CYTRX CORP
Form 10-Q/A
November 14, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q/A
(Amendment No. 1)

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

For the quarterly period ended June 30, 2007

OR

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 0-15327

CYTRX CORPORATION
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**58-1642740** (I.R.S. Employer Identification No.)
11726 San Vicente Blvd. **Suite 650** **Los Angeles, CA** (Address of principal executive offices)	**90049** (Zip Code)

(310) 826-5648
(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 þ No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

Number of shares of CytRx Corporation Common Stock, $.001 par value, issued and outstanding as of November 9, 2007:
90,221,370 exclusive of treasury shares.

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EXPLANATORY NOTES

CytRx Corporation (CytRx, we, our, us and the Company) is amending in certain respects our Quarterly Rep Form 10-Q for the quarter ended June 30, 2007, which we sometimes refer to in this amendment as our original Form 10-Q. The purpose of this amendment is to restate our condensed consolidated financial statements for the quarter ended June 30, 2007 as described below. The restatement relates to our accounting for an equity transaction by our majority-owned subsidiary, RXi Pharmaceuticals Corporation (RXi), the accounting for tax withholding amounts related to common stock option exercises and the reclassification of certain general and administrative expenses as research and development expenses.

For the quarter ended June 30, 2007, we originally reported additional paid-in capital of $2.3 million attributable to RXi s issuance to the University of Massachusetts Medical School, or UMMS, of approximately 462,000 shares of RXi common stock in payment for RXi s acquisition of four technology licenses and an invention disclosure agreement entered into with UMMS in January 2007 that should have been accounted for on our consolidated balance sheet as minority interest in RXi. This accounting correction resulted in a corresponding reduction of $2.3 million in our additional paid-in capital and stockholders equity as of June 30, 2007, as well as an increase in loss attributable to minority interests and a decrease in our consolidated net loss of $176,000 for both the three-month and six-month periods ended June 30, 2007. Additionally, we originally reported $227,000 in payroll taxes and other withholdings in connection with exercises of employee stock options as an offset to general and administrative expenses in our consolidated statements of operations for the three-month and six-month periods ended June 30, 2007. The $227,000 is properly classified as a current liability as of June 30, 2007, which correction resulted in an increase in our consolidated net loss by the same amount for both the three-month and six-month periods ended June 30, 2007. The net effect of the correction of both of these items was a $51,000 increase in our consolidated net loss for the three-month and six-month periods ended June 30, 2007. Our reported earnings per share for these periods were not affected by these corrections.

For the quarter ended June 30, 2007, our originally-reported general and administrative expenses included charges of approximately $391,000 that we determined are properly classified as research and development expenses. The reclassification of these expenses will have no effect on our consolidated net loss for that period.

The following Items and Exhibits of our original Form 10-Q are amended by this amendment:

Part I Item 1. Financial Statements (unaudited)

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

Part I Item 4. Controls and Procedures

Part II Item 6. Exhibits

Exhibit 31.1 Certification of Chief Executive Officer

Exhibit 31.2 Certification of Chief Financial Officer

Exhibit 32.1 Certification of Chief Executive Officer

Exhibit 32.2 Certification of Chief Financial Officer

Except for the foregoing Items and Exhibits, this amendment does not modify any disclosures contained in our original Form 10-Q. Additionally, the text of this amendment, except for the restatement information, speaks as of the filing date of the original Form 10-Q and does not attempt to update the disclosures in our original Form 10-Q or to discuss any developments subsequent to the date of the original filing. In accordance with the rules and regulations of the Securities and Exchange Commission, the information contained in the original Form 10-Q and this amendment is subject to updated or supplemental information contained in reports filed by us with the Securities and Exchange Commission subsequent to the filing dates of the original Form 10-Q and this amendment.

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Part I FINANCIAL INFORMATION

Item 1. Financial Statements

CYTRX CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2007 (Unaudited) (Restated)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 69,697,571	$ 30,381,393
Accounts receivable	1,500,000	105,930
Prepaid expense and other current assets	666,334	233,323
Total current assets	71,863,905	30,720,646
Equipment and furnishings, net	214,715	252,719
Molecular library, net	238,703	283,460
Goodwill	183,780	183,780
Deposits and prepaid insurance expense	172,418	195,835
Total assets	$ 72,673,521	$ 31,636,440
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,904,002	$ 955,156
Accrued expenses and other current liabilities	2,960,002	2,722,478
Deferred revenue, current portion	7,329,548	6,733,350
Total current liabilities	12,193,552	10,410,984
Deferred revenue, non-current portion	11,662,413	16,075,117
Total liabilities	23,855,965	26,486,101
Commitment and Contingencies		
Minority interest in subsidiary	2,134,424	
Stockholders equity:		
Preferred Stock, $.01 par value, 5,000,000 shares authorized, including 5,000 shares of Series A Junior Participating Preferred Stock; no shares issued and outstanding		
Common stock, $.001 par value, 125,000,000 shares authorized; 88,528,000 and 70,789,000 shares issued at June 30, 2007 and December 31, 2006, respectively	88,528	70,789
Additional paid-in capital	199,309,674	146,961,657
Treasury stock, at cost (633,816 shares held at June 30, 2007 and December 31, 2006, respectively)	(2,279,238)	(2,279,238)
Accumulated deficit	(150,435,832)	(139,602,869)

Total stockholders equity	46,683,132	5,150,339
Total liabilities, minority interest and stockholders equity	$ 72,673,521	$ 31,636,440

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

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CYTRX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007 (Restated)	2006	2007 (Restated)	2006
Revenue:				
Service revenue	$ 2,369,513	$	$ 3,816,506	$ 60,830
Grant revenue			116,070	
Other revenue	1,000		1,000	
	2,370,513		3,933,576	60,830
Expenses:				
Research and development (includes non-cash expense as follows: $175,000 and $77,000 of employee stock-based compensation expense for the three months ended June 30, 2007 and 2006, respectively, $212,000 and $160,000 of employee stock-based compensation expense for the six months ended June 30, 2007 and 2006 respectively; $339,000 and $61,000 of non-employee stock-based compensation for the three months ended June 30, 2007 and 2006, respectively; $1,315,000 and $105,000 of non-employee stock-based compensation for the six months ended June 30, 2007 and 2006, respectively, and an aggregate 462,112 shares of RXi common stock valued at $2,311,560 issued in exchange for licensing rights)	6,884,296	3,205,372	10,892,670	5,517,383
General and administrative (includes non-cash expense as follows: $568,000 and $274,000 of employee stock-based compensation for the three months ended June 30, 2007 and 2006, respectively, and $679,000 and $536,000 of employee stock-based compensation expense for the six months ended June 30, 2007 and 2006, respectively, and $0 and $58,000 of non-employee stock-based compensation for the three months ended June 30, 2007 and 2006, respectively, and $0 and $126,000 of non-employee stock-based compensation for the six months ended June 30, 2007 and 2006, respectively)	4,106,597	2,436,916	6,591,681	4,459,582

	10,990,893	5,642,288	17,484,351	9,976,965
Loss before other income	(8,620,380)	(5,642,288)	(13,550,775)	(9,916,135)
Other income:				
Interest and dividend income	659,062	176,908	1,039,676	284,398
Other income	1,500,000		1,500,000	
Minority interest in losses of subsidiary	176,136		178,136	
Net loss applicable to common shareholders before deemed dividend	(6,285,182)	(5,465,380)	(10,832,963)	(9,631,737)
Deemed dividend for anti-dilution adjustment made to outstanding common stock warrants				(488,429)
Net loss applicable to common shareholders	$ (6,285,182)	$ (5,465,380)	$ (10,832,963)	$ (10,120,166)
Basic and diluted loss per common share	$ (0.07)	$ (0.08)	$ (0.14)	$ (0.15)
Weighted average shares outstanding	85,379,769	69,977,876	79,242,321	66,181,900

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

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CYTRX CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2007 (Restated)	**2006**
Cash flows from operating activities:		
Net loss	$ (10,832,963)	$ (9,631,737)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	121,067	138,941
Minority interest in losses of subsidiary	(178,136)	
Common stock, stock options and warrants issued for services	2,895,605	230,547
Expense related to employee and non-employee stock options	1,622,874	696,378
Net change in operating assets and liabilities	(4,431,803)	788,796
Total adjustments	29,607	1,854,662
Net cash used in operating activities	(10,803,356)	(7,777,075)
Cash flows from investing activities:		
Purchases of property and equipment	(38,303)	(22,335)
Net cash used in investing activities	(38,303)	(22,335)
Cash flows from financing activities:		
Proceeds from exercise of stock options and warrants	15,909,775	339,194
Net proceeds from issuances of common stock	34,248,062	12,404,360
Net cash provided by financing activities	50,157,837	12,743,554
Net increase in cash and cash equivalents	39,316,178	4,944,144
Cash and cash equivalents at beginning of period	30,381,393	8,299,390
Cash and cash equivalents at end of period	$ 69,697,571	$ 13,243,534
Supplemental disclosure of cash flow information:		
Cash received during the period for interest received	$ 1,039,676	$ 248,398

Non-Cash Financing Activities:

In connection with the Company s adjustment to the terms of certain outstanding warrants on March 2, 2006, the Company recorded a deemed dividend of approximately $488,000 in the six months ended June, 2006. The deemed dividend was recorded as a charge to retained earning and a corresponding credit to additional paid-in capital.

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

CYTRX CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2007
(Unaudited)

1. Description of Company and Basis of Presentation

CytRx Corporation (CytRx or the Company) is a biopharmaceutical research and development company engaged in developing human therapeutic products based primarily upon our small molecule molecular chaperone amplification technology. The Company has completed a three-month Phase IIa clinical trial and six-month open-label trial extension of that trial, for its lead small molecule product candidate, arimoclomol, for the treatment of amyotrophic lateral sclerosis, which is commonly known as ALS or Lou Gehrig s disease. Arimoclomol has received Orphan Drug and Fast Track designation from the U.S. Food and Drug Administration, or FDA, and orphan medicinal product status from the European Commission for the treatment of ALS. The Company plans to initiate a Phase IIb efficacy trial of arimoclomol for this indication during the second half of 2007, subject to FDA clearance. Based on preliminary discussions with the FDA, CytRx is now considering a second efficacy clinical trial for ALS, possibly in parallel with the upcoming Phase IIb trial, to provide additional efficacy data to support a possible approval decision by the FDA. Additionally, recent preclinical animal studies indicated that arimoclomol accelerated the recovery of sensory and motor functions following a stroke, even when administered up to 48 hours after the stroke. Based upon these positive indications, the Company has announced plans to commence a Phase II clinical trial for arimoclomol in stroke recovery in the first half of 2008, subject to FDA clearance. The Company has also announced plans to commence a Phase II clinical trial with its next drug candidate, iroxanadine, for diabetic foot ulcers in the first half of 2008, subject to FDA clearance. In addition, subsequent to period end, the Company opened a research and development facility in San Diego to provide it with a dedicated laboratory to accelerate its molecular chaperone drug development programs.

The Company also is engaged in developing therapeutic products based upon ribonucleic acid interference, or RNAi, which has the potential to effectively treat a broad array of diseases by interfering with the expression of targeted disease-associated genes. In order to fully realize the potential value of its RNAi technologies, in January 2007, the Company transferred to RXi Pharmaceuticals Corporation (RXi), its majority-owned subsidiary, substantially all of its RNAi-related technologies and assets in exchange for equity in RXi. These assets consisted primarily of the Company s licenses from University of Massachusetts Medical School, or UMMS, and the Carnegie Institution of Washington relating to fundamental RNAi technologies, as well as research and other equipment situated at the Company s Worcester, Massachusetts, laboratory. On April 30, 2007, the Company contributed to RXi $15.0 million, net of expenses of approximately $2.0 million reimbursed to it by RXi, to satisfy certain initial funding requirements under its agreements with UMMS. As a result of these transactions, CytRx owned as of June 30, 2007 approximately 86% of the outstanding capital stock of RXi. RXi is focused solely on developing and commercializing therapeutic products based upon RNAi technologies for the treatment of human diseases, with an initial focus on neurodegenerative diseases, cancer, type 2 diabetes and obesity. The Company has agreed to reduce its share of ownership of RXi to less than a majority of the outstanding voting power as soon as reasonably practicable. In order to do so, the Company has announced its intention to issue a dividend of a portion of its RXi shares to its stockholders. Any proposed dividend to its stockholders of RXi shares would be subject to approval of the CytRx board of directors and compliance with applicable Securities and Exchange Commission, or SEC, rules and the requirements of the Delaware General Corporation Law. Any such dividend may be taxable to CytRx, although any applicable taxes due may be off-set by the Company s net operating loss carryforwards; however there is no assurance that the Company s current net operating loss carryforwards will be sufficient to cover any such taxable event, and if they are not, then CytRx might be required to pay income tax.

To date, the Company has relied primarily upon sales of its equity securities and upon proceeds received upon the exercise of options and warrants and, to a much lesser extent, upon payments from its strategic partners and licensees, to generate funds needed to finance our business and operations. See Note 5 Liquidity and Capital Resources.

In August 2006, the Company received approximately $24.3 million in proceeds from the privately-funded ALS Charitable Remainder Trust (ALSCRT) in exchange for the commitment to continue research and development of

arimoclomol and other potential treatments for ALS and a one percent royalty in the worldwide sales of arimoclomol. Under the arrangement, the Company retains the rights to any developments funded by the arrangement and the proceeds of the transaction are non-refundable. Further, the ALS Charitable Remainder Trust has no obligation to provide any further funding to the Company. Management has analyzed the transaction and concluded that due to the research and development components of the transaction that it is properly accounted for under SFAS No. 68, *Research and Development Arrangements* (SFAS No. 68). Accordingly, the Company has recorded the value

received under the arrangement as deferred service revenue and will recognize service revenue using the proportional performance method of revenue recognition, meaning that service revenue is recognized as a percentage of actual research and development expense incurred for the research and development of arimoclomol or the development of other ALS treatments.

The accompanying condensed consolidated financial statements at June 30, 2007 and for the three and six-month periods ended June 30, 2007 and 2006 are unaudited, but include all adjustments, consisting of normal recurring entries, which the Company s management believes to be necessary for a fair presentation of the periods presented. Interim results are not necessarily indicative of results for a full year. Balance sheet amounts as of December 31, 2006 have been derived from our audited financial statements as of that date.

The financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the Untied States have been condensed or omitted pursuant to such rules and regulations. The financial statements should be read in conjunction with the Company s audited financial statements in its Form 10-K for the year ended December 31, 2006. The Company s operating results will fluctuate for the foreseeable future. Therefore, period-to-period comparisons should not be relied upon as predictive of the results in future periods.

The accompanying condensed consolidated financial statements have been restated to reflect corrections in our accounting for an equity transaction by RXi, the accounting for tax withholding amounts related to common stock option exercises and the classification of certain general and administrative expenses as research and development expenses. The consolidated balance sheet as of June 30, 2007 was restated to reflect an increase of $2.3 million in minority interest in RXi (offset by approximately $178,000 of losses attributable to that minority interest), and a corresponding reduction of $2.3 million in additional paid-in capital and stockholders equity, as well as a $227,000 increase in current liabilities. The consolidated statements of operations were restated to reflect a $51,000 increase in our consolidated net loss for the three-month and six-month periods ended June 30, 2007, in arriving at the net loss applicable to common stockholders of $6,285,182 and $10,832,963 for the those periods, respectively. The restated net loss applicable to common stockholders did not change the net loss per share of $.07 and $.14 for those periods, respectively. The consolidated statements of operations were also restated to reflect approximately $391,000 of expenses that were reclassified from general and administrative expenses to research and development expenses for both the three-month and six-month periods ended June 30, 2007.

2. Recent Accounting Pronouncements

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 (FIN No. 48), to create a single model to address accounting for uncertainty in tax positions. FIN No. 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold in which a tax position be reached before financial statement recognition. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted FIN No. 48 as of January 1, 2007, as required. The adoption of FIN No. 48 did not have an impact on the Company s financial position and results of operations.

On September 15, 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect SFAS No. 157 will have a significant impact on the Company s consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is

currently assessing the impact of SFAS No. 159 on the Company s consolidated financial statements.

In June 2007, the FASB ratified the consensus on Emerging Issues Task Force (EITF) Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards* (EITF 06-11). EITF 06-11 requires companies to recognize the income tax benefit realized from dividends or dividend equivalents that are charged to retained earnings and paid to employees for non-vested equity-classified employee share-based payment awards as an increase to additional paid-in capital. EITF 06-11 is effective for fiscal years beginning after September 15, 2007 (fiscal year 2008 for the Company). The adoption is not expected to have a material impact on the Company s consolidated financial statements.

In June 2007, the FASB ratified the consensus reached on EITF Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3), which requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and amortized over the period that the goods are delivered or the related services are performed, subject to an assessment of recoverability. EITF 07-3 will be effective for fiscal years beginning after December 15, 2007, which will be the Company s fiscal year 2008. The Company does not expect that the adoption of EITF 07-3 will have an impact on the Company s consolidated financial statements.

3. Basic and Diluted Loss Per Common Share

Basic net loss per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares primarily consist of employee stock options and warrants. Common share equivalents which potentially could dilute basic earnings per share in the future, and which were excluded from the computation of diluted loss per share, as the effect would be anti-dilutive, totaled approximately 20.4 million and 29.2 million shares at June 30, 2007 and 2006, respectively.

In connection with the Company s adjustment to the exercise terms of certain outstanding warrants to purchase common stock on March 2, 2006, the Company recorded deemed dividend of approximately $488,000. The deemed dividend is reflected as an adjustment to net loss for the first quarter of 2006, to arrive at net loss applicable to common stockholders on the Condensed Consolidated Statement of Operations and for purposes of calculating basic and diluted loss per shares.

4. Stock Based Compensation

CytRx Corporation

As of June 30, 2007, an aggregate of 10,000,000 shares of common stock were reserved for issuance under the Company s 2000 Stock Option Incentive Plan, including approximately 6,294,000 shares subject to outstanding common stock options and approximately 1.9 million shares available for future grant. Additionally, the Company has one other active plan, the 1998 Long Term Incentive Plan, which includes approximately 86,000 shares subject to outstanding common stock options and approximately 30,000 shares are available for future grant. Options granted under these plans generally vest and become exercisable as to 33% of the option grants on each anniversary of the grant date until fully vested. The options will expire, unless previously exercised, not later than ten years from the grant date.

Prior to January 1, 2006, the Company accounted for its common stock based compensation plans under the recognition and measurement provisions of Accounting Principles Board No. 25, Accounting for Stock Issued to Employees (APB 25), and related interpretations for all awards granted to employees. Under APB 25, when the exercise price of options granted to employees under these plans equals the market price of the common stock on the date of grant, no compensation expense is recorded. When the exercise price of options granted to employees under these plans is less than the market price of the common stock on the date of grant, compensation expense is recognized over the service period.

The Company s stock-based employee compensation plans are described in Note 13 to our financial statements contained in our Annual Report on Form 10-K filed for the year ended December 31, 2006. On January 1, 2006, the Company adopted SFAS 123(R), Accounting for Stock-based Compensation (Revised 2004) (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees, non-employee directors, and consultants, including employee stock options. SFAS 123(R) supersedes the Company s previous accounting under APB 25 and SFAS 123, *Employee Stock-Based Compensation*, for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued SAB 107, *Share-Based Payment*, relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006. The Company s Statement of Operations as of and for the year ended December 31, 2006 reflects the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Statements of Operations for prior periods have not been restated to reflect, and do

not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was $1.3 million.

For stock options paid in consideration of services rendered by non-employees, the Company recognizes compensation expense in accordance with the requirements of SFAS No. 123(R) and Emerging Issues Task Force Issue No. 96-18 (EITF 96-18), *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.* Under SFAS No. 123(R), the compensation associated with stock options paid to non-employees is generally recognized in the period during which services are rendered by such non-employees. Since its adoption of SFAS 123(R) and EITF 96-18, there have been no changes to the Company s equity plans or modifications of its outstanding stock-based awards.

Non-employee option grants that do not vest immediately upon grant are recorded as an expense over the vesting period of the underlying common stock options, using the method prescribed by FASB Interpretation 28. At the end of each financial reporting period prior to vesting, the value of these options, as calculated using the Black-Scholes option pricing model, will be re-measured using the fair value of the Company s common stock and the non-cash compensation recognized during the period will be adjusted accordingly. Since the fair market value of options granted to non-employees is subject to change in the future, the amount of the future compensation expense is subject to adjustment until the common stock options are fully vested. The Company recognized approximately $1,315,000 and $105,000 of stock based compensation expense related to non-employee common stock options for the six-month periods ended June 30, 2007 and 2006, respectively. Included in the amount recognized in 2007 is an adjustment of approximately $303,000 related to options granted to consultants in 2006.

During the first six months of 2007, the Company issued options to purchase 900,000 shares of its common stock. The fair value of the common stock options granted in the six month periods listed in the table below was estimated using the Black-Scholes option-pricing model, based on the following assumptions:

	Six Months Ended	
	June 30, 2007	**June 30, 2006**
Risk-free interest rate	4.43% - 4.78%	4.27% - 5.23%
Expected volatility	108.9%	117.0%
Expected lives (years)	6	6
Expected dividend yield	0.00%	0.00%

The Company s expected stock price volatility assumption is based upon the historical daily volatility of its publicly traded stock. For option grants issued during the six-month periods ended June 30, 2007 and 2006, the Company used a calculated volatility for each grant. The expected life assumptions were based upon the simplified method provided for under SAB 107, which averages the contractual term of the Company s options of ten years with the average vesting term of three years for an average of six years. The dividend yield assumption of zero is based upon the fact the Company has never paid cash dividends and presently has no intention of paying cash dividends. The risk-free interest rate used for each grant is equal to the U.S. Treasury rates in effect at the time of the grant for instruments with a similar expected life. Based on historical experience, for the six-month periods ended June 30, 2007 and 2006, the Company has estimated an annualized forfeiture rate of 15% and 10%, respectively, for options granted to its employees and 3% for each period for options granted to senior management and directors. The Company will record additional expense if the actual forfeitures are lower than estimated and will record a recovery of prior expense if the actual forfeiture rates are higher than estimated. Under provisions of SFAS 123(R), the Company recorded $1,239,000 and $696,000 of employee stock-based compensation for the six-month periods ended June 30, 2007 and 2006, respectively. No amounts relating to employee stock-based compensation have been capitalized. Compensation costs will be adjusted for future changes in estimated forfeitures.

At June 30, 2007, there remained approximately $3.5 million of unrecognized compensation expense related to unvested stock options granted to employees, directors, scientific advisory board members and consultants, to be recognized as expense over a weighted-average period of 1.55 years. Presented below is the Company s stock option activity:

Stock Options
Six-Months Ended

	June 30, 2007			
	Number of Shares (Employees)	Number of Shares (Non-Employees)	Total Number of Shares	Weighted Average Exercise Price
Outstanding at January 1, 2007	4,150,000	2,708,000	6,858,000	$ 1.66
Granted	900,000		900,000	$ 4.40
Exercised	(596,000)	(136,000)	(732,000)	$ 1.91
Forfeited	(150,000)	(582,000)	(732,000)	$ 1.73
Outstanding at June 30, 2007	4,304,000	1,990,000	6,294,000	$ 2.02
Options exercisable at June 30, 2007	2,642,000	1,740,000	4,382,000	$ 1.76

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A summary of the activity for non-vested common stock options as of June 30, 2007 is presented below:

	Number of Shares (Employees)	Number of Shares (Non-Employees)	Total Number of Shares	Weighted Average Grant Date Fair Value per Share
Non-vested at January 1, 2007	1,183,000	917,000	2,100,000	$ 1.19
Granted	900,000		900,000	$ 3.70
Forfeited	(150,000)	(582,000)	(732,000)	$ 1.52
Vested	(272,000)	(104,000)	(376,000)	$ 1.57
Non-vested at June 30, 2007	1,661,000	250,000	1,911,000	$ 2.21

The following table summarizes significant ranges of outstanding common stock options under the two plans at June 30, 2007:

Range of Exercise Prices	Number of Options	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Contractual Life	Weighted Average Exercise Price
$0.25 1.00	999,000	7.13	$ 0.80	699,000	7.13	$ 0.81
$1.01 2.00	3,057,000	7.48	1.53	2,309,000	7.48	1.24
$2.01 2.50	1,336,000	6.06	2.45	1,336,000	6.06	2.45
$2.51 3.00	2,000	1.95	2.63	2,000	1.95	2.63
$3.01 4.51	900,000	9.81	4.40	36,000	9.81	4.51
	6,294,000	7.45	$ 2.02	4,382,000	6.75	$ 1.76

The aggregate intrinsic value of outstanding options as of June 30, 2007 was $8.8 million, of which $6.0 million was related to exercisable options. The aggregate intrinsic value was calculated based on the positive difference between the closing fair market value of the Company s common stock on June 30, 2007 ($3.12) and the exercise price of the underlying options. The intrinsic value of options exercised was $847,000 for the six-month period ended June 30, 2007, and the intrinsic value of options that vested was approximately $650,000 for the same period.

RXi Pharmaceuticals

RXi is a majority owned subsidiary of CytRx and has its own stock option plan, named the RXi Pharmaceuticals Corporation 2007 Incentive Plan. As of June 30, 2007, an aggregate of 1,902,000 shares of common stock were reserved for issuance under the RXi Pharmaceuticals Corporation 2007 Incentive Plan, including approximately 1,177,000 shares subject to outstanding common stock options granted under this plan and approximately 725,000 shares available for future grant. The administrator of the plan determines the times which an option may become exercisable. Vesting periods of options granted to date include vesting upon grant to vesting at the end of a five year period.

RXi which began its operations on January 8, 2006, adopted SFAS 123(R), Accounting for Stock-based Compensation (Revised 2004) , which requires the measurement and recognition of compensation expense for all stock-based payment awards made to employees and non-employee directors. In March 2005, the Securities and

Exchange Commission issued SAB 107, *Share-Based Payment*, relating to SFAS 123(R). RXi has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

For common stock options paid in consideration of services rendered by non-employees, RXi recognizes compensation expense in accordance with the requirements of SFAS No. 123(R) and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.* Under SFAS No. 123(R), the compensation associated with common stock options paid to non-employees is generally recognized in the period during which services are rendered by such non-employees. There have been no changes to RXi s equity plans or modifications of its outstanding stock-based awards.

Non-employee option grants that do not vest immediately upon grant are recorded as an expense over the vesting period of the underlying common stock options, using the method prescribed by FASB Interpretation 28. At the end of each financial reporting period prior to vesting, the value of these options, as calculated using the Black-Scholes option pricing model, will be re-measured using the fair value of the Company s common stock and the non-cash compensation recognized during the period will be adjusted accordingly. Since the fair market value of options granted to non-employees is subject to change in the future, the amount of the future compensation expense is subject to adjustment until the common stock options are fully vested. The Company used an independent third-party valuation firm to estimate the fair market value of RXi and the fair market value of RXi options. Based on

those estimates, RXi recognized approximately $732,000 of stock based compensation expense related to non-employee stock options for the six-month period ended June 30, 2007.

During the first six months of 2007, the Company issued options to purchase 829,000 shares of its common stock. The fair value of the common stock options granted in the six month period listed in the table below was estimated using the Black-Scholes option-pricing model, based on the following assumptions:

	Six-Months Ended June 30, 2007
Risk-free interest rate	4.43% - 4.78%
Expected volatility	1.1% - 1.9%
Expected lives (years)	6
Expected dividend yield	0.00%

The fair value of RXi s common stock and RXi s expected common stock price volatility assumption is based upon an independent third-party valuation that determined the RXi corporate valuation and analyzed the volatility of a basket of comparable companies. The expected life assumptions were based upon the simplified method provided for under SAB 107, which averages the contractual term of RXi s options of ten years with the average vesting term of three years for an average of six years. The dividend yield assumption of zero is based upon the fact that RXi has never paid cash dividends and presently has no intention of paying cash dividends. The risk-free interest rate used for each grant was also based upon prevailing short-term interest rates. Based on CytRx s historical experience, for the six-month period ended June 30, 2007, RXi has estimated an annualized forfeiture rate of 15% for options granted to its employees, 8% for options granted to senior management and no forfeiture rate for the directors. RXi will record additional expense if the actual forfeitures are lower than estimated and will record a recovery of prior expense if the actual forfeiture rates are higher than estimated. Under provisions of SFAS 123(R), RXi recorded $329,000 of employee stock-based compensation for the six-month period ended June 30, 2007. No amounts relating to employee stock-based compensation have been capitalized. As of June 30, 2007, there was $2,700,000 of unrecognized compensation cost related to outstanding options that is expected to be recognized as a component of RXi s operating expenses through 2009. Compensation costs will be adjusted for future changes in estimated forfeitures.

At June 30, 2007, the unrecognized compensation expense related to unvested common stock options granted to employees, directors, scientific advisory board members and consultants is expected to be recognized as expense over a weighted-average period of 1.78 years. Presented below is RXi s common stock option activity:

	Stock Options Six-Months Ended June 30, 2007			
	Number of Shares (Employees)	Number of Shares (Non-Employees)	Total Number of Shares	Weighted Average Exercise Price
Outstanding at January 1, 2007				
Granted	829,000	348,000	1,177,000	$ 5.00
Exercised				
Forfeited				
Outstanding at June 30, 2007	829,000	348,000	1,177,000	$ 5.00
Options exercisable at June 30, 2007	98,000	215,000	313,000	$ 5.00

A summary of the activity for non-vested stock options as of June 30, 2007 is presented below:

	Number of Shares (Employees)	Number of Shares (Non-Employees)	Total Number of Shares	Weighted Average Grant Date Fair Value per Share
Non-vested at January 1, 2007				
Granted	829,000	348,000	1,177,000	$ 5.00
Forfeited				
Vested	(97,000)	(216,000)	(313,000)	$ 5.00
Non-vested at June 30, 2007	732,000	132,000	864,000	$ 5.00

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The following table summarizes significant ranges of outstanding common stock options under the plan at June 30, 2007:

Range of Exercise Prices	Number of Options	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Contractual Life	Weighted Average Exercise Price
$5.00	1,177,000	9.87	$ 5.00	313,000	9.88	$ 5.00

The aggregate intrinsic value of outstanding options as of June 30, 2007 is negligible. The aggregate intrinsic value is calculated based on the positive difference between the closing fair market value of RXi s common stock on June 30, 2007 and the exercise price of the underlying options.

5. Liquidity and Capital Resources

At June 30, 2007, the Company had cash and cash equivalents of $69.7 million, including $19.2 million that it received from the sale of 8.6 million shares at $4.30 per share in its April 2007 financing transaction, net of offering expenses of approximately $2.8 million and the $15.0 million of net proceeds that it provided to RXi on April 30, 2007 to satisfy the initial funding requirements under its agreements with UMMS. Management believes that the Company has adequate financial resources to support its currently planned level of operations into the second half of 2009. That belief is based in part on projected expenditures through the remainder of 2007 and the first half of 2008 of $24.5 million, including $7.3 million for the Company s Phase IIb trial of arimoclomol for ALS and related studies and $10.8 million for its other clinical programs, including a planned Phase II clinical trial of arimoclomol in stroke patients and a planned Phase II clinical trial of iroxanadine for diabetic foot ulcers (which the Company estimates will, through completion, cost $10.0 million and $5.6 million, respectively). Management estimates that RXi separately will expend approximately $8.2 million on development activities through the remainder of 2007 and the first half of 2008. Management s estimate regarding the Company s financial resources assumes that no second efficacy trial will be required for arimoclomol for ALS. If the Company undertakes an additional efficacy trial, its actual expenses will be materially greater than currently estimated. The Company will be required to obtain additional funding in order to execute its long-term business plans, although it does not currently have commitments from any third parties to provide it with capital. The Company cannot assure that additional funding will be available on favorable terms, or at all. If the Company fails to obtain additional funding when needed, it may not be able to execute its business plans and its business may suffer, which would have a material adverse effect on its financial position, results of operations and cash flows.

6. Equity Transactions

On March 2, 2006, the Company completed a $13.4 million private equity financing in which it issued 10.6 million shares of its common stock and warrants to purchase an additional 5.3 million shares of its common stock at an exercise price of $1.54 per share. Net of investment banking commissions, legal, accounting and other expenses related to the transaction, we received proceeds of approximately $12.4 million.

In connection with the March 2006 financing, the Company adjusted the price and number of underlying shares of warrants to purchase approximately 2.8 million shares that had been issued in prior equity financings in May and September 2003. The adjustment was made as a result of anti-dilution provisions in those warrants that were triggered by the Company s issuance of common stock in that financing at a price below the closing market price on the date of the transaction. The Company accounted for the anti-dilution adjustments as deemed dividends analogous with the guidance in Emerging Issues Task Force Issue (EITF) No. 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios*, and EITF 00-27, *Application of 98-5 to Certain Convertible Instruments*, and recorded an approximate $488,000 charge to retained earnings and a corresponding credit to additional paid-in capital.

In connection with the March 2006 private equity financing, the Company entered into a registration rights agreement with the purchasers of its common stock and warrants. That agreement provides, among other things, for cash penalties, up to a maximum of 16% (approximately $2.1 million) of the purchase price paid for the securities in the event that the Company failed to initially register or maintain the effective registration of the securities until the sooner of two years or the date on which the securities could be sold pursuant to Rule 144 of the Securities Act of 1933, as amended. The Company has evaluated the penalty provisions of the March 2006 registration rights agreement in light of FASB Staff Position No. EITF 00-19-2*, Accounting for Registration Payment Arrangements*, which specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*, pursuant to which a contingent obligation must be accrued only if it is reasonably estimable and probable. In

management s estimation, the contingent payments related to the registration payment arrangement are not probable to occur, and thus no amount need be accrued.

On April 19, 2007, the Company completed a $37.0 million private equity financing in which it issued approximately 8.6 million shares of its common stock at a price of $4.30 per share. Net of investment banking commissions, legal, accounting and other expenses related to the transaction, the Company received proceeds of approximately $34.2 million. On April 30, 2007, the Company contributed $15.0 million, net of reimbursed expenses of approximately $2.0 million paid by RXi to the Company, in exchange for equity in RXi, to satisfy the initial funding requirements under its agreements with UMMS. Following that transaction, CytRx owned as of June 30, 2007 approximately 86% of the outstanding capital stock of RXi.

In connection with the private equity financing, the Company adjusted the price and number of underlying shares of warrants to purchase approximately 1.4 million shares that had been issued in prior equity financings in May and September 2003. The adjustment was made as a result of anti-dilution provisions in those warrants that were triggered by the Company s issuance of common stock in the April 2007 financing at a price below the closing market price on the date of the transaction. For the reasons described above, the Company accounted for the anti-dilution adjustments as deemed dividends. Because the fair value of the outstanding warrants decreased as a result of the anti-dilution adjustment, no deemed dividend was recorded, and thus the Company did not record a charge to retained earnings or a corresponding credit to additional paid-in capital.

In connection with the April 2007 private equity financing, the Company entered into a registration rights agreement with the purchasers of its common stock and warrants. That agreement provides, among other things, for cash penalties, up to a maximum of 16% (approximately $5.9 million) of the purchase price paid for the securities in the event that the Company failed to initially register or maintain the effective registration of the securities until the sooner of two years or the date on which the securities could be sold pursuant to Rule 144 of the Securities Act of 1933, as amended. The Company has evaluated the penalty provisions of the April 2007 registration rights agreement in light of FASB Staff Position No. EITF 00-19-2*, Accounting for Registration Payment Arrangements*, which specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*, pursuant to which a contingent obligation must be accrued only if it is reasonably estimable and probable. In management s estimation, the contingent payments related to the registration payment arrangement are not probable to occur, and thus no amount need be accrued.

During the three-month period ended June 30, 2007, the Company issued 2.6 million shares of its common stock, and received $4.8 million, upon the exercise of stock options and warrants. During the second quarter of 2007, the Company granted stock options covering 900,000 shares. During the three-month period ended March 31, 2007, the Company issued 6.9 million shares of its common stock, and received $11.1 million, upon the exercise of stock options and warrants. During the first quarter of 2007, the Company did not grant any stock options.

During the second quarter of 2007, the Company s RXi subsidiary issued approximately 462,000 shares of its common stock in connection with its UMMS licensing agreements. The shares were valued at $2.3 million which was recorded as a charge to research and development expense. Additionally, RXi granted stock options to purchase 1,177,000 shares of RXi common stock at an exercise price of $5.00 per share to certain officers, employees, directors and scientific advisory board members. RXi did not issue any shares of common stock in connection with license agreements, or grant any stock options, during the first quarter of 2007.

7. Other Income

In June 2007, we recognized $1.5 million of income arising from a fee received pursuant to a change-in-control provision included in the purchase agreement for our 1998 sale of our animal pharmaceutical unit. Management concluded that the fee did not represent revenue generated from our normal course of our business, and accordingly we recorded this fee as other income.

8. Minority Interest

The Company offset against its net loss $178,136 related to the minority interest in RXi held by its minority stockholders in the six months ended June 30, 2007. During 2006, no comparable entry was necessary as there were no subsidiary losses. This loss was the minority shareholder s portion of the loss attributed to RXi and was limited to the extent of their investment.

9. Subsequent Events

On July 20, 2007, the Company entered into a lease, as part of its previously announced relocation of its laboratory facility to San Diego, California. Under the terms of the lease, CytRx will occupy approximately 10,000 square feet of office and laboratory space. The lease is for a term of three years expiring on July 31, 2010, unless earlier terminated in accordance with the lease.

As of July 31, 2007, the Company had received approximately $482,000 in connection with the exercise of warrants and options since June 30, 2007.

In July 2007, the Company amended its Restated Certificate of Incorporation to increase the authorized number of shares of its common stock from 125,000,000 to 150,000,000 shares.

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

Forward Looking Statements

From time to time, we make oral and written statements that may constitute forward-looking statements (rather than historical facts) as defined in the Private Securities Litigation Reform Act of 1995 or by the Securities and Exchange Commission, or SEC, in its rules, regulations and releases, including Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. We desire to take advantage of the safe harbor provisions in the Private Securities Litigation Reform Act of 1995 for forward-looking statements made from time to time, including, but not limited to, the forward-looking statements made in this Quarterly Report on Form 10-Q, as well as those made in other filings with the SEC.

All statements in this Quarterly Report, including statements in this section, other than statements of historical fact are forward-looking statements for purposes of these provisions, including statements of our current views with respect to the recent developments regarding our RXi Pharmaceuticals Corporation subsidiary, our business strategy, business plan and research and development activities, our future financial results, and other future events. These statements include forward-looking statements both with respect to us, specifically, and the biotechnology industry, in general. In some cases, forward-looking statements can be identified by the use of terminology such as may, will, expects, plans, anticipates, estimates, potential or could or the negative thereof or other comparable terminolo Although we believe that the expectations reflected in the forward-looking statements contained herein are reasonable, there can be no assurance that such expectations or any of the forward-looking statements will prove to be correct, and actual results could differ materially from those projected or assumed in the forward-looking statements.

All forward-looking statements involve inherent risks and uncertainties, and there are or will be important factors that could cause actual results to differ materially from those indicated in these statements. We believe that these factors include, but are not limited to, those factors set forth in this Quarterly Report under the captions Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations, all of which you should review carefully. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we anticipate. Please consider our forward-looking statements in light of those risks as you read this Quarterly Report. We undertake no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise.

Overview

We are a biopharmaceutical research and development company engaged in developing human therapeutic products based primarily upon our small molecule molecular chaperone amplification technology. We have completed a three-month Phase IIa clinical trial of our lead small molecule product candidate, arimoclomol, and a six-month open-label extension of that trial, of our lead small molecule product candidate, arimoclomol, for the treatment of amyotrophic lateral sclerosis, which is commonly known as ALS or Lou Gehrig s disease. Arimoclomol has received Orphan Drug and Fast Track designation from the U.S. Food and Drug Administration, or FDA, and orphan medicinal product status from the European Commission for the treatment of ALS. We plan to initiate a Phase IIb efficacy trial

of arimoclomol for this indication during the second half of 2007, subject to FDA clearance. Based on preliminary discussions with the FDA, we are now considering a second efficacy clinical trial for ALS, possibly in parallel with the upcoming Phase IIb trial, to provide additional efficacy data to support a possible approval decision by the FDA. Additionally, recent preclinical animal studies indicated that arimoclomol accelerated the recovery of sensory and motor functions following a stroke, even when administered up to 48 hours after the stroke. Based upon these positive indications, we have announced plans to commence a Phase II clinical trial for arimoclomol in stroke recovery in the first half of 2008, subject to FDA clearance. We have also announced

plans to commence a Phase II clinical trial with our next drug candidate, iroxanadine, for diabetic foot ulcers in the first half of 2008, subject to FDA clearance. In addition, we recently opened a research and development facility in San Diego to provide us with a dedicated laboratory to accelerate our molecular chaperone drug development programs.

We are also engaged in developing therapeutic products based upon ribonucleic acid interference, or RNAi, which has the potential to effectively treat a broad array of diseases by interfering with the expression of targeted disease-associated genes. In order to fully realize the potential value of our RNAi technologies, in January 2007 we transferred to RXi Pharmaceuticals Corporation, our majority-owned subsidiary, substantially all of our RNAi-related technologies and assets in exchange for equity in RXi. These assets consisted primarily of our licenses from University of Massachusetts Medical School, or UMMS, and the Carnegie Institution of Washington relating to fundamental RNAi technologies, as well as research and other equipment situated at our Worcester, Massachusetts, laboratory. On April 30, 2007, we provided to RXi $15.0 million, net of expenses of approximately $2.0 million reimbursed to us by RXi, in exchange for additional equity in RXi, to satisfy certain initial funding requirements under its agreements with UMMS. RXi is focused solely on developing and commercializing therapeutic products based upon RNAi technologies for the treatment of human diseases, with an initial focus on neurodegenerative diseases, cancer, type 2 diabetes and obesity.

We have relied primarily upon sales of our equity securities and upon proceeds received upon the exercise of options and warrants and, to a much lesser extent, upon payments from our strategic partners and licensees, to generate funds needed to finance our business and operations. At June 30, 2007, we had cash and cash equivalents of $69.7 million, including $19.2 million that we received from the sale of shares in our April 2007 financing transaction, net of offering expenses of approximately $2.8 million and the $15.0 million of net proceeds that we provided to RXi on April 30, 2007 to satisfy the initial funding requirements under its agreements with UMMS. Management believes that we have adequate financial resources to support our currently planned level of operations into the second half of 2009. That belief is based in part on projected expenditures through the remainder of 2007 and the first half of 2008 of $24.5 million, including $7.3 million for our Phase IIb trial of arimoclomol for ALS and related studies and $10.8 million for our other clinical programs, including a planned Phase II clinical trial of arimoclomol in stroke patients and a planned Phase II clinical trial of iroxanadine for diabetic foot ulcers (which we estimate will, through completion, cost $10.0 million and $5.6 million, respectively). Management estimates that RXi separately will expend approximately $8.2 million on development activities through the remainder of 2007 and the first half of 2008. Management s estimate regarding our financial resources assumes that no second efficacy trial will be required for arimoclomol for ALS. If we undertake an additional efficacy trial, our actual expenses will be materially greater than currently estimated. We will be required to obtain additional funding in order to execute our long-term business plans, although we do not currently have commitments from any third parties to provide us with capital. We cannot assure that additional funding will be available on favorable terms, or at all. If we fail to obtain additional funding when needed, we may not be able to execute our business plans and our business may suffer, which would have a material adverse effect on our financial position, results of operations and cash flows.

We have agreed to reduce our share of ownership of RXi to less than a majority of the outstanding voting power as soon as reasonably practicable. In order to reduce our ownership interest in RXi, we have announced our intention to issue a dividend of a portion of our RXi shares to our stockholders. Any proposed dividend to our stockholders of RXi shares would be subject to approval of the CytRx board of directors, SEC rules and the requirements of the Delaware General Corporation Law. We may be unable to comply with these rules and requirements, or may experience delays in complying. Any such dividend may be taxable to us, although any applicable taxes due may be off-set by our net operating loss carryforwards; however there is no assurance that our current net operating loss carryforwards will be sufficient to cover any such taxable event, and if they are not, then CytRx might be required to pay income tax.

RXi began operating as a stand-alone company with its own management, business, and operations in January 2007. We have agreed under our letter agreement with UMMS and our separate stockholders agreement with RXi and its other current stockholders to reduce our share of ownership of RXi to less than a majority of the outstanding voting power as soon as reasonably practicable. During the time that RXi is majority-owned, the consolidated financial statements of CytRx will include 100% of the assets and liabilities of RXi and the ownership of

the interests of the minority shareholders will be recorded as minority interests. In the future, if CytRx owns more than 20% but less than 50% of the outstanding shares of RXi, CytRx would account for its investment in RXi using the equity method. Under the equity method, CytRx would record its pro-rata share of the gains or losses of RXi against its historical basis investment in RXi. For 2007, we expect RXi s research and development expenses will be approximately $6.5 million.

Critical Accounting Policies and Estimates

Management s discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The

preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, impairment of long-lived assets, including finite lived intangible assets, accrued liabilities and certain expenses. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

Our significant accounting policies are summarized in Note 2 to our financial statements contained in our Annual Report on Form 10-K filed for the year ended December 31, 2006. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

Revenue Recognition

Biopharmaceutical revenues consist of license fees from strategic alliances from pharmaceutical companies as well as service revenues. Service revenues consist of contract research and laboratory consulting. Grant revenues consist of government and private grants.

Monies received for license fees are deferred and recognized ratably over the performance period in accordance with Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition*. Milestone payments will be recognized upon achievement of the milestone as long as the milestone is deemed substantive and we have no other performance obligations related to the milestone and collectibility is reasonably assured, which is generally upon receipt, or recognized upon termination of the agreement and all related obligations. Deferred revenue represents amounts received prior to revenue recognition.

Revenues from contract research, government grants, and consulting fees are recognized over the respective contract periods as the services are performed, provided there is persuasive evidence or an arrangement, the fee is fixed or determinable and collection of the related receivable is reasonably assured. Once all conditions of the grant are met and no contingencies remain outstanding, the revenue is recognized as grant fee revenue and an earned but unbilled revenue receivable is recorded.

In August 2006, we received approximately $24.3 million in proceeds from the privately-funded ALS Charitable Remainder Trust (ALSCRT) in exchange for the commitment to continue research and development of arimoclomol and other potential treatments for ALS and a one percent royalty in the worldwide sales of arimoclomol. Under the arrangement, we retain the rights to any products or intellectual property funded by the arrangement and the proceeds of the transaction are non-refundable. Further, the ALSCRT has no obligation to provide any further funding to us. We have analyzed the transaction and concluded that due to the research and development components of the transaction that it is properly accounted for under SFAS No. 68, *Research and Development Arrangements*. Accordingly, we have recorded the value received under the arrangement as deferred service revenue and will recognize service revenue using the proportional performance method of revenue recognition, meaning that service revenue is recognized on a dollar-for-dollar basis for each dollar of expense incurred for the research and development of arimoclomol and then the development of other potential ALS treatments. We believe that this method best approximates the efforts expended related to the services provided. We adjust our estimates quarterly. As of December 31, 2006, we recognized approximately $1.8 million of service revenue related to this transaction. For three and six-months ended June 30, 2007, we recognized approximately $2.4 and $3.8 million, respectively, in service revenue. Any significant change in ALS related research and development expense in any particular quarterly or annual period will result in a change in the recognition of revenue for that period and consequently affect the comparability or revenue from period to period.

The amount of deferred revenue, current portion is the amount of deferred revenue that is expected to be recognized in the next twelve months and is subject to fluctuation based upon management estimates. Management s estimates include what pre-clinical and clinical trials are necessary, the size of the trial, the timing of when trials will be performed and the estimated cost of the trials. These estimates are subject to changes and could have a significant effect on the amount and timing of when the deferred revenues are recognized.

Research and Development Expenses

Research and development expenses consist of costs incurred for direct and overhead-related research expenses and are expensed as incurred. Costs to acquire technologies which are utilized in research and development and which have no alternative future use are

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expensed when incurred. Technology developed for use in its products is expensed as incurred until technological feasibility has been established.

Clinical Trial Expenses

Clinical trial expenses, which are included in research and development expenses, include obligations resulting from our contracts with various clinical research organizations in connection with conducting clinical trials for our product candidates. We recognize expenses for these activities based on a variety of factors, including actual and estimated labor hours, clinical site initiation activities, patient enrollment rates, estimates of external costs and other activity-based factors. We believe that this method best approximates the efforts expended on a clinical trial with the expenses we record. We adjust our rate of clinical expense recognition if actual results differ from our estimates.

Stock-based Compensation

Effective January 1, 2006, we adopted the provisions of SFAS 123(R), Share-Based Payment (revised 2004). SFAS 123(R) requires that companies recognize compensation expense associated with stock option grants and other equity instruments to employees in the financial statements. SFAS 123(R) applies to all grants after the effective date and to the unvested portion of stock options outstanding as of the effective date. We adopted SFAS 123(R) using the modified-prospective method and use the Black-Scholes valuation model for valuing share-based payments. We will continue to account for transactions in which services are received in exchange for equity instruments based on the fair value of such services received from non-employees, in accordance with SFAS 123(R) and Emerging Issues Task Force (EITF) Issue No. 96-18, Accounting for Equity Instruments that Are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

The fair value of each CytRx and RXi common stock option grant is estimated using the Black-Scholes option pricing model, which uses certain assumptions related to risk-free interest rates, expected volatility, expected life of the common stock options and future dividends. Compensation expense is recorded based upon the value derived from the Black-Scholes option pricing model, based on an expected forfeiture rate that is adjusted for actual experience. If our Black-Scholes option pricing model assumptions or our actual or estimated forfeiture rate are different in the future, that could materially affect compensation expense recorded in future periods.

Impairment of Long-Lived Assets

We review long-lived assets, including finite lived intangible assets, for impairment on an annual basis, as of December 31, or on an interim basis if an event occurs that might reduce the fair value of such assets below their carrying values. An impairment loss would be recognized based on the difference between the carrying value of the asset and its estimated fair value, which would be determined based on either discounted future cash flows or other appropriate fair value methods.

Earnings Per Share

Basic and diluted loss per common share are computed based on the weighted average number of common shares outstanding. Common share equivalents (which consist of options and warrants) are excluded from the computation of diluted loss per share since the effect would be antidilutive. Common share equivalents which could potentially dilute basic earnings per share in the future, and which were excluded from the computation of diluted loss per share, totaled approximately 20.4 million shares and 29.2 million shares at June 30, 2007 and 2006, respectively. In connection with our adjustment to the exercise terms of certain outstanding warrants to purchase common stock on March 2, 2006, we recorded a deemed dividends of $488,000. The deemed dividend was reflected as an adjustment to net loss for the first quarter of 2006, to arrive at net loss applicable to common stockholders on the consolidated statement of operations and for purposes of calculating basic and diluted loss per shares.

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Liquidity and Capital Resources

At June 30, 2007, we had cash and cash equivalents of $69.7 million and total assets of $72.7 million, compared to $30.4 million and $31.6 million, respectively, at December 31, 2006. Working capital totaled $59.7 million at June 30, 2007, compared to $20.3 million at December 31, 2006.

We have relied primarily upon sales of our equity securities and upon proceeds received upon the exercise of options and warrants and, to a much lesser extent, upon payments from our strategic partners and licensees, to generate funds needed to finance our business and operations. At June 30, 2007, we had cash and cash equivalents of $69.7 million, including $19.2 million that we received from the sale of shares in our April 2007 financing transaction, net of offering expenses of approximately $2.8 million and the $15.0 million of net proceeds that we provided to RXi on April 30, 2007 to satisfy the initial funding requirements under its agreements with UMMS. Management believes that we have adequate financial resources to support our currently planned level of operations into the second half of 2009. That belief is based in part on projected expenditures through the remainder of 2007 and the first half of 2008 of $24.5 million, including $7.3 million for our Phase IIb trial of arimoclomol for ALS and related studies and $10.8 million for our other clinical programs, including a planned Phase II clinical trial of arimoclomol in stroke patients and a planned Phase II clinical trial of iroxanadine for diabetic foot ulcers (which we estimate will, through completion, cost $10.0 million and $5.6 million, respectively). Management estimates that RXi separately will expend approximately $8.2 million on development activities through the remainder of 2007 and the first half of 2008. Management s estimate regarding our financial resources assumes that no second efficacy trial will be required for arimoclomol for ALS. If we undertake an additional efficacy trial, our actual expenses will be materially greater than currently estimated. We have no significant revenue, and we expect to have no significant revenue and to continue to incur significant losses over the next several years. Our net losses may increase from current levels primarily due to expenses related to our ongoing and planned clinical trials, research and development programs, possible technology acquisitions, and other general corporate activities. In the event that actual costs of our clinical program for ALS, or any of our other ongoing research activities, are significantly higher than our current estimates, we may be required to significantly modify our planned level of operations. In the future, we will be dependent on obtaining financing from third parties in order to maintain our operations, including completion of the clinical development arimoclomol for ALS and our ongoing research and development efforts related to our other small molecule drug candidates.

We currently have no commitments from any third parties to provide us with capital. We cannot assure that additional funding will be available to us on favorable terms, or at all. If we fail to obtain additional funding when needed in the future, we would be forced to scale back, or terminate, our operations, or to seek to merge with or to be acquired by another company.

Our net loss, which includes non-cash charges relating to (1) common stock, stock option and warrants issued for services (2) common stock issued related to the acquisition of licensing rights and (3) expenses related to employee stock options, increased by approximately $700,000 from the quarter ended June 30, 2006 to the quarter ended June 30, 2007. This increase was due to several factors including our subsidiary RXi s issuance of approximately 462,000 shares with an estimated fair value $2.3 million for the licensing rights of certain technologies and a new invention disclosure agreement, as well as the recognition of option expense of $1.1 million related to the issuance of options to RXi s employees, members of its board of directors and scientific advisory board. These non cash increases in net loss were offset in part by $2.4 million in deferred revenue related to our $24.3 million sale to the ALS Charitable Remainder Trust of a 1% royalty interest in worldwide sales of arimoclomol in August 2006.

In the six months ended June 30, 2007 and 2006, net cash used in investing activities consisted of approximately $38,000 and $22,000, respectively, for the purchase of equipment. We expect capital spending during the second half of 2007 to be higher than the first six months of 2007 due to additional laboratory equipment necessary for our new San Diego laboratory.

Cash provided by financing activities in the six months ended June 30, 2007 was $50.2 million. During the 2007 period, we raised $34.2 million, net of offering expenses of $2.8 million, from the issuance of 8.6 million shares of common stock in a private equity financing in April of 2007, and received proceeds from the exercise of stock options and warrants of approximately $15.9 million. Cash provided by financing activities in the six months ended June 30,

2006 was approximately $12.7 million. During the 2006 period, we raised $12.4 million, net of expenses, from the issuance of common stock in a private equity financing in March of 2006, and received proceeds from the exercise of stock options and warrants of approximately $339,000.

As a result of the activities described above, our cash and cash equivalents at June 30, 2007 were approximately $39.3 million more than at December 31, 2006.

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We are evaluating other potential future sources of capital, although we do not currently have commitments from any third parties to provide us with capital. The results of our technology licensing efforts and the actual proceeds of any fund-raising activities will determine our ongoing ability to operate as a going concern. Our ability to obtain future financings through joint ventures, product licensing arrangements, royalty sales, equity financings, gifts, and grants or otherwise is subject to market conditions and out ability to identify parties that are willing and able to enter into such arrangements on terms that are satisfactory to us. Depending upon the outcome of our fundraising efforts, the accompanying financial information may not necessarily be indicative of future operating results or future financial condition.

We expect to incur significant losses for the foreseeable future and there can be no assurance that we will become profitable. Even if we become profitable, we may not be able to sustain that profitability.

Results of Operations

We recorded a net loss applicable to common shareholders of approximately $6.3 million and $10.8 million for the three and six month periods ended June 30, 2007, respectively, as compared to $5.5 million and $10.1 for the same periods in 2006.

We recognized $2.4 million and $3.9 million of revenue for the three and six month periods ended June 30, 2007, and had no material revenue for the same periods in 2006. We recognized $2.4 million and $3.8 million from our $24.3 million sale to the ALS Charitable Remainder Trust of a 1% royalty interest in worldwide sales of arimoclomol in 2007. Additionally during the three month period ended June 30, 2007, we recognized $1.5 million of other income related to a change-in-control provision included in the purchase agreement for our 1998 sale of our animal pharmaceutical unit. All future licensing fees under our current licensing agreements are dependent upon successful development milestones being achieved by the licensor. During 2007, we do not anticipate receiving any significant service or licensing fees. We will continue to recognize the balance of the deferred revenue recorded from the royalty transaction with the ALS Charitable Remainder Trust over the development period of our arimoclomol research.

Research and Development

	Three-Month Period Ended June 30,		Six-Month Period Ended June 30,	
	2007 (Restated)	2006	2007 (Restated)	2006
	(In thousands)		(In thousands)	
Research and development expense	$ 4,014	$ 3,035	$ 7,245	$ 5,165
Non-cash research and development expense	2,650	61	3,323	105
Employee stock option expense	175	77	212	160
Depreciation and amortization	45	32	112	87
	$ 6,884	$ 3,205	$ 10,892	$ 5,517

Research expenses are expenses incurred by us in the discovery of new information that will assist us in the creation and the development of new drugs or treatments. Development expenses are expenses incurred by us in our efforts to commercialize the findings generated through our research efforts.

Research and development expenses incurred during the first three and six month periods of 2007 and 2006 relate primarily to (i) our Phase II clinical program for arimoclomol in ALS, (ii) our ongoing research and development related to other molecular chaperone drug candidates, (iii) our acquisition of technologies covered by the UMMS license agreements acquired by our RXi subsidiary, (iv) our prior collaboration and invention disclosure agreement pursuant to which UMMS had agreed to disclose certain inventions to us and provide us with the right to acquire an option to negotiate exclusive licenses for those disclosed technologies, and (v) the small molecule drug discovery operations at our Massachusetts laboratory. All research and development costs related to the activities of RXi and our laboratory were expensed.

As compensation to members of our scientific advisory board and consultants, and in connection with the acquisition of technology, we sometimes issue shares of our common stock, stock options and warrants to purchase shares of our common stock. For financial statement purposes, we value these shares of common stock, stock options, and warrants at the fair value of the common stock, stock options or warrants granted, or the services received, whichever is more reliably measurable. We recorded non-cash charges of $2.7 million and $3.3 million for the three and six month periods ended June 30, 2007 and $61,000 and $105,000 for the same periods ended June 30, 2006. Included in the non-cash research and development charges were $2.3 million of expense related to RXi s issuance of 462,112 shares of common stock to UMMS related for certain license agreement rights and the new invention disclosure agreement. Additionally, we recognized $732,000 of option expense as a result of RXi s issuance of options to members of

its scientific advisory board members during the three months ended June 30, 2007. With our adoption of SFAS 123(R) during 2006, we recorded $175,000 and $212,000 of employee stock option expense during the three and six month periods ended June 30, 2007, as compared with $77,000 and $160,000 for the related periods in 2006. The increase is primarily related to the hiring of additional staff related to the anticipation of the opening of our new San Diego facility.

In 2007, we expect our research and development expenses to increase primarily as a result of our ongoing Phase II clinical program for arimoclomol and related studies for the treatment of ALS, our potential Phase II clinical trial of arimoclomol for stroke recovery, our further development of iroxanadine for diabetic wound healing an the continued development of our RNAi assets by our majority-owned subsidiary RXi. We are currently evaluating our estimates for our clinical program for arimoclomol for the treatment of ALS, including the completion of the planned Phase IIb efficacy clinical trial and related studies. We recently announced that an additional efficacy trial may be required prior to any FDA approval for arimcolomol for ALS. If we undertake an additional efficacy trial, our actual research and development expenses will be materially greater than currently estimated.

General and administrative expenses

	Three-Month Period Ended June 30,		Six-Month Period Ended June 30,	
	2007 (Restated)	2006	2007 (Restated)	2006
	(In thousands)		(In thousands)	
General and administrative expenses	$ 3,534	$ 2,057	$ 5,904	$ 3,746
Non-cash general and administrative expenses		58		126
Employee stock option expense	568	274	679	536
Depreciation and amortization	5	48	9	52
	$ 4,107	$ 2,437	$ 6,592	$ 4,460

General and administrative expenses include all salaries and general corporate expenses, including legal expenses associated with the prosecution of our intellectual property. General and administrative expenses increased by approximately $1.7 million and $2.1 million for the three and six months ended June 30, 2007, respectively, as compared to the same time periods in 2006. The increase in general and administrative expenses was as a result of salary, stock-based compensation and consulting expenses related to RXi of $1.0 million for each of the three and six months ended June 30, 2007, respectively, for which there were no corresponding expense in 2006. Also, contributing to the increase are higher levels of accounting and consulting expenses primarily related to our efforts to comply with the attestation requirements of Section of the Sarbanes-Oxley Act, as well as an increase in our overall salary level. Additionally, we incurred higher legal fees during 2007, primarily related to our the formation funding efforts of RXi. In our efforts to comply with the attestation requirements under Section 404 of the Sarbanes-Oxley Act for the first time for the year ended December 31, 2006, we incurred approximately $800,000 in consulting, audit, and accounting system conversion expense. We expect our consulting expenses related to information technology to decrease in the remainder of 2007, as our accounting system conversion is now complete.

From time to time, we issue shares of our common stock or warrants or options to purchase shares of our common stock to consultants and other service providers in exchange for services. For financial statement purposes, we value these shares of common stock, stock options, and warrants at the fair value of the common stock, stock options or warrants granted, or the services received, whichever we can measure more reliably. We recorded approximately $568,000 and $679,000 million of employee stock option expense during the three and six months ended June 30, 2007, respectively, as compared to approximately $274,000 and $536,000, respectively during the three and six months ended June 30, 2006. The increase in employee stock option expense relates primarily to stock option grants by RXi and the overall increase in our common share price.

Depreciation and amortization

Depreciation and amortization expenses for the three and six months ended June 30, 2007 were approximately $49,000 and $121,000, as compared to $80,000 and $139,000 for the three and six months ended June 30, 2006, respectively. The depreciation expense reflects the depreciation of our equipment and furnishings and the amortization expenses related to our molecular library, which was placed in service in March 2005.

Interest income

Interest income was $659,000 and $1.0 million for the three and six months ended June 30, 2007, respectively, compared to $177,000 and 284,000, respectively for the comparable periods of 2006. The variances between periods is attributable primarily to the cash available for investment each year and, to a lesser extent, changes in prevailing market rates.

Minority interest in losses of subsidiary

We offset against our net loss $178,136 related to the minority interest in RXi held by its minority stockholders in the six months ended June 30, 2007. During 2006, no comparable entry was necessary as there were no subsidiary losses. This loss was the minority shareholder s portion of the loss attributed to RXi and was limited to the extent of their investment.

Related Party Transactions

RXi was incorporated jointly in April 2006 by CytRx and the four current members of RXi s scientific advisory board for the purpose of pursuing the possible development or acquisition of RNAi-related technologies and assets.

On January 8, 2007, CytRx entered into a Contribution Agreement with RXi under which CytRx assigned and contributed to RXi substantially all of its RNAi-related technologies and assets, and entered into a letter agreement with RXi under which RXi has agreed to reimburse CytRx, following its initial funding, for all organizational and operational expenses incurred by CytRx in connection with the formation, initial operations and funding of RXi. On April 30, 2007, CytRx additionally contributed $15.0 million, net of reimbursed expenses of approximately $2.0 million, to RXi.

Tod Woolf, Ph.D., the President and Chief Executive Officer of RXi, is one of the Company s executive officers. Under the terms of Dr. Woolf s employment agreement he is entitled to base annual compensation and other employee benefits. Additionally, he received a grant by RXi of options to purchase 317,000 shares of RXi common stock. Dr. Woolf may be deemed to have a material interest in the Company s transactions with RXi described above, and in its future dealings with RXi, by reason of his status as RXi s President and Chief Executive Officer and in light of the stock options granted to him by RXi.

Item 4 Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer at that time, performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)) as of June 30, 2007, the end of the period covered by our original Form 10-Q. Based on that evaluation, our Chief Executive Officer and former Chief Financial Officer concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. There were no changes made during the period covered by our original Form 10-Q in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

During the period covered by this Quarterly Report on Form 10-Q, we originally identified a material weakness in our internal controls over financial reporting related to the process for closing our books and records for purposes of preparing our quarterly financial statements.

Subsequently, in conjunction with the preparation of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2007, our management, with the participation of our Chief Executive Officer and our new Chief Financial Officer, identified new deficiencies, discussed below, that it considered to be material weaknesses in the effectiveness of our internal controls over financial reporting related to the recording of journal entries and our accounting for equity transactions. Pursuant to standards established by the Public Company Accounting Oversight Board, a material weakness is a deficiency or combination of deficiencies in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company s annual or interim financial statements will not be prevented or detected on a timely basis.

For the quarter ended June 30, 2007, we reported additional paid-in capital of $2.3 million attributable to RXi s issuance to the University of Massachusetts Medical School, or UMMS, of approximately 462,000 shares of RXi common stock in payment for RXi s acquisition of four technology licenses and an invention disclosure agreement entered into with UMMS in January 2007. In the restatement, the $2.3 million is properly reflected as minority interest in RXi, resulting in a corresponding reduction in additional paid-in capital and stockholders equity. We also recorded an increased loss attributable to minority interests of approximately $176,000 in the consolidated statements of operations for the three-month and six-month periods ended June 30, 2007, which resulted in decreases in our consolidated net loss by the same amount for the respective periods. Additionally, during the quarter ended June 30, 2007, we originally reported $227,000 in amounts withheld from employees for income taxes on compensation derived from exercises of options to purchase our common stock as an offset to general and administrative expenses in the consolidated statements of operations for the three-month and six-month periods ended June 30, 2007. In the restatement, the $227,000 is reclassified as a current liability on the balance sheet as of June 30, 2007, which resulted in an increase in our consolidated net loss by the same amount for both the three-month and six-month periods ended June 30, 2007 consolidated statements of operations. The net effect of the correction of both of these items was a $51,000 increase in our consolidated net loss reported in the consolidated statements of operations for the three-month and six-month periods ended June 30, 2007, which did not result in any change in our reported earnings per share for these same periods.

Based on the evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, our Chief Executive Officer and new Chief Financial Officer concluded that, in addition to the material weakness identified in the original Form 10-Q for the period ended June 30, 2007, our disclosure controls and procedures over our recording of journal entries and our accounting for equity transactions were not effective as of June 30, 2007.

We continuously seek to improve and strengthen our control processes to ensure that all of our controls and procedures are adequate and effective. Any failure to implement and maintain improvements in the controls over our financial reporting could cause us to fail to meet our reporting obligations under the Securities and Exchange Commission s rules and regulations. Any failure to improve our internal controls to address the weaknesses we have identified could also cause investors to lose confidence in our reported financial information, which could have a negative impact on the trading price of our common stock.

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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.

CYTRX CORPORATION
(Registrant)

Date: November 13, 2007

By: /s/ MITCHELL K. FOGELMAN
Mitchell K. Fogelman
Chief Financial Officer (Principal Financial and Accounting Officer)

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INDEX TO EXHIBITS

Exhibit Number	Description
31.1	Certification of Chief Executive Officer Pursuant to 17 CFR 240.13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to 17 CFR 240.13a-14(a)
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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Health IQ purchase price adjustment		70
Balance, February 28, 2006	$	96,090

On June 8, 2005, we acquired certain assets from Health IQ Diagnostics, LLC (Health IQ), a health support company that uses a proprietary model to provide enrollees of employer-sponsored health plans and their dependents with a personal health risk assessment and score as well as the information they need to maintain or improve their health status. The Health IQ purchase price adjustment for the six months ended February 28, 2006 relates to an earn-out agreement under which we are obligated to pay the

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former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ s programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

(5) Intangible and Other Assets

Intangible assets subject to amortization at February 28, 2006 consist of the following:

	Gross Carrying Amount	Accumulated Amortization	Net
(In $000s)			
Acquired technology	$ 10,163	$ 5,082	$ 5,081
Customer contracts	9,217	4,638	4,579
Other	200	50	150
Total	$ 19,580	$ 9,770	$ 9,810

Acquired technology, customer contracts, and other intangible assets are being amortized on a straight-line basis over a five-year estimated useful life. Total amortization expense for each of the six months ended February 28, 2006 and 2005 was $2.0 million. Estimated amortization expense for the remainder of fiscal 2006 and the following four fiscal years thereafter is $2.0 million, $3.9 million, $3.9 million, $40,000, and $10,000, respectively. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

Intangible assets not subject to amortization at February 28, 2006 consist of a trade name of $4.3 million associated with the StatusOne Health Systems, LLC (StatusOne) acquisition. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired.

Other assets consist primarily of deferred loan costs net of accumulated amortization.

(6) Long-Term Debt

On October 29, 2004, we amended our previous revolving credit and term loan agreement dated September 5, 2003 (the Former Credit Agreement) by entering into a First Amended and Restated Revolving Credit Loan Agreement (the First Amended Credit Agreement). The First Amended Credit Agreement provided us with up to $150.0 million in borrowing capacity, including a $75.0 million sub facility for letters of credit, under a senior revolving credit facility that was to expire on October 29, 2009. We repaid the outstanding principal on the term loan under the Former Credit Agreement of $48.0 million with $23.0 million in cash and a $25.0 million draw on the revolving credit facility under the First Amended Credit Agreement.

The First Amended Credit Agreement required us to repay the principal on any loans at the maturity date of October 29, 2009. Borrowings under the First Amended Credit Agreement bore interest, at our option, at the prime rate plus a spread of 0.0% to 1.0% or LIBOR plus a spread of 1.25% to 2.25%, or a combination thereof. The First Amended Credit Agreement also provided for a fee ranging between 0.25% and 0.5% of unused commitments.

On September 19, 2005, we entered into a Second Amended and Restated Revolving Credit Loan Agreement (the Second Amended Credit Agreement). The Second Amended Credit Agreement provides us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million, and expires on September 19, 2010. As of February 28, 2006, our available line of credit totaled $249.3 million.

The Second Amended Credit Agreement requires us to repay the principal on any loans at the maturity date of September 19, 2010. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5% or at the prime rate. The Second Amended Credit Agreement also provides for a fee ranging between 0.175% and 0.3% of unused commitments. The Second Amended Credit Agreement is secured by guarantees from our active domestic subsidiaries and by security interests in substantially all of our and our subsidiaries assets.

The Second Amended Credit Agreement contains various financial covenants, which require us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) fixed charge coverage, and (iii) net worth. It also restricts the payment of dividends and limits the amount of repurchases of the Company s common stock. As of February 28, 2006, we were in compliance with all of the financial covenant requirements of the Second Amended Credit Agreement.

As of February 28, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement for $0.7 million primarily to support our requirement to repay fees under one health plan contract in the event we do not perform at established target levels and do not repay the fees due in accordance with the terms of the contract.

(7) Commitments and Contingencies

In conjunction with contractual requirements under one contract that began on March 1, 2004, we funded an escrow account in the amount of approximately $3.8 million, which was classified as restricted cash. We were required to deposit a percentage of all fees received from this customer during the first year of the contract into the escrow account to be used to repay fees under the contract in the event we did not perform at target levels. In accordance with the terms of the contract, in January 2006 the entire $3.8 million was released from escrow and reclassified to cash and cash equivalents as our first-year results were validated with the customer.

Pursuant to an earn-out agreement executed in connection with the acquisition of certain assets of Health IQ, we are obligated to pay the former stockholders of Health IQ additional purchase price equal to a percentage of revenues recognized from Health IQ s programs in each of the fiscal quarters during the three-year period ending August 31, 2008.

In June 1994, a former employee whom we dismissed in February 1994 filed a whistle blower action on behalf of the United States government. Subsequent to its review of this case, the federal government determined not to intervene in the litigation. The employee sued Healthways, Inc. and our wholly-owned subsidiary, American Healthways Services, Inc. (AHSI), as well as certain named and unnamed medical directors and one named client hospital, West Paces Medical Center (WPMC), and other unnamed client hospitals.

Healthways, Inc. has since been dismissed as a defendant; however, the case is still pending against AHSI before the United States District Court for the District of Columbia. In addition, WPMC

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has settled claims filed against it as part of a larger settlement agreement that WPMC s parent organization, HCA Inc., reached with the United States government.

The complaint alleges that AHSI, the client hospitals and the medical directors violated the federal False Claims Act by entering into certain arrangements that allegedly violated the federal anti-kickback statute and provisions of the Social Security Act prohibiting physician self-referrals. Although no specific monetary damage has been claimed, the plaintiff, on behalf of the federal government, seeks treble damages plus civil penalties and attorneys fees. The plaintiff also has requested an award of 30% of any judgment plus expenses. In February 2006, WPMC filed an arbitration claim seeking indemnification from us for certain costs and expenses incurred by it in connection with the case. Substantial discovery has taken place to date and additional discovery is expected to occur. No trial date has been set. The parties have had initial discussions regarding their respective positions in the case; however, no resolution of this case has been reached or can be assured prior to the case proceeding to trial.

We believe that we have conducted our operations in full compliance with applicable statutory requirements and that we have meritorious defenses to the claims made in the case and the related arbitration proceeding, and intend to contest the claims vigorously. Nevertheless, it is possible that resolution of these legal matters could have a material adverse effect on our consolidated results of operations in a particular financial reporting period. We believe that we will continue to incur legal expenses associated with the defense of these matters, which may be material to our consolidated results of operations in a particular financial reporting period. However, we believe that any resolution of this case and all related matters will not have a material effect on our liquidity or financial condition.

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

Overview

Founded in 1981, Healthways, Inc. (the Company) provides specialized, comprehensive health and care support programs and services, including disease management and care enhancement services to health plans, the Centers for Medicare & Medicaid Services (CMS), and hospitals in addition to wellness programs to health plans and employers, in all 50 states, the District of Columbia, Puerto Rico, and Guam. These services include, but are not limited to:

providing members with educational materials and personal interactions with highly trained nurses designed to create and sustain healthier behaviors;

incorporating current evidence-based clinical guidelines in interventions to optimize patient care;

developing care support plans and motivating members to set attainable goals for themselves;

providing local market resources to address acute episode interventions; and

coordinating members care with local health-care providers.

Our integrated health and care support programs serve entire health plan populations through member and physician health and care support interventions, advanced neural network predictive modeling, and a confidential, secure Internet-based application that provides patients and physicians with individualized health information. Our programs enable health plans to develop relationships with all of their members, not just the chronically ill, and to identify those at highest risk for a health problem, allowing for early interventions.

Our programs are designed to help people lead healthier lives by making sure they understand and follow doctors orders including medication compliance, are aware of and can recognize early warning signs associated with a major health episode, and are setting achievable goals for themselves to exercise more, lose weight, quit smoking or otherwise improve their current health status.

We believe that our patient and physician support regimens, delivered and/or supervised by a multi-disciplinary team, have demonstrated that they assist in providing more effective care for the enrollee populations diagnosed with one or more diseases or conditions, which will improve the health status of the enrollee populations with the disease or condition and reduce both the short-term and long-term health-care costs for these enrollees. In addition, our consumer-directed health support services enable health plans and employers to reach and engage everyone in their covered populations through interventions which are sensitive and specific to each individual s health risks and needs, thereby motivating behavior change and generating measurable cost savings.

Our integrated health and care support product line includes programs for people with diabetes, coronary artery disease, heart failure, asthma, chronic obstructive pulmonary disease, end-stage renal disease, cancer, chronic kidney disease, depression, tobacco addiction, high-risk obesity, acid-related stomach disorders, atrial fibrillation, decubitus ulcer, fibromyalgia, hepatitis C, inflammatory bowel disease, irritable bowel syndrome, low-back pain, osteoarthritis, osteoporosis, and urinary incontinence, as well as high-risk population management. We design our programs to create and maintain key desired behaviors of each program member and of the providers who care for them in order to improve member health status, thereby reducing health-care costs. The programs incorporate interventions necessary to optimize member care and are based on the most up-to-date, evidence-based clinical guidelines.

The flexibility of our programs allows customers to enter the health and care support market at the level they deem appropriate for their organization. Customers may select a single or multiple chronic

disease approach, a total-population, or high-risk approach, in which people with more than one disease or condition receive the benefit of multiple programs at a single cost.

In December 2004, we were selected by CMS to participate in two Medicare Health Support (MHS) pilots awarded under the Chronic Care Improvement Program authorized by the Medicare Modernization Act of 2003. We began operating one pilot in August 2005 to serve 20,000 Medicare fee-for-service beneficiaries in Maryland and the District of Columbia. All fees under this pilot are performance-based. In addition, in September 2005 we began serving 20,000 beneficiaries in Georgia in collaboration with CIGNA HealthCare, Inc. The majority of our fees under our contract with CIGNA are performance-based. Both of the pilots are for complex diabetes and congestive heart failure disease management services and are operationally similar to our programs for commercial and Medicare Advantage health plan populations.

Highlights of Performance for the Six Months Ended February 28, 2006

Revenues increased 30.1% compared to the six months ended February 28, 2005.
Actual lives under management at February 28, 2006 increased 36.3% from February 28, 2005, which included a 66.2% increase in self-insured employer actual lives under management to 811,000 at February 28, 2006 from 488,000 at February 28, 2005.

Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are based upon current expectations and involve a number of risks and uncertainties. Forward-looking statements include all statements that do not relate solely to historical or current facts, and can be identified by the use of words like may, believe, will, expect, project, estimate, anti plan, or continue. In order for us to use the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, we caution you that the following important factors, among others, may affect these forward-looking statements. Consequently, actual operations and results may differ materially from those expressed in the forward-looking statements. The important factors include but are not limited to:

our ability to sign and implement new contracts for health and care support services;

our ability to accurately forecast performance and the timing of revenue recognition under the terms of our health plan contracts and/or our cooperative agreement with CMS ahead of data collection and reconciliation in order to provide forward-looking guidance;

the timing and costs of implementation, and the effect, of regulations and interpretations relating to the Medicare Prescription Drug, Improvement, and Modernization Act of 2003;

our ability to anticipate the rate of market acceptance of health and care support solutions and the individual market dynamics in potential international markets and our ability to accurately forecast the costs necessary to implement our strategy of establishing a presence in these markets;

our ability to effectively manage any growth that we might experience;

our ability to retain existing customers if they are acquired by other health plans which already have or are not interested in health and care support programs;

the risks associated with a significant concentration of our revenues with a limited number of customers;

our ability to effect cost savings and clinical outcomes improvements under health and care support contracts and reach mutual agreement with customers and/or CMS with respect to cost savings, or to effect such savings and improvements within the time frames contemplated by us;

our ability to collect contractually earned performance incentive bonuses;

the ability of our customers and/or CMS to provide timely and accurate data that is essential to the operation and measurement of our performance under the terms of our health plan contracts;

our ability to favorably resolve contract billing and interpretation issues with our customers;

our ability to integrate the operations of Health IQ and other acquired businesses or technologies into our business;

our ability to develop new products and deliver outcomes on those products;

our ability to effectively integrate new technologies and approaches, such as those encompassed in our health and care support initiatives or otherwise licensed or acquired by us, into our health and care support platform;

our ability to renew and/or maintain contracts with our customers under existing terms or restructure these contracts on terms that would not have a material negative impact on our results of operations;

our ability to implement our health and care support strategy within expected cost estimates;

our ability to obtain adequate financing to provide the capital that may be necessary to support the growth of our operations and to support or guarantee our performance under new contracts;

unusual and unforeseen patterns of health care utilization by individuals with diabetes, cardiac, respiratory and/or other diseases or conditions for which we provide services, in the health plans with which we have executed a health and care support contract;

the ability of the health plans to maintain the number of covered lives enrolled in the plans during the terms of our agreements with the health plans;

our ability to attract and/or retain and effectively manage the employees required to implement our agreements;

the impact of litigation involving us and/or our subsidiaries;

the impact of future state and federal health-care and other applicable legislation and regulations on our ability to deliver our services and on the financial health of our customers and their willingness to purchase our services;

current geopolitical turmoil and the continuing threat of domestic or international terrorism;

general worldwide and domestic economic conditions and stock market volatility; and

other risks detailed in our other filings with the Securities and Exchange Commission.

We undertake no obligation to update or revise any such forward-looking statements.

Customer Contracts

Contract Terms

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month (PMPM) by the number of members covered by our services during the month. We set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In some contracts, the PMPM rates may differ between the health plan s lines of business [e.g. Preferred Provider Organizations (PPO), Health Maintenance Organizations (HMO), Medicare Advantage]. Contracts with health plans generally range from three to seven years with provisions for subsequent renewal; contracts between our health plan customers and their self-insured employer accounts typically have one-year terms. Some contracts allow the health plan to terminate early under certain conditions.

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer (performance-based) if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer s health-care costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 10% of revenues recorded during the six months ended February 28, 2006 were performance-based and remain subject to final reconciliation. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

Information Systems

Our contracts require sophisticated management information systems to help us manage the care of large populations of health plan members with targeted chronic diseases or other medical conditions and to report clinical and financial outcomes before and after we implement our programs. We have developed and are continually expanding and improving our proprietary clinical, data management, and reporting systems, to continue to meet our information management needs for our health and care support services. Due to the anticipated expansion and improvement in our information management systems, we expect to continue making significant investments in our information technology software and hardware and in our information technology staff.

Contract Revenues

Our contract revenues depend on the contractual terms we establish and maintain with health plans to provide health and care support services to their members. Some contracts allow the health plan to terminate early under certain conditions. Restructurings and possible terminations at or prior to renewal could have a material negative impact on our results of operations and financial condition.

Approximately 39% of our revenues for the six months ended February 28, 2006 were derived from two customers that each comprised more than 10% of our revenues for the period. The loss of either of these customers or any other large health plan customer or a reduction in the profitability of any contract with these customers would have a material negative impact on our results of operations, cash flows, and financial condition.

Actual Lives under Management

We measure the volume of participation in our programs by the actual number of health plan members and hospital patients who are benefiting from our services, which is reported as actual lives under management. Annualized revenue in backlog represents the estimated annualized revenue at target performance associated with signed contracts at February 28, 2006 for which we have not yet begun providing services. The number of actual lives under management and annualized revenue in backlog are shown below at February 28, 2006 and February 28, 2005.

At February 28,	2006	2005
Actual lives under management	2,027,000	1,487,000
Annualized revenue in backlog (in $000s)	$ 5,215	$ 14,360

Employers typically make decisions on which health insurance carriers they will offer to their employees and may also allow employees to switch between health plans on an annual basis. These annual membership disenrollment and re-enrollment processes of employers (whose employees are the health plan members) from health plans can result in a seasonal reduction in actual lives under management during our second fiscal quarter.

Historically, we have found that a majority of employers and employees make these decisions effective December 31 of each year. An employer s change in health plans or employees changes in health plan elections may cause a decrease in our actual lives under management for existing contracts as of January 1. Although these decisions may also cause a gain in enrollees as new employers sign on with our customers, the identification of new members eligible to participate in our programs is based on the submission of health-care claims, which lags enrollment by an indeterminate period.

As a result, historically, actual lives under management for existing contracts have decreased between 6% and 8% on January 1 and have not been restored through new member identification until later in the fiscal year, thereby negatively affecting our revenues on existing contracts in our second fiscal quarter. In recent years, the decrease in actual lives under management resulting from health plans seasonal enrollment and disenrollment has been offset by growth from self-insured employer accounts as many of these accounts have implemented new health and care support programs as of January 1, resulting in a sequential quarter increase in lives under management.

Another seasonal impact on actual lives could occur if a health plan decided to withdraw coverage altogether for a specific line of business, such as Medicare Advantage, or in a specific geographic area, thereby automatically disenrolling previously covered members. Historically, we have experienced minimal covered life disenrollment from such decisions.

We have seen increasing demand for our health and care support services from self-insured employer accounts for which our health plan customers do not assume medical cost risk but provide primarily administrative claim and health network access services. Signed contracts between these self-insured employers and our health plan customers are incorporated in our contracts with our health plan customers, and these program-eligible members are included in the lives under management or the annualized revenue in backlog reported in the table above, as appropriate.

Business Strategy

Our primary strategy is to create value for governments, health plans, employers and consumers through health and care support programs and services that improve the quality and affordability of health-care. We plan to use our scaleable state-of-the-art care enhancement centers and medical information content and proprietary technologies to gain a competitive advantage in delivering our health and care support services.

We expect to continue adding services to our product mix that extend our programs beyond a chronic disease focus and provide services to individuals who currently have, or face the risk of developing, one or more additional medical conditions. We believe that we can achieve improvements in care, and therefore significant cost savings, by addressing care and treatment requirements for these additional selected diseases and conditions, which will enable us to address a larger percentage of a health plan s population and total health-care costs. In addition, we expect to continue developing proprietary, proactive health support for whole populations across the continuum of care, including next generation wellness solutions.

We anticipate that we will incur significant costs during the remainder of fiscal 2006 to enhance and expand our clinical programs and data and financial reporting systems, pursue opportunities in international markets, enhance our information technology support, and open additional or expand current care enhancement centers as needed. We may add some of these new capabilities and technologies through strategic alliances with other entities, one or more of which we may make minority investments in or acquire for stock and/or cash.

Critical Accounting Policies

We describe our accounting policies in Note 1 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2005. We prepare the consolidated financial statements in accordance with U.S. generally accepted accounting principles, which require us to make estimates and judgments that affect the reported amounts of assets and liabilities and related disclosures at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

We believe the following accounting policies to be the most critical in understanding the judgments that are involved in preparing our financial statements and the uncertainties that could impact our results of operations, financial condition and cash flows.

Revenue Recognition

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month (PMPM) by the number of members covered by our services during the month. We set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In some contracts, the PMPM rate may differ between the health plan s lines of business (e.g., PPO, HMO, Medicare Advantage). Contracts with health plans generally range from three to seven years with provisions for subsequent renewal; contracts between our health plan customers and their self-insured employer accounts typically have one-year terms.

Some contracts provide that a portion (up to 100%) of our fees may be refundable to the customer (performance-based) if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer s health-care costs and selected clinical and/or other criteria that

focus on improving the health of the members. Approximately 10% of revenues recorded during the six months ended February 28, 2006 were performance-based and remain subject to final reconciliation. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We bill our customers each month for the entire amount of the fees contractually due for the prior month s enrollment, which typically includes the amount, if any, that is performance-based and may be subject to refund should we not meet performance targets. Contractually, we cannot bill for any incentive bonus until after contract settlement.

We recognize revenue as follows: 1) we recognize the fixed portion of the monthly fees as revenue during the period we perform our services; 2) we recognize the performance-based portion of the monthly fees based on our performance to date in the contract year; and 3) we recognize additional incentive bonuses based on our performance to date in the contract year, to the extent we consider such amounts collectible.

We assess our level of performance based on medical claims and other data that the health plan customer is contractually required to supply each month. A minimum of four to six months data is typically required for us to measure performance. In assessing our performance, we may include estimates such as medical claims incurred but not reported and a health plan s medical cost trend compared to a baseline year. In addition, we may also provide contractual reserves, when appropriate, for billing adjustments at contract reconciliation.

If data from the health plan is insufficient or incomplete to measure performance, or interim performance measures indicate that we are not meeting performance targets, we do not recognize performance-based fees subject to refund as revenues but instead record them in a current liability account contract billings in excess of earned revenue . Only in the event we do not meet performance levels by the end of the contract year are we contractually obligated to refund some or all of the performance-based fees. We would only reverse revenues that we had already recognized if performance to date in the contract year, previously above targeted levels, dropped below targeted levels due to subsequent adverse performance and/or adjustments in contractual reserves. Historically, any such adjustments have been immaterial to our financial condition and results of operations.

During the settlement process under a contract, which generally occurs six to eight months after the end of a contract year, we settle any performance-based fees and reconcile health-care claims and clinical data. As of February 28, 2006, performance-based fees that have not yet been settled with our customers but that have been recognized as revenue in the current and prior years totaled approximately $48.3 million. Of this amount, $29.8 million was based entirely on actual data received from our customers, while $18.5 million was based on calculations which include estimates such as medical claims incurred but not reported and/or a health plan s medical cost trend compared to a baseline year. Data reconciliation differences, for which we provide contractual allowances until we reach agreement with respect to identified issues, can arise between the customer and us due to health plan data deficiencies, omissions, and/or data discrepancies.

Performance-related adjustments (including any amounts recorded as revenue that were ultimately refunded), changes in estimates, data reconciliation differences, or adjustments to incentive bonuses may cause us to recognize or reverse revenue in a current fiscal year that pertains to services

provided during the prior fiscal year. During the six months ended February 28, 2006, we recognized a net increase in revenue of $1.5 million that related to services provided prior to fiscal 2006.

Impairment of Intangible Assets and Goodwill

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we review goodwill for impairment on an annual basis or more frequently whenever events or circumstances indicate that the carrying value may not be recoverable.

If we determine that the carrying value of goodwill is impaired based upon an impairment review, we calculate any impairment using a fair-value-based goodwill impairment test as required by SFAS No. 142. Fair value is the amount at which the asset could be bought or sold in a current transaction between two willing parties. We estimate fair value using a number of techniques, including quoted market prices or valuations by third parties, present value techniques based on estimates of cash flows, or multiples of earnings or revenues performance measures.

We amortize other identifiable intangible assets, such as acquired technologies and customer contracts, on the straight-line method over their estimated useful lives, except for trade names, which have an indefinite life and are not subject to amortization. We review intangible assets not subject to amortization on an annual basis or more frequently whenever events or circumstances indicate that the assets might be impaired. We assess the potential impairment of intangible assets subject to amortization whenever events or changes in circumstances indicate that the carrying values may not be recoverable.

If we determine that the carrying value of other identifiable intangible assets may not be recoverable, we calculate any impairment using an estimate of the asset s fair value based on the projected net cash flows expected to result from that asset, including eventual disposition.

Future events could cause us to conclude that impairment indicators exist and that goodwill and/or other intangible assets associated with our acquired businesses are impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

Share-Based Compensation

On September 1, 2005, we adopted SFAS No. 123(R), which requires us to measure and recognize compensation expense for all share-based payment awards based on estimated fair values at the date of grant. Determining the fair value of share-based awards at the grant date requires judgment in developing assumptions, which involve a number of variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards, and expected stock option exercise behavior. In addition, we also use judgment in estimating the number of share-based awards that are expected to be forfeited. In June 2005, we changed the method we use to estimate the fair values of stock options from the Black-Scholes model to a lattice binomial model, which we consider preferable to the Black-Scholes model because the lattice binomial model considers characteristics of fair value option pricing, such as an option s contractual term and the probability of exercise before the end of the contractual term, that are not available under the Black-Scholes model. We contract with a third party to assist in developing the assumptions used in estimating the fair values of stock options.

Results of Operations

The following table shows the components of the statements of operations for the three and six months ended February 28, 2006 and 2005 expressed as a percentage of revenues:

	Three Months Ended February 28,		Six Months Ended February 28,	
	2006	2005	2006	2005
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of services	70.8%	63.9%	70.7%	64.2%
Gross margin	29.2%	36.1%	29.3%	35.8%
Selling, general and administrative expenses	10.9%	9.7%	11.0%	9.2%
Depreciation and amortization	5.8%	7.3%	6.0%	7.5%
Interest expense	0.3%	0.6%	0.3%	0.7%
Income before income taxes	12.2%	18.5%	12.0%	18.4%
Income tax expense	4.9%	7.3%	4.8%	7.3%
Net income	7.3%	11.2%	7.2%	11.1%

Revenues

Revenues for the three months ended February 28, 2006 increased 32.8% compared to the three months ended February 28, 2005, primarily due to the following:

existing health plan customers adding or expanding 22 new programs since the beginning of the second quarter of fiscal 2005;
an increase in the number of self-insured employer actual lives under management from 488,000 at February 28, 2005 to 811,000 at February 28, 2006;
increased membership in our customers' existing programs;
the commencement of six new health plan contracts since the beginning of the second quarter of fiscal 2005; and
revenues from the MHS pilots of $1.5 million during the three months ended February 28, 2006.

Revenues for the six months ended February 28, 2006 increased 30.1% compared to the six months ended February 28, 2005, primarily due to the following:

existing health plan customers adding or expanding 23 new programs since the beginning of fiscal 2005;
an increase in the number of self-insured employer actual lives under management from 488,000 at February 28, 2005 to 811,000 at February 28, 2006;
the commencement of six new health plan contracts since the beginning of fiscal 2005;
increased membership in our customers existing programs; and
revenues from the MHS pilots of $3.1 million during the six months ended February 28, 2006.

We anticipate that total revenues for the remainder of fiscal 2006 will increase over fiscal 2005 revenues primarily due to the expansion of existing contracts, increasing demand for our health and care support services from self-insured employers who contract with our health plan customers, anticipated new health plan contracts, and revenues from the MHS pilots.

Cost of Services

Cost of services as a percentage of revenues for the three months ended February 28, 2006

increased to 70.8% compared to 63.9% for the same period in fiscal 2005. This increase is primarily related to the following costs during the three months ended February 28, 2006 which were not incurred during the comparable period in fiscal 2005:

- costs of servicing the two MHS pilots, which began in August and September of 2005, respectively. A substantial majority of our fees under the MHS pilots are performance-based and, consistent with our policy with new contracts which include performance-based fees, have not yet been recognized as revenue because we are not yet able to measure performance. For the three months ended February 28, 2006, we recorded revenues of $1.5 million, which represent the non-performance-based portion of our fees under one of the MHS pilots, and costs of $4.9 million attributable to the MHS pilots; and
- long-term incentive compensation costs of $1.8 million incurred during the second quarter of fiscal 2006, including share-based compensation expensed under SFAS No. 123(R) and cash-based awards issued in lieu of share-based awards that were historically granted to certain levels of management.

Excluding the revenues and costs associated with the MHS pilots and the long-term incentive compensation costs noted above, cost of services as a percentage of revenues would have increased to 65.1% from 63.9% for the three months ended February 28, 2006 and 2005, respectively, primarily due to the following:

- an increase in the employee performance bonus accrual during the three months ended February 28, 2006 compared to the three months ended February 28, 2005; and
- increased expenditures for product development activities for the three months ended February 28, 2006 compared to the three months ended February 28, 2005.

These increases were somewhat offset by decreases related to increased capacity utilization, economies of scale, and productivity enhancements during the second quarter of fiscal 2006 compared to the second quarter of fiscal 2005.

Cost of services as a percentage of revenues for the six months ended February 28, 2006 increased to 70.7% compared to 64.2% for the same period in fiscal 2005. This increase is primarily related to the following costs during the six months ended February 28, 2006 which were not incurred during the comparable period in fiscal 2005:

- costs of servicing the two MHS pilots, which began in August and September of 2005, respectively. A substantial majority of our fees under the MHS pilots are performance-based and, consistent with our policy with new contracts which include performance-based fees, have not yet been recognized as revenue because we are not yet able to measure performance. For the six months ended February 28, 2006, we recorded revenues of $3.1 million, which represent the non-performance-based portion of our fees under one of the MHS pilots, and costs of $9.7 million attributable to the MHS pilots; and
- long-term incentive compensation costs of $3.5 million incurred during the six months ended February 28, 2006, including share-based compensation expensed under SFAS No. 123(R) and cash-based awards issued in lieu of share-based awards that were historically granted to certain levels of management.

Excluding the revenues and costs associated with the MHS pilots and the long-term incentive compensation costs noted above, cost of services as a percentage of revenues would have increased to 64.9% from 64.2% for the six months ended February 28, 2006 and 2005, respectively, primarily due to

the following:

- an increase in the employee performance bonus accrual during the six months ended February 28, 2006 compared to the six months ended February 28, 2005;
- a new enterprise agreement for software licensing and servicing entered into in November 2004, which enhanced and expanded a previous agreement that expired in August 2004; and
- increased expenditures for product development activities for the six months ended February 28, 2006 compared to the six months ended February 28, 2005.

These increases were somewhat offset by decreases related to increased capacity utilization, economies of scale, and productivity enhancements during the six months ended February 28, 2006 compared to the six months ended February 28, 2005.

We anticipate that cost of services for the remainder of fiscal 2006 will increase over fiscal 2005 primarily as a result of share-based payments required to be expensed under SFAS No. 123(R) and other long-term employee incentive costs, operating costs related to the MHS pilots, increases in operating staff required for expected increases in demand for our services, increases in indirect staff costs associated with the continuing development and implementation of our health and care support services, and increases in information technology and other support staff and costs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses as a percentage of revenues for the three and six months ended February 28, 2006 increased to 10.9% and 11.0%, respectively, compared to 9.7% and 9.2% for the same periods in fiscal 2005. These increases are primarily related to the following costs:

- costs attributable to pursuing opportunities in international markets, which totaled $0.8 million and $1.4 million, respectively, for the three and six months ended February 28, 2006 compared to no corresponding costs during the three and six months ended February 28, 2005; and
- long-term incentive compensation costs of $1.9 million and $3.7 million during the three and six months ended February 28, 2006, respectively, which consisted of share-based compensation expensed under SFAS No. 123(R) and cash-based awards issued in lieu of share-based awards that were historically granted to certain levels of management, compared to $0.1 million and $0.3 million of share-based compensation costs during the three and six months ended February 28, 2005, respectively.

Excluding the costs above, selling, general and administrative expenses as a percentage of revenues would have decreased to 8.3% for the three and six months ended February 28, 2006, compared to 9.5% and 9.0%, respectively, for the same periods in fiscal 2005 primarily due to our ability to more effectively leverage our selling, general and administrative expenses as a result of growth in our operations.

We anticipate that selling, general and administrative expenses for the remainder of fiscal 2006 will increase over fiscal 2005 primarily due to share-based payments required to be expensed under SFAS No. 123(R) and other long-term employee incentive costs, anticipated investments in international initiatives, and increases in indirect support costs for our existing and anticipated new and expanded health plan contracts.

Depreciation and Amortization

Depreciation and amortization expense for the three and six months ended February 28, 2006 increased 6.0% and 4.9%, respectively, over the same periods in fiscal 2005 primarily due to increased depreciation and amortization expense associated with equipment, software, leasehold improvements, and computer-related capital expenditures. We made these capital expenditures to enhance our health plan information technology capabilities, expand our corporate office, and increase calling capacity at existing care enhancement centers.

We anticipate that depreciation and amortization expense for the remainder of fiscal 2006 will increase over fiscal 2005 primarily as a result of additional capital expenditures associated with expected increases in demand for our services and growth and improvement in our information technology capabilities.

Interest Expense

Interest expense for the three and six months ended February 28, 2006 decreased 45.6% and 54.0%, respectively, compared to the three and six months ended February 28, 2005 primarily due to a reduction in our long-term debt balance resulting from net repayments of $18.0 million of revolving debt since February 28, 2005.

We anticipate that interest expense for the remainder of fiscal 2006 will decrease over fiscal 2005 primarily as a result of a lower balance of long-term debt.

Income Tax Expense

Our effective tax rate increased to 39.7% for the three and six months ended February 28, 2006 compared to 39.5% for the three months ended February 28, 2005 and 39.7% for the six months ended February 28, 2005, primarily as a result of our geographic mix of earnings, which impacts our average state income tax rate, and other factors. The differences between the statutory federal income tax rate of 35% and our effective tax rate are due primarily to the impact of state income taxes and certain non-deductible expenses for income tax purposes.

Liquidity and Capital Resources

Operating activities for the six months ended February 28, 2006 generated cash flows of $31.9 million compared to $18.4 million for the six months ended February 28, 2005. The increase in operating cash flow of $13.5 million resulted primarily from 1) payments during the six months ended February 28, 2005 related to accounts payable accrued at August 31, 2004 associated with capital expenditures for upgrades to hardware in support of core business functions and 2) an increase in cash collections recorded to contract billings in excess of earned revenue for the six months ended February 28, 2006 compared to the same period in fiscal 2005, primarily related to the MHS pilots. These increases were somewhat offset by a higher employee bonus payment during the six months ended February 28, 2006 compared to the six months ended February 28, 2005.

Investing activities during the six months ended February 28, 2006 used $10.2 million in cash, which primarily consisted of the purchase of property and equipment associated with the addition of information technology hardware and software.

Financing activities for the six months ended February 28, 2006 generated $16.6 million in cash primarily due to proceeds from the exercise of stock options and the related tax benefit. In addition, the

entire $3.8 million that was previously classified as restricted cash and held in escrow due to contractual requirements with a customer was released from escrow and reclassified to cash and cash equivalents as our first-year results were validated with the customer.

On September 19, 2005, we amended and restated the First Amended Credit Agreement and entered into the Second Amended Credit Agreement, which provides us with a $250.0 million revolving credit facility, including a swingline sub facility of $10.0 million and a $75.0 million sub facility for letters of credit, together with an uncommitted incremental accordion facility of $50.0 million, and expires on September 19, 2010. As of February 28, 2006, our available line of credit totaled $249.3 million.

The Second Amended Credit Agreement requires us to repay the principal on any loans at the maturity date of September 19, 2010. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5% or at the prime rate. The Second Amended Credit Agreement also provides for a fee ranging between 0.175% and 0.3% of unused commitments. The Second Amended Credit Agreement is secured by guarantees from our active domestic subsidiaries and by security interests in substantially all of our and our subsidiaries assets.

The First Amended Credit Agreement provided us with up to $150.0 million in borrowing capacity and contained various financial covenants, which required us to maintain, as defined, ratios or levels of (i) total funded debt to EBITDA, (ii) interest coverage, (iii) fixed charge coverage, and (iv) net worth. The Second Amended Credit Agreement contains similar financial covenants with the exclusion of the interest coverage ratio. Both agreements restrict the payment of dividends and limit the amount of repurchases of the Company s common stock. As of February 28, 2006, we were in compliance with all of the financial covenant requirements of the Second Amended Credit Agreement.

As of February 28, 2006, there were letters of credit outstanding under the Second Amended Credit Agreement totaling $0.7 million primarily to support our requirement to repay fees under one health plan contract in the event we do not perform at established target levels and do not repay the fees due in accordance with the terms of the contract.

In conjunction with contractual requirements under one contract that began on March 1, 2004, we funded an escrow account in the amount of approximately $3.8 million, which was classified as restricted cash. We were required to deposit a percentage of all fees received from this customer during the first year of the contract into the escrow account to be used to repay fees under the contract in the event we did not perform at target levels. In accordance with the terms of the contract, in January 2006 the entire $3.8 million was released from escrow and reclassified to cash and cash equivalents as our first-year results were validated with the customer.

We believe that cash flow from operating activities, our available cash, and our available credit under the Second Amended Credit Agreement will continue to enable us to meet our contractual obligations and to fund the current level of growth in our operations for the foreseeable future. However, if expanding our operations requires significant additional financing resources, such as capital expenditures for technology improvements, additional care enhancement centers and/or letters of credit or other forms of financial assurance to guarantee our performance under the terms of new contracts, or if we are required to refund performance-based fees pursuant to contract terms, we may need to raise additional capital by expanding our existing credit facility and/or issuing debt or equity. If we face a limited ability to arrange such financing, it may restrict our ability to expand our operations.

In addition, if contract development accelerates or acquisition opportunities arise that would expand our operations, we may need to issue additional debt or equity to provide the funding for these increased growth opportunities. We may also issue equity in connection with future acquisitions or strategic alliances. We cannot assure you that we would be able to issue additional debt or equity on terms that would be acceptable to us.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are subject to market risk related to interest rate changes, primarily as a result of the Second Amended Credit Agreement and the First Amended Credit Agreement, which bear interest based on floating rates. Borrowings under the First Amended Credit Agreement bore interest, at our option, at the prime rate plus a spread of 0.0% to 1.0% or LIBOR plus a spread of 1.25% to 2.25%, or a combination thereof. Borrowings under the Second Amended Credit Agreement generally bear interest, at our option, at LIBOR plus a spread of 0.875% to 1.5% or at the prime rate. We do not execute transactions or hold derivative financial instruments for trading purposes.

Because there was no variable rate debt outstanding during the six months ended February 28, 2006, a one-point interest rate change would not have caused interest expense to fluctuate for the six months ended February 28, 2006.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer have reviewed and evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the Exchange Act)) as of February 28, 2006. Based on that evaluation, the chief executive officer and chief financial officer have concluded that our disclosure controls and procedures effectively and timely provide them with material information relating to the Company and its consolidated subsidiaries required to be disclosed in the reports the Company files or submits under the Exchange Act.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal controls over financial reporting during the quarter ended February 28, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II

Item 1. Legal Proceedings.

In June 1994, a former employee whom we dismissed in February 1994 filed a whistle blower action on behalf of the United States government. Subsequent to its review of this case, the federal government determined not to intervene in the litigation. The employee sued Healthways, Inc. and our wholly-owned subsidiary, American Healthways Services, Inc. (AHSI), as well as certain named and unnamed medical directors and one named client hospital, West Paces Medical Center (WPMC), and other unnamed client hospitals.

Healthways, Inc. has since been dismissed as a defendant; however, the case is still pending against AHSI before the United States District Court for the District of Columbia. In addition, WPMC has settled claims filed against it as part of a larger settlement agreement that WPMC s parent organization, HCA Inc., reached with the United States government.

The complaint alleges that AHSI, the client hospitals and the medical directors violated the federal False Claims Act by entering into certain arrangements that allegedly violated the federal anti-kickback statute and provisions of the Social Security Act prohibiting physician self-referrals. Although no specific monetary damage has been claimed, the plaintiff, on behalf of the federal government, seeks treble damages plus civil penalties and attorneys fees. The plaintiff also has requested an award of 30% of any judgment plus expenses. In February 2006, WPMC filed an arbitration claim seeking indemnification from us for certain costs and expenses incurred by it in connection with the case. Substantial discovery has taken place to date and additional discovery is expected to occur. No trial date has been set. The parties have had initial discussions regarding their respective positions in the case; however, no resolution of this case has been reached or can be assured prior to the case proceeding to trial.

We believe that we have conducted our operations in full compliance with applicable statutory requirements and that we have meritorious defenses to the claims made in the case the related arbitration proceeding, and intend to contest the claims vigorously. Nevertheless, it is possible that resolution of these legal matters could have a material adverse effect on our consolidated results of operations in a particular financial reporting period. We believe that we will continue to incur legal expenses associated with the defense of these matters, which may be material to our consolidated results of operations in a particular financial reporting period. We believe that any resolution of this case and all related matters will not have a material effect on our liquidity or financial condition.

Item 1A. Risk Factors.

Not Applicable.

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

Not Applicable.

Item 3. Defaults Upon Senior Securities.

Not Applicable.

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

(a) The Annual Meeting of Stockholders of Healthways, Inc. was held on January 19, 2006.

(c) The following proposals were voted upon at the Annual Meeting of Stockholders:

(i) Nominations to elect Henry D. Herr, Dr. Jay Bisgard, and Dr. Mary Jane England as Directors of the Company. The results of the election of the above-mentioned nominees were as follows:

	For	Against	Withheld
Henry D. Herr	28,929,038	--	3,094,733
Dr. Jay Bisgard	30,898,816	--	1,124,955
Dr. Mary Jane England	30,899,875	--	1,123,896

(ii) Approval to amend the Company s Certificate of Incorporation and change the name of the Company from American Healthways, Inc. to Healthways, Inc. The voting results of the above-mentioned amendment were as follows:

For	Against	Abstain from Voting
31,210,311	800,784	12,676

(iii) Ratification of the appointment of Ernst & Young LLP as the Company s independent registered public accounting firm. The voting results were as follows:

For	Against	Abstain from Voting
31,962,683	43,849	17,239

Item 5. Other Information.

Not Applicable.

Item 6. Exhibits.

(a) Exhibits

10 1996 Stock Incentive Plan, as amended

11 Earnings Per Share Reconciliation

31.1 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by Ben R. Leedle, Jr., President and Chief Executive Officer

31.2 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002 made by Mary A. Chaput, Executive Vice President and Chief Financial Officer

32 Certification Pursuant to 18 U.S.C section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 made by Ben R. Leedle, Jr., President

and Chief Executive Officer and Mary A. Chaput, Executive Vice President and Chief Financial Officer

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 hereunto duly authorized.

Healthways, Inc.

(Registrant)

Date April 7, 2006 By /s/ Mary A. Chaput

Mary A. Chaput
Executive Vice President
Chief Financial Officer
(Principal Financial Officer)

Date April 7, 2006 By /s/ Alfred Lumsdaine

Alfred Lumsdaine
Senior Vice President and
Controller
(Principal Accounting Officer)

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