAS No. 141(R) (revised 2007), Business Combinations. This statement replaces SFAS No. 141, Business Combinations and applies to all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree), including those sometimes referred to as "true mergers" or "mergers of equals" and combinations achieved without the transfer of consideration. This statement establishes principles and requirements for how the acquirer: a) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; b) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This statement will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, or our fiscal year beginning September 1, 2009. Earlier adoption is prohibited. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements. This statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, and amends Accounting Research Bulletin ("ARB") 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It also amends certain of ARB 51's consolidation procedures for consistency with the requirements of SFAS No. 141(R) (revised 2007). This statement will be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, or our fiscal year beginning September 1, 2009. Earlier adoption is prohibited. We currently are unable to determine what impact the future application of this pronouncement may have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. Most of the provisions of SFAS No. 159 apply only to entities that elect the fair value option. However, the amendment to SFAS No. 115 Accounting for Certain Investments in Debt and Equity Securities applies to all entities with available-for-sale and trading securities. SFAS No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. We adopted SFAS No. 159 on September 1, 2008, with no material impact on our financial statements.

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In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of their financial instruments according to a fair value hierarchy as defined in the standard. Additionally, companies are required to provide enhanced disclosure regarding financial instruments in one of the categories, including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. In February 2008, the FASB issued FASB Staff Position (FSP) No. FAS 157-2, which delays by one year the effective date of SFAS No. 157 for certain types of non-financial assets and non-financial liabilities. As a result, SFAS No. 157 will be effective for financial statements issued for fiscal years beginning after November 15, 2007 for financial assets and liabilities carried at fair value on a recurring basis, and for fiscal years beginning after November 15, 2008 for non-recurring non-financial assets and liabilities that are recognized or disclosed at fair value. In October 2008, the FASB issued FSP No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active, or FSP 157-3. FSP 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements have not been issued.

We adopted SFAS No. 157 for financial assets and liabilities carried at fair value on a recurring basis on September 1, 2008, with no material impact on our financial statements. We are currently unable to determine the impact on our financial statements of the application of SFAS No. 157 on September 1, 2009, for non-recurring non-financial assets and liabilities that are recognized or disclosed at fair value.

FORWARD-LOOKING STATEMENTS

With the exception of historical facts, the statements contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which reflect our current expectations and beliefs regarding our future results of operations, performance and achievements. These statements are subject to risks and uncertainties and are based upon assumptions and beliefs that may or may not materialize. These forward-looking statements include, but are not limited to, statements concerning:

- our belief about the market opportunities for our products;
- our anticipated financial performance and business plan;
- our expectations regarding the commercialization of the BSD-2000, BSD 500 and MicroThermX-100 systems;
- our expectations to further expand our developments to treat other diseases and medical conditions;
- our expectations that in a higher production environment of established commercial sales we could achieve a 60% gross margin on system sales and an 80% gross margin on service agreements and disposable applicators used with our MicroThermX-100 system;
- our belief concerning the market potential for developed cancer therapy systems;
- our expectations related to the after-market opportunity for service agreements;
- our expectations related to the replacement cycle for our systems;
-

our expectations that we will incur increased expenses related to seeking governmental and regulatory approvals for our products;

- our expectations and efforts regarding FDA approvals relating to the BSD-2000 system;

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- our belief that our technology has application for additional approaches to treating cancer and for other medical purposes;

- our expectations related to the amount of expenses we will incur for the commercial introduction of our systems;

- our expectation that we will incur increased expenses related to our corporate governance and compliance with the Sarbanes-Oxley Act of 2002;

- our belief that we can cover any cash shortfall with cost cutting or available cash; and

- our belief that our current working capital, investments and cash from operations will be sufficient to finance our operations through working capital and capital resources needs for the next twelve months.

We wish to caution readers that the forward-looking statements and our operating results are subject to various risks and uncertainties that could cause our actual results and outcomes to differ materially from those discussed or anticipated, including the factors set forth in Item 1A – "Risk Factors" in our Annual Report on Form 10-K for the year ended August 31, 2008 and our other filings with the Securities and Exchange Commission. We also wish to advise readers not to place any undue reliance on the forward-looking statements contained in this report, which reflect our beliefs and expectations only as of the date of this report. We assume no obligation to update or revise these forward-looking statements to reflect new events or circumstances or any changes in our beliefs or expectations, other than as required by law.

Item 3. Quantitative and Qualitative Disclosure About Market Risk.

A significant portion of the Company's cash equivalents and short-term investments bear variable interest rates that are adjusted to market conditions. Changes in financial market conditions and in market rates will affect interest and investment income earned and potentially the market value of the principal of these instruments. The Company does not utilize derivative instruments to offset the exposure to interest rate changes. Significant changes in interest rates may have a material impact on the Company's results of operations.

The Company does have significant sales to foreign customers and is therefore subject to the effects of changes in foreign currency exchange rates may have on demand for its products and services. The Company does not utilize derivative instruments to offset the exposure to changes in foreign currency exchange rates. To minimize foreign exchange risk, the Company's export sales are transacted in United States dollars.

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Item 4. Controls and Procedures.

Evaluation of disclosure controls and procedures.

As of the end of the period covered by this report, we conducted an evaluation, under the supervision and with the participation of our management including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Based on this evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, in a manner that allows timely decisions regarding required disclosure.

Changes in internal controls over financial reporting.

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) during our most recently completed fiscal quarter 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.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Item 1A – “Risk Factors” in our Annual Report on Form 10-K for the year ended August 31, 2008, which could materially affect our business, financial condition or future results of operations.

Item 6. Exhibits.

The following exhibits are filed as part of this report:

Exhibit No.	Description of Exhibit
31.1	Certification of the Principal Executive Officer Required Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Principal Accounting Officer Required Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer Required Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Principal Accounting Officer Required Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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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.

BSD MEDICAL CORPORATION

Date: January 9, 2009	/s/ Hyrum A. Mead Hyrum A. Mead President (Principal Executive Officer)
Date: January 9, 2009	/s/ Dennis P. Gauger Dennis P. Gauger Chief Financial Officer (Principal Accounting Officer)

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