

NEPHROS INC  
Form 10-Q  
August 14, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON D.C. 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended: **June 30, 2012**

OR

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: 001-32288

**NEPHROS, INC.**

(Exact name of Registrant as Specified in Its Charter)

DELAWARE  
(State or Other Jurisdiction of  
Incorporation or Organization)

13-3971809  
(I.R.S. Employer  
Identification No.)

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41 Grand Avenue  
River Edge, NJ 07661  
(Address of Principal Executive Offices) (Zip code)

**(201) 343-5202**

Registrant's Telephone Number, Including Area Code

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES  NO

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

As of August 9, 2012, 11,608,345 shares of issuer's common stock, with \$0.001 par value per share, were outstanding.

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**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements.****NEPHROS, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)**

	(Unaudited) June 30, 2012	(Audited) December 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 987	\$ 1,669
Accounts receivable	890	1,170
Inventory, less allowances of \$150 at June 30, 2012 and \$218 at December 31, 2011	268	247
Prepaid expenses and other current assets	90	113
Total current assets	2,235	3,199
Property and equipment, net	21	17
Long-term receivable	-	778
Other assets, net of accumulated amortization	2,093	-
Total assets	\$ 4,349	\$ 3,994
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 360	\$ 284
License and supply agreement fee payable	1,238	-
Accrued expenses	170	195
Deferred revenue, current portion	674	698
Total current liabilities	2,442	1,177
Long-term portion of deferred revenue	1,010	1,396
Total liabilities	3,452	2,573

## Commitments and Contingencies (Note 9)

## Stockholders' equity:

Preferred stock, \$.001 par value; 5,000,000 shares authorized at June 30, 2012 and December 31, 2011; no shares issued and outstanding at June 30, 2012 and December 31, 2011.

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Common stock, \$.001 par value; 90,000,000 shares authorized at June 30, 2012 and December 31, 2011; 11,383,727 and 10,501,477 shares issued and outstanding at June 30, 2012 and December 31, 2011, respectively.	11	10
Additional paid-in capital	96,426	95,630
Accumulated other comprehensive income	39	49
Accumulated deficit	(95,579 )	(94,268 )
Total stockholders' equity	897	1,421
Total liabilities and stockholders' equity	\$ 4,349	\$ 3,994

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

## NEPHROS, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net revenues:				
Product revenues	\$ 132	\$ 637	\$ 492	\$ 1,318
License revenues	170	0	343	0
Total net revenues	302	637	835	1,318
Cost of goods sold	35	434	257	916
Gross margin	267	203	578	402
Operating expenses:				
Research and development	199	117	344	240
Depreciation and amortization	42	24	44	48
Selling, general and administrative	838	660	1,558	1,358
Total operating expenses	1,079	801	1,946	1,646
Loss from operations	(812 )	(598 )	(1,368 )	(1,244 )
Interest income	1	1	2	1
Interest expense	-	-	-	(12 )
Amortization of debt issuance costs	-	-	-	(40 )
Other income (expense)	57	(5 )	55	(14 )
Net loss	(754 )	(602 )	(1,311 )	(1,309 )
Other comprehensive income (loss), foreign currency translation adjustments	(54 )	13	(10 )	48
Total comprehensive loss	(808 )	(589 )	(1,321 )	(1,261 )
Net loss per common share, basic and diluted	\$(0.07 )	\$(0.06 )	\$(0.12 )	\$(0.19 )
Weighted average common shares outstanding, basic and diluted	10,967,245	10,065,118	10,765,553	7,052,504

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





## NEPHROS, INC. AND SUBSIDIARY

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended June 30,	
	2012	2011
Operating activities:		
Net loss	\$ (1,311 )	\$ (1,309 )
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	44	48
Noncash stock-based compensation	168	165
Amortization of debt issuance costs	-	40
Noncash interest	-	12
Gain on translation adjustments	(4 )	-
(Increase) decrease in operating assets:		
Accounts receivable	1,014	(239 )
Inventory	(21 )	410
Prepaid expenses and other current assets	23	92
Increase (decrease) in operating liabilities:		
Accounts payable and accrued expenses	58	(274 )
Deferred revenue	(343 )	(33 )
Net cash used in operating activities	(372 )	(1,088 )
Investing activities:		
Purchase of property and equipment	(7 )	-
Purchase of intangible assets	(659 )	-
Net cash used in investing activities	(666 )	-
Financing activities:		
Proceeds from exercise of warrants	356	-
Repayment of debt	-	(500 )
Payment of financing costs	-	(140 )
Proceeds from issuance of common stock	-	3,190
Net cash provided by financing activities	356	2,550
Effect of exchange rates on cash	-	11
Net increase (decrease) in cash	(682 )	1,473
Cash, beginning of period	1,669	240
Cash, end of period	\$ 987	\$ 1,713
Supplemental disclosure of cash flow information		
Cash paid for taxes	\$ 15	\$ 2
Payable related to license and supply agreement	\$ 1,238	\$ -
Receivable related to license agreement	\$ 755	\$ -

Fair value of stock options granted to Medica	\$ 273	\$ -
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*The accompanying notes are an integral part of these unaudited condensed consolidated interim financial statements*

**NEPHROS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**1. Basis of Presentation and Going Concern**

**Interim Financial Information**

The accompanying unaudited condensed consolidated interim financial statements of Nephros, Inc. and its wholly owned subsidiary, Nephros International Limited (collectively, the “Company” or “Nephros”) should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company’s 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission (the “SEC”) on March 22, 2012. The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 8 and Article 10 of Regulation S-X. Accordingly, since they are interim statements, the accompanying condensed consolidated financial statements do not include all of the information and notes required by GAAP for a complete financial statement presentation. The condensed consolidated balance sheet as of December 31, 2011 was derived from the Company’s audited consolidated financial statements but does not include all disclosures required by GAAP. In the opinion of management, the interim condensed consolidated financial statements reflect all adjustments consisting of normal, recurring adjustments that are necessary for a fair presentation of the financial position, results of operations and cash flows for the condensed consolidated interim periods presented. Interim results are not necessarily indicative of results for a full year. All significant intercompany transactions and balances have been eliminated in consolidation.

**Use of Estimates**

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

**Going Concern and Management’s Response**

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company's recurring losses and difficulty in generating sufficient cash flow to meet its obligations and sustain its operations raise substantial doubt about its ability to continue as a going concern. The Company's condensed consolidated interim financial statements do not include any adjustments that might result from the outcome of this uncertainty.

The Company has incurred significant losses in operations in each quarter since inception. For the six months ended June 30, 2012 and 2011, the Company has incurred net losses of \$1,311,000 and \$1,309,000, respectively. To become profitable, the Company must increase revenue substantially and achieve and maintain positive gross and operating margins. If the Company is not able to increase revenue and gross and operating margins sufficiently to achieve profitability, its results of operations and financial condition will be materially and adversely affected.

There can be no assurance that the Company's future cash flow will be sufficient to meet its obligations and commitments. If the Company is unable to generate sufficient cash flow from operations in the future to service its commitments, the Company will be required to adopt alternatives, such as seeking to raise debt or equity capital, curtailing its planned activities or ceasing its operations. There can be no assurance that any such actions could be effected on a timely basis or on satisfactory terms or at all, or that these actions would enable the Company to continue to satisfy its capital requirements.

**NEPHROS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**2. Concentration of Credit Risk**

For the six months ended June 30, 2012 and 2011, the following customers accounted for the following percentages of the Company's sales, respectively.

Customer	2012	2011
A	41%	56%
B	14%	19%
C	16%	5%

As of June 30, 2012 and December 31, 2011, the following customers accounted for the following percentages of the Company's accounts receivable, respectively.

Customer	2012	2011
A	85%	58%
B	0%	16%
C	5%	4%

**3. Revenue Recognition**

Revenue is recognized in accordance with Accounting Standards Codification ("ASC") Topic 605. Four basic criteria must be met before revenue can be recognized: (i) persuasive evidence that an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the fee is fixed or determinable; and (iv) collectability is reasonably assured.

The Company recognizes revenue related to product sales when delivery is confirmed by its external logistics provider and the other criteria of ASC Topic 605 are met. Product revenue is recorded net of returns and allowances. All costs and duties relating to delivery are absorbed by Nephros. Shipments for all products are currently received directly by the Company's customers.

On June 27, 2011, the Company entered into a License Agreement, effective July 1, 2011, with Bellco S.r.l., as licensee (“Bellco”), an Italy-based supplier of hemodialysis and intensive care products, for the manufacturing, marketing and sale of Nephros’ patented mid-dilution dialysis filters. This agreement provides the Company with payments of €500,000, €750,000, and €600,000 on July 1, 2011, January 15, 2012 and January 15, 2013, respectively. The first two payments have been received. The Company recognizes the fixed license revenue on a straight line basis over the forty-two month expected obligation period which ends on December 31, 2014. Any difference between payments received and recognized revenue is reported as deferred revenue.

Deferred revenue on the accompanying June 30, 2012 condensed consolidated balance sheet is approximately \$1,684,000 and is related to the License Agreement with Bellco. The total fixed payments to be received as a result of this agreement approximate \$2,327,000 and the Company has recognized approximately \$708,000 of revenue related to this license agreement to date and approximately \$343,000 for the six months ended June 30, 2012, resulting in \$1,684,000 being deferred over the remainder of the expected obligation period and approximately \$65,000 was accounted for as foreign exchange gain. The total deferred revenue of \$1,684,000 is shown as \$674,000 in current liabilities and \$1,010,000 in long-term liabilities on the accompanying June 30, 2012 condensed consolidated balance sheet.

The final guaranteed fixed payment of approximately \$755,000 is due in January 2013 and is included in current trade receivables on the accompanying June 30, 2012 condensed consolidated balance sheet.

#### **4. Stock-Based Compensation**

The Company accounts for stock option grants to employees and non-employee directors under the provisions of ASC 718, Stock Compensation. ASC 718 requires the recognition of the fair value of stock-based compensation in the statement of operations. In addition, the Company accounts for stock option grants to consultants under the provisions of ASC 505-50, Equity-Based Payments to Non-Employees, and as such, these stock options are revalued at each reporting period through the vesting period.

The fair value of stock option awards is estimated using a Black-Scholes option pricing model. The fair value of stock-based awards is amortized over the vesting period of the award using the straight-line method.

**NEPHROS, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS****4. Stock-Based Compensation (continued)**

The Company granted 1,216,000 stock options during the six months ended June 30, 2012 to employees, non-employees, directors and consultants. These stock options vest over a three-year or four-year period and will be expensed over the applicable vesting period. The fair value of all stock-based awards granted during the six months ended June 30, 2012 was approximately \$1,031,140.

The following assumptions were used for options granted for the six months ended June 30, 2012.

	<b>Six Months</b>
Assumptions for Option Grants	<b>Ended</b>
	<b>June 30, 2012</b>
Risk-free interest rate	1.09 - 1.19%
Volatility	123.48 - 126.18%
Expected dividend yield	0
Expected term	6.00 - 6.25 yrs

The Company calculates expected volatility for a stock-based grant based on historic monthly stock price observations of common stock during the period immediately preceding the grant that is equal in length to the expected term of the grant. The Company also estimates future forfeitures at 5.8% as a part of the estimate of expense as of the grant date. The Company has used historical data to estimate expected employee behaviors related to forfeitures. With respect to grants of options, the risk free rate of interest is based on the U.S. Treasury rates appropriate for the expected term of the grant.

On April 23, 2012, the Company entered into a License and Supply Agreement (the "License and Supply Agreement") with Medica S.p.A. ("Medica"), an Italy-based medical product manufacturing company, for the marketing and sale of certain filtration products based upon Medica's proprietary Medisulfone ultrafiltration technology in conjunction with the Company's filtration products. In addition to cash payments as further described in Note 9 Commitments and Contingencies, the Company granted Medica options to purchase 300,000 shares of the Company's common stock. The fair market value of these stock options was approximately \$273,000 at the time of their issuance. The fair market

value of the options has been capitalized as a long-term intangible asset along with the total installment payments. Other long-term assets on the accompanying June 30, 2012 condensed consolidated balance sheet is approximately \$2,093,000, net of \$39,000 accumulated amortization, and is related to the License and Supply Agreement. The asset is being amortized as an expense on a straight-line basis over the life of the agreement. Approximately \$39,000 has been charged to amortization expense for the three months ended June 30, 2012 on the condensed consolidated statement of operations and comprehensive loss. The term of the License and Supply Agreement commenced on April 23, 2012 and continues in effect through December 31, 2022, unless earlier terminated by either party in accordance with the terms of the License and Supply Agreement.

Stock-based compensation expense for the Company was approximately \$168,000 and \$165,000 for the six months ended June 30, 2012 and 2011, respectively. This expense is presented in the operating results as approximately \$14,000 and \$36,000 in the Research and Development expenses and \$154,000 and \$129,000 in the Selling, General and Administrative expenses for the six months ended June 30, 2012 and 2011, respectively on the accompanying condensed consolidated statement of operations.

There was no tax benefit related to expense recognized in the three months ended June 30, 2012 and 2011, as the Company is in a net operating loss position. As of June 30, 2012, there was approximately \$822,000 of total unrecognized compensation cost related to unvested share-based compensation awards granted under the equity compensation plans which will be amortized over the weighted average remaining requisite service period of 3.2 years. Such amount does not include the effect of future grants of equity compensation, if any. Of the total \$822,000, the Company expects to recognize approximately 21% in the remaining interim periods of 2012, approximately 31% in 2013, approximately 23% in 2014, approximately 21% in 2015, and approximately 4% in 2016.

During the six months ended June 30, 2012, 954,482 warrants were exercised, resulting in proceeds of approximately \$356,000 and the issuance of 882,250 shares of the Company's common stock. Additional warrants were exercised subsequent to the balance sheet that resulted in the issuance of 224,618 shares of the Company's common stock.

## **5. Comprehensive Income (Loss)**

Comprehensive income (loss), as defined in ASC 220, is the total of net income (loss) and all other non-owner changes in equity (or other comprehensive income (loss)) such as foreign currency translation adjustments. As of June 30, 2012 and December 31, 2011, accumulated other comprehensive income was approximately \$39,000 and \$49,000, respectively. Accumulated other comprehensive income was impacted by foreign exchange currency translation adjustments in the six months ended June 30, 2012 and 2011.



**NEPHROS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**6. Loss per Common Share**

In accordance with ASC 260-10, net loss per common share amounts (“basic EPS”) are computed by dividing net loss attributable to common stockholders by the weighted-average number of common shares outstanding and excluding any potential dilution. Net loss per common share amounts assuming dilution (“diluted EPS”) is generally computed by reflecting potential dilution from conversion of convertible securities and the exercise of stock options and warrants. However, because their effect is anti-dilutive, the Company has excluded stock options and warrants aggregating 17,533,282 and 17,546,200 shares, respectively, from the computation of diluted EPS for the six-month periods ended June 30, 2012 and 2011, respectively.

**7. Recently Adopted Accounting Pronouncements**

In December 2011, the FASB issued an update on comprehensive income, which pertains to the deferral of the effective date for amendments to the presentation of reclassification of items out of accumulated other comprehensive income in a previous accounting standard update that pertained to the presentation of comprehensive income. The update defers the presentation on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods. All other requirements of the previous accounting standard on the presentation of comprehensive income, issued in June 2011, are not affected. The previous presentation related to the comprehensive income standard requires that entities report components of comprehensive income in either a continuous statement of comprehensive income or two separate but consecutive statements. Under the continuous statement approach, the statement would include the components and total of net income, the components and total of other comprehensive income and the total of comprehensive income. Under the two statement approach, the first statement would include the components and total of net income and the second statement would include the components and total of other comprehensive income and the total of comprehensive income. It does not change the items that must be reported in other comprehensive income and it is effective retrospectively for interim and annual periods beginning after December 15, 2011, with early adoption permitted. The Company adopted the update on January 1, 2012, resulting in no impact to the Company’s condensed consolidated balance sheets, statements of operations and comprehensive loss and cash flows.

**8. Inventory, net**

Inventory is stated at the lower of cost or market using the first-in first-out method and consists entirely of finished goods. The Company's inventory as of June 30, 2012 and December 31, 2011 was approximately as follows:

	Unaudited June 30, 2012	Audited December 31, 2011
Total Gross Inventory, finished goods	\$ 418,000	\$ 465,000
Less: Inventory reserve	(150,000 )	(218,000 )
Total Inventory	\$ 268,000	\$ 247,000

## 9. Commitments and Contingencies

### Manufacturing and Suppliers

The Company has not and does not intend in the near future, to manufacture any of its products and components. With regard to the OLpūr MD190 and MD220, on June 27, 2011, the Company entered into a License Agreement, effective July 1, 2011, with Bellco S.r.l., an Italy-based supplier of hemodialysis and intensive care products, for the manufacturing, marketing and sale of our patented mid-dilution dialysis filters (MD 190, MD 220), referred to herein as the Products. Under the agreement, Nephros granted Bellco a license to manufacture, market and sell the Products under its own name, label and CE mark in Italy, France, Belgium, Spain and Canada on an exclusive basis, and to do the same on a non-exclusive basis in the United Kingdom and Greece and, upon our written approval, other European countries where the Company does not sell the Products as well as non-European countries, all such countries herein referred to as the Territory.

In exchange for the rights granted to it under the Bellco License Agreement through December 31, 2014, Bellco agreed to pay Nephros installment payments of €500,000, €750,000, €600,000 on July 1, 2011, January 15, 2012 and January 15, 2013, respectively. Such installment payments, herein referred to as the Installment Payments, are Bellco's sole financial obligations through December 31, 2014. Beginning on January 1, 2015 through and including December 31, 2016, Bellco will pay Nephros a royalty based on the number of units of Products sold per year in the Territory as follows: for the first 103,000 units sold, Bellco will pay €4.50 per unit; thereafter, Bellco will pay €4.00 per unit. Bellco must meet minimum sales targets of 15,000 units in each quarter of 2015 and 2016. If Bellco fails to meet a quarterly minimum, the license in Italy, France, Belgium, Spain and Canada will, at our discretion, convert to a

**NEPHROS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

**9. Commitments and Contingencies (continued)**

non-exclusive one. All sums payable under the agreement will be paid in Euros, as adjusted to account for currency exchange fluctuations between the Euro and the U.S. dollar that occur between July 1, 2011, the effective date of the agreement, and the date of payment.

License and Supply Agreement

On April 23, 2012, the Company entered into a License and Supply Agreement (the “License and Supply Agreement”) with Medica S.p.A. (“Medica”), an Italy-based medical product manufacturing company, for the marketing and sale of certain filtration products based upon Medica’s proprietary Medisulfone ultrafiltration technology in conjunction with the Company’s filtration products (collectively, the “Filtration Products”), and to engage in an exclusive supply arrangement for the Filtration Products. Under the License and Supply Agreement, Medica granted to the Company an exclusive license, with right of sublicense, to market, promote, distribute, offer for sale and sell the Filtration Products worldwide, excluding Italy for the first three years, during the term of the License and Supply Agreement. In addition, the Company granted to Medica an exclusive license under the Company’s intellectual property to make the Filtration Products during the term of the License and Supply Agreement. In exchange for the rights granted, the Company has agreed to make minimum annual aggregate purchases from Medica of €300,000, €500,000 and €750,000 for the years 2012, 2013 and 2014, respectively. For the six months ended June 30, 2012, the Company’s aggregate purchase commitments total approximately €263,000. For calendar years thereafter, annual minimum amounts will be mutually agreed upon between Medica and the Company.

As consideration for the license and other rights granted to the Company, the Company is required to pay Medica installment payments of €500,000 and €1,000,000 on April 23, 2012 and January 25, 2013, respectively. The April 23, 2012 payment was made. The January 25, 2013 payment is included on the accompanying June 30, 2012 consolidated condensed balance sheet as license and supply agreement fee payable of approximately \$1,238,000. The total installment payments approximate \$1,886,000. As further consideration for the license and other rights granted to the Company, the Company granted Medica options to purchase 300,000 shares of the Company’s common stock. The fair market value of these stock options was approximately \$273,000 at the time of their issuance, calculated as described in Footnote 4 Stock-based Compensation. The fair market value of the options has been capitalized as a long-term intangible asset along with the total installment payments described. Other long-term assets on the accompanying June 30, 2012 consolidated condensed balance sheet is approximately \$2,093,000, net of \$39,000 accumulated amortization, and is related to the License and Supply Agreement. The asset is being amortized as an expense over the life of the agreement. Approximately \$39,000 has been charged to amortization expense for the three months ended

June 30, 2012 on the consolidated condensed statement of operations and comprehensive loss. In addition, for the period beginning April 23, 2014 through December 31, 2022, the Company will pay Medica a royalty rate of 3% of net sales of the Filtration Products sold, subject to reduction as a result of a supply interruption pursuant to the terms of the License and Supply Agreement. The term of the License and Supply Agreement commenced on April 23, 2012 and continues in effect through December 31, 2022, unless earlier terminated by either party in accordance with the terms of the License and Supply Agreement. On April 23, 2012, the Company issued a press release announcing its entry into the License and Supply Agreement.

#### Contractual Obligations

At June 30, 2012, the Company had an operating lease that will expire on November 30, 2012 for the rental of its U.S. office and research and development facilities with a monthly cost of approximately \$7,813. On June 26, 2012, the Company signed a one year lease extension for the same office space which will expire on November 30, 2013 with a monthly cost of approximately \$8,399 beginning December 1, 2012.

#### Employment Agreement

On April 20, 2012, the Company entered into an Employment Agreement (the "Employment Agreement"), effective as of April 20, 2012, with Mr. Houghton. The Employment Agreement has a term of four years, ending on April 20, 2016. The Employment Agreement provides that Mr. Houghton's annual base salary will be \$350,000. Mr. Houghton will be eligible to receive a target discretionary bonus of 30% of annual base salary, as determined by the Company. The targets with respect to the bonus for the year ending December 31, 2012 were mutually agreed upon between Mr. Houghton and the Compensation Committee of the Board within 60 days following April 20, 2012 and such bonus will be appropriately prorated for such annual period. The targets for each subsequent annual period will be mutually agreed upon at the beginning of each calendar year between Mr. Houghton and the Compensation Committee.

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

*This discussion should be read in conjunction with our consolidated financial statements included in this Quarterly Report on Form 10-Q and the notes thereto, as well as the other sections of this Quarterly Report on Form 10-Q, including the "Risk Factors" section hereof, and our Annual Report on Form 10-K for the year ended December 31, 2011, including the "Risk Factors" and "Business" sections thereof. This discussion contains a number of forward-looking statements, all of which are based on our current expectations and could be affected by the uncertainties and risk factors described in this Quarterly Report on Form 10-Q and our Annual Report on Form 10-K for the year ended December 31, 2011. Our actual results may differ materially.*

### **Business Overview**

Nephros is a global medical device company that focuses on the development and commercialization of liquid purification filters that combine a best in class purification to flow rate ratio with filter endurance.

Nephros was founded in 1997, by healthcare professionals affiliated with Columbia University Medical Center, initially to address the needs of chronic renal failure patients.

The company has developed an alternative to current hemodialysis therapy known as Mid-dilution hemodiafiltration (mid-HDF). Nephros' proprietary blood purification technologies enable mid-HDF to be offered to chronic renal failure patients. Nephros' mid-dilution filters remove a range of harmful substances, specifically substances known as middle molecules, which have been linked to conditions such as carpal tunnel syndrome, dialysis related amyloidosis, and degenerative bone disease in chronic renal failure patients.

Nephros has extended its filtration technologies to meet the demand for liquid purification in other areas, in particular water purification. Today, Nephros ultrafilters remove biological contaminants from water and bicarbonate to provide ultrapure water and bicarbonate for use in hemodialysis. Nephros ultrafilters also purify water in the hospital/healthcare setting particularly at the point of use (i.e. at the end of the faucet or shower head). This approach has been shown to be particularly useful for infection control. Nephros is currently developing its filter technology in individual water purifiers for military applications.

On April 30, 2012, we announced that we received clearance from the U.S. Food and Drug Administration, or FDA to market the OLpūr H2H Module and OLpūr MD 220 Hemodiafilter for use with a UF controlled hemodialysis machine that provides ultrapure dialysate in accordance with current ANSI/AAMI/ISO standards, for the treatment of patients with chronic renal failure in the United States.

We currently have three products in various stages of development in the HDF modality to deliver an alternative treatment for chronic renal failure patients:

OLpūr MD HDF filter series (which we sell in various countries in Europe and currently consists of our MD190 and MD220 Hemodiafilters); we believe that it is the only filter designed expressly for HDF therapy and employs our proprietary Mid-Dilution Hemodiafiltration technology;

OLpūr H2H, our add-on module designed to allow the most common types of hemodialysis machines to be used for HDF therapy; and

·OLpūr NS2000 system, our stand-alone HDF machine and associated filter technology.

We have also developed our OLpūr HD 190 high-flux dialyzer cartridge, which incorporates the same materials as our OLpūr MD series but does not employ our proprietary Mid-Dilution Hemodiafiltration technology. Our OLpūr HD190 was designed for use with either hemodialysis or hemodiafiltration machines, and received its clearance from the FDA, under Section 510(k) of the Food, Drug and Cosmetic Act, or the FDC Act, in June 2005.

OLpūr is a registered trademark in the U.S. H2H is a trademark for which U.S. registration is pending. H2H is a registered European Union trademark. We have assumed that the reader understands that these terms are source-indicating. Accordingly, such terms appear throughout the remainder of this report without trademark notices for convenience only and should not be construed as being used in a descriptive or generic sense.

We believe that products in our OLpūr MD HDF Hemodiafilter series provide an effective alternative to products currently available for chronic renal failure patients. They remove certain larger toxins (known in the industry as “middle molecules” because of their heavier molecular weight) from blood. The accumulation of middle molecules in the blood has been related to such conditions as malnutrition, impaired cardiac function, carpal tunnel syndrome, and degenerative bone disease in the chronic renal failure patient. We also believe that OLpūr H2H will, upon introduction, expand the use of HDF as a cost-effective and attractive alternative for chronic renal failure treatment.

We believe that our OLpūr H2H Module and OLpūr MD 220 Hemodialfilters will potentially reduce hospitalization, medication and care costs as well as improve patient health (including reduced drug requirements and improved blood pressure profiles), and therefore, quality of life, by removing a broad range of toxins through a more patient-friendly, better-tolerated process. In addition, independent studies in Europe have indicated that, when compared with dialysis as it is currently offered in the United States, HDF can reduce the patient’s mortality risk by up to 35%. We believe that the OLpūr MD HDF Hemodiafilter series and the OLpūr H2H Module will provide these benefits to chronic renal failure patients at competitive costs and without the need for dialysis treatment providers to make significant capital expenditures in order to use our products. We also believe that the OLpūr NS2000 system, if successfully developed, will be the most cost-effective stand-alone hemodiafiltration system available.

On June 27, 2011, the Company entered into a license agreement, effective as of July 1, 2011, with Bellco S.r.l. as licensee, an Italy-based supplier of hemodialysis and intensive care products, for the manufacturing, marketing and sale of Nephros’ patented mid-dilution dialysis filters (MD 190, MD 220), referred to herein as the Products. Under the agreement, Nephros granted Bellco a license to manufacture, market and sell the Products under its own name, label and CE mark in Italy, France, Belgium, Spain and Canada on an exclusive basis, and to do the same on a

non-exclusive basis in the United Kingdom and Greece and, upon the written approval of Nephros, other European countries where Nephros does not sell the Products as well as non-European countries, all such countries herein referred to as the Territory. In addition, if requested by Nephros, Bellco will be required to sell the Products to Nephros' distributors in the Territory.

We currently have multiple products in various stages of development and commercialization for the ultrafiltration of water or bicarbonate:

- DSU and SSU, our in-line Dual Stage and Single Stage Ultrafilters respectively, for use in filtering water or bicarbonate used in hemodialysis and also in hospital infection control;

- SafeSpout and SafeShower, our point-of-use Ultrafilters, for end-point use on faucets and showers as an aid to hospital infection control;

- MSU, our large capacity Ultrafilter for commercial applications; and

- UF-40 and UF-30, our compact in-line and point-of-use Ultrafilters, for use in military applications and outdoor activities, such as hiking.

In January 2006, we introduced our in-line DSU water filtration system. Our in-line DSU represents a new and complementary product line to our existing dialysis therapy business. The in-line DSU incorporates our unique and proprietary dual stage filter architecture and is, to our knowledge, the only water filter that allows the user to sight-verify that the filter is properly performing its cleansing function. Our research and development work on the OLpūr H2H and MD Mid-Dilution Hemodiafilter technologies for chronic renal therapy provided the foundations for a proprietary multi-stage water filter that we believe is cost effective, extremely reliable, and long-lasting.



On October 7, 2008, we filed a 510(k) application for clearance to market our DSU to dialysis clinics for in-line purification of dialysate water and/or bicarbonate. On July 1, 2009, we received FDA clearance of the DSU to be used to filter biological contaminants from water or bicarbonate concentrate used in hemodialysis procedures.

On May 10, 2011, we received approval from the Therapeutic Products Directorate of Health Canada, the Canadian health regulatory agency, to market our DSU in Canada to filter out biological contaminants from water or bicarbonate solution used in hemodialysis procedures.

On July 21, 2011 the Company announced that it received 510(k) clearance from the U.S. Food and Drug Administration to market its MSU and SSU ultrafilters to filter out biological contaminants from water or bicarbonate solution used in hemodialysis procedures.

The Nephros DSU, MSU, and SSU are FDA cleared devices for the filtration of biological contaminants from water or bicarbonate concentrate used in hemodialysis procedures. Within the U.S., there are approximately 5,700 clinics providing over 50 million dialysis treatments to 370,000 patients annually. To perform hemodialysis, ultrapure water is crucial to the production of dialysate. Dialysis clinics have water purification systems; however, microbial contaminants can originate from the water treatment system, the water distribution loop, or the dialysate concentrates. Nephros ultrafilters filter out substances down to the 0.005 micron level and address dialysate contamination at crucial points; after the reverse osmosis module and at the dialysis machine entrance from the water distribution loop. Nephros ultrafilters can be used as the last step in the water purification process to ensure that ultrapure water is used for dialysis procedures. Regular use of Nephros ultrafilters offers an affordable safety measure when utilized with modern water treatment systems and optimally maintained hemodialysis machines. Recent data have shown that the Nephros DSU, when used as part of the water purification system for dialysis systems, may reduce the required dosage of erythropoietin stimulating agents, which we believe could provide a unique benefit to patients.

The Association for the Advancement of Medical Instruments' (AAMI) adoption of more stringent water purity standards for dialysis applications as well as observational studies showing a significant reduction in required erythropoietin dosing when the Nephros DSU is utilized during dialysis therapy has increased interest in the product. We expect to realize accelerating product sales to the U.S. dialysis market as a combined result of these driving factors. We also expect to realize initial sales of DSU products to dialysis markets outside the U.S. in 2012.

We also believe our in-line DSU can offer a robust solution to a broad range of contaminated water and disease prevention issues. Hospitals are particularly stringent in their water quality requirements; transplant patients and other individuals whose immune systems are compromised can face a substantial infection risk in drinking or bathing with standard tap water that would generally not present a danger to individuals with normal immune function. The DSU is designed to remove a broad range of bacteria, viral agents and toxic substances, including salmonella, hepatitis,

cholera, HIV, Ebola virus, ricin toxin, legionella, fungi and e-coli. With over 5,800 registered hospitals in the United States alone (as reported by the American Hospital Association in Fast Facts of January 3, 2012), we believe the in-line hospital shower and faucet market can offer us a valuable opportunity in water filtration.

We have introduced product line extensions for the hospital infection control market which include a more durable filter design to withstand the higher pressures of hospital plumbing, filter covers to improve the aesthetics of the filters in hospital showers, and the SafeSpout and SafeShower Ultrafilters as convenient point-of-use filters to address acute outbreak scenarios.

In 2006, the U.S. Defense Department budget included an appropriation for the U.S. Marine Corps for development of a dual stage water ultra-filter. In connection with this Federal appropriation of approximately \$1 million, we worked on the development of a personal potable water purification system for use by warfighters. Work on this project was completed in August 2009 and we billed approximately \$900,000 during the twenty months ended August 2009. In August 2009, we were awarded a new \$1.849 million research contract from the Office of Naval Research (ONR) for continued development of a potable dual-stage military water purifying filter. The research contract is an expansion of our former ONR contract and is being performed as part of the Marine Corps Advanced Technology Demonstration (ATD) project. The primary objective of this expanded research program is to select concepts and functional prototype filter/pump units which were developed during the first phase of the project, and further develop them into smaller field-testable devices that can be used for military evaluation purposes. An advantage of our ultrafilter is the removal of viruses which are not removed with commercially available off-the-shelf microfilter devices. Such devices generally rely on a secondary chemical disinfection step to make the water safe to drink. The expanded contract also includes research geared toward improving membrane performance, improving device durability, developing larger squad-level water purifier devices, and investigating desalination filter/pump devices for emergency-use purposes. Approximately \$1,849,000 of revenue has been recognized on this new project since September 2009. This project has been completed as of March 31, 2012.

During 2010, in response to a Request For Information (RFI) from the U.S. Army, we submitted our UF-40 ultrafilter for consideration as part of the standard issue hydration pack for soldiers in the field. We have been informed by the U.S. Army Public Health Command that our UF-40 filter has been validated to meet the military's NSF P248 standard for emergency military operations as a microbiological water purifier. We believe that our UF-40 filter is the only stand-alone filter to date to have met the performance criteria of the NSF P248 standard without secondary disinfection steps. The Army has not to date issued a Request For Proposal (RFP), and we have no confirmation regarding when or if an RFP applicable to the UF-40 ultrafilter may be put forth by the U.S. Army.

We have also introduced the DSU to various government agencies as a solution to providing potable water in certain emergency response situations. We have also begun investigating a range of commercial, industrial and retail opportunities for our DSU technology.

In March 2010, we entered into a development agreement with STERIS Corporation to jointly develop filtration-based products for medical device applications. We received an initial payment upon entering into the agreement of \$40,000 and were eligible to receive additional payments upon successful completion of product development milestones. During 2010, we completed the initial milestone under the joint collaboration agreement with STERIS Corporation and completed the remaining milestones under the agreement during the first three quarters of 2011. Completion of these milestones resulted in aggregate payments to us of \$100,000 during 2010, of which approximately \$67,000 was recognized in 2010 and approximately \$33,000 was recognized in 2011.

On June 27, 2011, the Company entered into a license agreement, effective July 1, 2011, with Bellco S.r.l., as licensee, an Italy-based supplier of hemodialysis and intensive care products, for the manufacturing, marketing and sale of Nephros' patented mid-dilution dialysis filters (MD 190, MD 220), referred to herein as the Products.

Under the agreement, Nephros granted Bellco a license to manufacture, market and sell the Products under its own name, label and CE mark in Italy, France, Belgium, Spain and Canada on an exclusive basis, and to do the same on a non-exclusive basis in the United Kingdom and Greece and, upon the written approval of Nephros, other European countries where Nephros does not sell the Products as well as non-European countries, all such countries herein referred to as the Territory. In addition, if requested by Nephros, Bellco will be required to sell the Products to Nephros' distributors in the Territory.

In exchange for the rights granted to it under the agreement through December 31, 2014, Bellco agreed to pay Nephros installment payments of €500,000, €750,000, and €600,000 on July 1, 2011, January 15, 2012 and January 15, 2013, respectively. The first two fixed payments have been received. Such installment payments, herein referred to as the Installment Payments, are Bellco's sole financial obligations through December 31, 2014. Beginning on January 1, 2015 through and including December 31, 2016, Bellco will pay to Nephros a royalty based on the number of units of Products sold in the Territory as follows: for the first 103,000 units sold, Bellco will pay €4.50 per unit; thereafter, Bellco will pay €4.00 per unit. Bellco must meet minimum sales targets of 15,000 units in each quarter of 2015 and 2016. If Bellco fails to meet a quarterly minimum, the license in Italy, France, Belgium, Spain and Canada will, at the discretion of Nephros, convert to a non-exclusive one. All sums payable under the agreement will be paid in Euros, as adjusted to account for currency exchange fluctuations between the Euro and the U.S. dollar that occur between July 1, 2011, the effective date of the agreement, and the date of payment.

In the case where Nephros desires to pursue a Change in Control transaction (as defined in the license agreement), Bellco will have a 30-day right of first offer with respect to such acquisition, and where either party pursues a change in control transaction, it will require the acquirer to assume such party's obligations under the agreement.

If there is an infringement of any of the patents underlying the Products, Nephros will have the first right to decide whether to act to protect such patents. Where Nephros decides not to act, Bellco, upon the written consent of Nephros, will be allowed to act to protect the patents and Nephros will reimburse Bellco the reasonable expenses sustained by Bellco as a credit against royalties due under the agreement.

The term of the agreement is from July 1, 2011 through December 31, 2016, or until earlier terminated by either party as follows. Either party may terminate immediately after giving notice of a breach of any material obligation or upon the insolvency or bankruptcy of the other party, in each case that remains uncured after the expiration of a 30-day cure period. In addition, in the event the agreement is terminated by Bellco on or prior to December 31, 2014 due to a material breach by Nephros that causes any of the patents underlying the Products to lapse, Nephros will be required to reimburse Bellco any of the Installment Payments paid by Bellco prior to the date of termination. Finally, Nephros may terminate the agreement immediately for the following reasons: Bellco's failure to cure a monetary default within 30 days of being provided notice of such default; in the event any required permit of Bellco expires, is not approved, is not issued, or is terminated, revoked, withdrawn or deactivated; and in respect of any calendar year commencing January 1, 2015, if aggregate royalties payable to Nephros fall below €270,000. The parties are subject to standard indemnification obligations.

On April 20, 2012, the Company entered into an Employment Agreement (the "Employment Agreement") with Mr. John C. Houghton to become President and Chief Executive Officer of the Company, effective as of April 20, 2012. The Employment Agreement has a term of four years, ending on April 20, 2016.

Under an agreement with DHR International, an international executive search firm, Nephros paid to DHR the final cash retainer installment of \$34,000 in the second quarter of 2012.

On April 30, 2012, the Company announced it had received clearance from the FDA to market the OLpür H2H Module and OLpür MD 220 Hemodiafilter for use with a UF controlled hemodialysis machine that provides ultrapure dialysate in accordance with current ANSI/AAMI/ISO standards, for the treatment of patients with chronic renal failure in the United States.

## Financial Operations Overview

*Revenue Recognition:* Revenue is recognized in accordance with ASC Topic 605. Four basic criteria must be met before revenue can be recognized: (i) persuasive evidence that an arrangement exists; (ii) delivery has occurred or services have been rendered; (iii) the fee is fixed and determinable; and (iv) collectability is reasonably assured.

*Cost of Goods Sold:* Cost of goods sold represents the acquisition cost for the products we purchase from our third party manufacturers as well as damaged and obsolete inventory written off.

*Research and Development:* Research and development expenses consist of costs incurred in identifying, developing and testing product candidates. These expenses consist primarily of salaries and related expenses for personnel, fees of our scientific and engineering consultants and subcontractors and related costs, clinical studies, machine and product parts and software and product testing. We expense research and development costs as incurred.

*Selling, General and Administrative:* Selling, general and administrative expenses consist primarily of sales and marketing expenses as well as personnel and related costs for general corporate functions, including finance, accounting, legal, human resources, facilities and information systems expense.

## Critical Accounting Policies

The discussion and analysis of our consolidated financial condition and results of operations are based upon our condensed consolidated financial statements. These condensed consolidated financial statements have been prepared following the requirements of accounting principles generally accepted in the United States (“GAAP”) and Rule 8-03 of Regulation S-X for interim periods and require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to potential impairment of investments and share-based compensation expense. As these are condensed consolidated financial statements, you should also read expanded information about our critical accounting policies and estimates provided in “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” included in our Form 10-K for the year ended December 31, 2011. There have been no material changes to our critical accounting policies and estimates from the information provided in our Form 10-K for the year ended December 31, 2011.

## Results of Operations

### *Fluctuations in Operating Results*

Our results of operations have fluctuated significantly from period to period in the past and are likely to continue to do so in the future. We anticipate that our quarterly results of operations will be impacted for the foreseeable future by several factors including the progress and timing of expenditures related to our research and development efforts, as well as marketing expenses related to product launches. Due to these fluctuations, we believe that the period to period comparisons of our operating results are not a good indication of our future performance.

### *Three Months Ended June 30, 2012 Compared to the Three Months Ended June 30, 2011*

#### *Revenues*

Total net revenues for the three months ended June 30, 2012 were approximately \$302,000 compared to approximately \$637,000 for the three months ended June 30, 2011. Total net revenues decreased approximately \$335,000. The decrease of approximately 53% is due to decreased revenue of approximately \$329,000 in sales of our MD filters in our Target European Market, decreased revenue of approximately \$131,000 in sales related to our contract with the Office of U.S. Naval Research, \$16,000 less revenue related to the STERIS project, and decreased DSU sales revenue of approximately \$29,000. These decreases were partially offset by approximately \$170,000 in increased license revenue for the three months ended June 30, 2012 compared to the same period in 2011.

#### *Cost of Goods Sold*

Cost of goods sold was approximately \$35,000 for the three months ended June 30, 2012 compared to approximately \$434,000 for the three months ended June 30, 2011. The decrease of approximately \$399,000, or 92%, in cost of goods sold is primarily related to our contract with the Office of U.S. Naval Research, where cost of goods sold decreased by approximately \$76,000, a \$278,000 reduction in cost of sales of our MD filters in our Target European Market, and a \$45,000 decrease in cost of goods sold related to DSU sales for the three months ended June 30, 2012 compared to the same period in 2011.

#### *Research and Development*

Research and development expenses were approximately \$199,000 and \$117,000 for the three months ended June 30, 2012 and June 30, 2011, respectively. This increase of approximately \$82,000 or 70% is primarily due to an increase

in research and development personnel related costs of approximately \$45,000 and an increase in purchases of research and development materials of \$37,000 during the three months ended June 30, 2012 compared to the same period in 2011.

*Depreciation and Amortization Expense*

Depreciation and amortization expense was approximately \$42,000 for the three months ended June 30, 2012 compared to approximately \$24,000 for the three months ended June 30, 2011, an increase of 75%. The increase of approximately \$18,000 is due to an increase of \$39,000 in amortization expense related to the Medica license and supply agreement. The increase is partially offset by approximately \$21,000 less depreciation expense, primarily due to several assets having been fully depreciated as of year-end 2011 resulting in no depreciation expense for those assets during the three months ended June 30, 2012. There were no disposals of assets during the three months ended June 30, 2012.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses were approximately \$838,000 for the three months ended June 30, 2012 compared to approximately \$660,000 for the three months ended June 30, 2011, an increase of \$178,000 or 27%. The increase is due to a \$31,000 increase in US personnel costs, an increase of \$72,000 in stock compensation expense, an increase of \$36,000 in recruiting fees, an increase of \$108,000 in legal fees, an increase of \$35,000 in business travel costs, a \$10,000 increase in investor relations expense, and an increase of \$10,000 in marketing and other US administrative costs. These increases were partially offset by a reduction of \$29,000 in insurance expense, a reduction of \$12,000 in professional services fees, and a reduction of \$83,000 in marketing and administrative costs in Europe.

*Interest Income*

Interest income was approximately \$1,000 for the three months ended June 30, 2012 and 2011, respectively.

*Interest Expense*

We had no interest expense for the three months ended June 30, 2012 and June 30, 2011.

*Amortization of Debt Issuance Costs*

There was no amortization of debt issuance costs in the three months ended June 30, 2012 and June 30, 2011.

*Other income (expense)*

Other income in the amount of approximately \$57,000 for the three months ended June 30, 2012 was comprised of approximately \$18,000 of write-offs of old vendor invoices which are no longer due and approximately \$39,000 of foreign currency gain on invoices paid to and due to an international supplier. Other expense in the amount of approximately \$5,000 for the three months ended June 30, 2011 related to a foreign currency loss on invoices paid to an international supplier.

***Six Months Ended June 30, 2012 Compared to the Six Months Ended June 30, 2011***

*Revenues*

Total net revenues for the six months ended June 30, 2012 were approximately \$835,000 compared to approximately \$1,318,000 for the six months ended June 30, 2011. Total net revenues decreased approximately \$483,000. The



decrease of approximately 37% is due to decreased revenue of approximately \$731,000 in sales of our MD filters in our Target European Market, decreased revenue of approximately \$132,000 in sales related to our contract with the office of U.S. Naval Research, and \$32,000 less revenue related to the STERIS project. These decreases were partially offset by approximately \$343,000 in increased license revenue and increased DSU sales revenue of approximately \$70,000 for the six months ended June 30, 2012 compared to the same period in 2011.

#### *Cost of Goods Sold*

Cost of goods sold was approximately \$257,000 for the six months ended June 30, 2012 compared to approximately \$916,000 for the six months ended June 30, 2011. The decrease of approximately \$659,000, or 72%, in cost of goods sold is primarily related to our contract with the Office of U.S. Naval Research, where cost of goods sold decreased by approximately \$75,000, a \$580,000 reduction in cost of sales of our MD filters in our Target European Market, and a \$21,000 decrease in cost of goods sold related to the STERIS project. These decreases were partially offset by approximately \$17,000 in increased cost of goods sold related to DSU sales for the six months ended June 30, 2012 compared to the same period in 2011.

#### *Research and Development*

Research and development expenses were approximately \$344,000 and \$240,000 for the six months ended June 30, 2012 and June 30, 2011, respectively. This increase of approximately \$104,000, or 43%, is primarily due to an increase in research and development personnel related costs of approximately \$36,000 and an increase in purchases of research and development materials of \$68,000 during the six months ended June 30, 2012 compared to the same period in 2011.

#### *Depreciation and Amortization Expense*

Depreciation and amortization expense was approximately \$44,000 for the six months ended June 30, 2012 compared to approximately \$48,000 for the six months ended June 30, 2011, a decrease of 8%. The decrease of approximately \$4,000 is primarily due to approximately \$44,000 less depreciation expense which relates to several assets having been fully depreciated as of year-end 2011 resulting in no depreciation expense for those assets during the six months ended June 30, 2012. The decrease is partially offset by an increase of \$39,000 in amortization expense related to the Medica license and supply agreement. There were no disposals of assets during the six months ended June 30, 2012.

#### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses were approximately \$1,558,000 for the six months ended June 30, 2012 compared to approximately \$1,358,000 for the six months ended June 30, 2011, an increase of \$200,000 or 15%. The increase is primarily due to an \$91,000 increase in US personnel costs, an increase of \$3,000 in stock compensation expense, an increase of \$44,000 in recruiting fees, an increase of \$131,000 in legal fees, an increase of \$41,000 in business travel costs, and a \$17,000 increase in professional services fees. These increases were partially offset by a reduction of \$22,000 in insurance expense, a reduction of \$11,000 in US marketing and other administrative costs, and \$94,000 reduced marketing and administrative costs in Europe during the six months ended June 30, 2012 compared to the same period in 2011.

*Interest Income*

Interest income was approximately \$2,000 for the six months ended June 30, 2012 compared to approximately \$1,000 for the six months ended June 30, 2011.

*Interest Expense*

We had no interest expense for the six months ended June 30, 2012. Interest expense was approximately \$12,000 for the six months ended June 30, 2011. This interest relates to interest accrued on the \$500,000 senior secured note issued to Lambda Investors LLC, which was paid in March 2011.

*Amortization of Debt Issuance Costs*

There was no amortization of debt issuance costs in the six months ended June 30, 2012 as there was no debt during that period. Amortization of debt issuance costs of \$40,000 for the six months ended June 30, 2011 is associated with the senior secured note issued to Lambda Investors LLC and paid in March 2011. These capitalized costs were fully amortized as of March 31, 2011.

*Other income (expense)*

Other income in the amount of approximately \$55,000 for the six months ended June 30, 2012 was comprised of approximately \$18,000 of write-offs of old vendor invoices which are no longer due and approximately \$37,000 of foreign currency gain on invoices paid to and due to an international supplier. Other expense in the amount of approximately \$14,000 for the six months ended June 30, 2011 related to foreign currency loss on invoices paid to an international supplier.

**Liquidity and Capital Resources**

At June 30, 2012, we had an accumulated deficit of approximately \$95,579,000 and we expect to incur additional losses in the foreseeable future at least until such time, if ever, that we are able to increase product sales or licensing revenue. We have financed our operations since inception primarily through the private placements of equity and debt securities, our initial public offering, licensing revenue and the March 2011 rights offering and concurrent private placement.

Our future liquidity sources and requirements will depend on many factors, including:

- receipt of scheduled payments per the Bellco S.r.l. license agreement;
- the availability of additional financing, through the sale of equity securities or otherwise, on commercially reasonable terms or at all;
- the market acceptance of our products, and our ability to effectively and efficiently produce and market our products;
- the continued progress in and the costs of clinical studies and other research and/or development programs;
- the costs involved in filing and enforcing patent claims and the status of competitive products; and
- the cost of litigation, including potential patent litigation and any other actual or threatened litigation.

We expect to put our current capital resources to the following uses:

- for the marketing and sales of our products;
- to continue our chronic renal treatment product development;
- to pursue business opportunities with respect to our water-filtration products; and
- for working capital purposes.

At June 30, 2012, we had cash and cash equivalents totaling approximately \$987,000 and tangible assets of approximately \$2,256,000. Tangible assets consist of total assets of approximately \$4,349,000, reduced by other intangible assets (related to the Medica License and Supply Agreement) of approximately \$2,093,000.

The Company entered into a License Agreement with Bellco, as licensee, which is discussed in the Business Overview. This Agreement provides the Company with payments of €500,000, €750,000, and €600,000 on July 1, 2011, January 15, 2012 and January 15, 2013, respectively. The first two fixed payments have been received. Beginning on January 1, 2015 through and including December 31, 2016, Bellco will pay to Nephros a royalty based on the number of units of Products sold in the Territory as follows: for the first 103,000 units sold, €4.50 per unit; thereafter, €4.00 per unit. Anticipated payments from this License Agreement would be a positive source of cash flow to the Company.

Our cash flow currently is not, and historically has not been, sufficient to meet our obligations and commitments. We must seek and obtain additional financing to fund our operations. If we cannot raise sufficient capital, we will be forced to curtail our planned activities and operations or cease operations entirely. There can be no assurance that we will be able to raise sufficient capital on a timely basis or on satisfactory terms or at all.

Net cash used in operating activities was approximately \$372,000 for the six months ended June 30, 2012 compared to net cash used in operating activities of approximately \$1,088,000 for the six months ended June 30, 2011. The most significant items contributing to this decrease of approximately \$716,000 in cash used in operating activities during the six months ended June 30, 2012 compared to the six months ended June 30, 2011 are highlighted below:

- our accounts receivable decreased by approximately \$1,014,000 during the 2012 period compared to an increase of approximately \$239,000 during the 2011 period;

- our noncash stock-based compensation expense increased by approximately \$3,000 for the 2012 period compared to the 2011 period; and

- our accounts payable and accrued expenses increased by approximately \$58,000 in the aggregate in the 2012 period compared to a decrease of approximately \$274,000 in the 2011 period.

Offsetting the above changes are the following items:

- our net loss increased by approximately \$2,000 for the 2012 period compared to the 2011 period;

depreciation and amortization expense decreased by approximately \$4,000 for the 2012 period compared to the 2011 period;

our inventory increased by approximately \$21,000 during the 2012 period compared to a decrease of approximately \$410,000 during the 2011 period;

during the 2012 period, we recorded deferred revenue of approximately \$343,000, whereas deferred revenue in the 2011 period was approximately \$33,000;

during the 2012 period, we had no amortization of debt issuance costs, whereas amortization of debt issuance costs were \$40,000 during the 2011 period;

during the 2012 period, we had no noncash interest, whereas noncash interest was \$12,000 during the 2011 period; and

our prepaid expenses and other current assets increased by approximately \$23,000 in the 2012 period compared to an increase of approximately \$92,000 in the 2011 period.

Net cash used in investing activities for the six months ended June 30, 2012 was approximately \$666,000 due to \$7,000 used for the purchase of equipment and \$659,000 for the purchase of intangible assets associated with the Medica License and Supply Agreement. We used no net cash in investing activities during the 2011 comparable period.

Net cash provided by financing activities for the six months ended June 30, 2012 resulted from the exercise of warrants, providing approximately \$356,000. Net cash provided by financing activities was approximately \$2,550,000 for the six months ended June 30, 2011, resulting from the issuance of stock and warrants, providing cash of \$3,190,000, which was offset by the payment of debt of \$500,000 and the payment of deferred financing costs of \$140,000.

## Safe Harbor for Forward-Looking Statements

This report contains certain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. Such statements include statements regarding the efficacy and intended use of our technologies under development, the timelines for bringing such products to market and the availability of funding sources for continued development of such products and other statements that are not historical facts, including statements which may be preceded by the words “intends,” “may,” “will,” “plans,” “expects,” “anticipates,” “projects,” “predicts,” “estimates,” “aims,” “believes,” “hopes,” “potential” or similar words. For such statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not guarantees of future performance, are based on certain assumptions and are subject to various known and unknown risks and uncertainties, many of which are beyond our control. Actual results may differ materially from the expectations contained in the forward-looking statements. Factors that may cause such differences include the risks that:

- we may not be able to continue as a going concern;
- we may not be able to obtain funding if and when needed or on terms favorable to us in order to continue operations;
- we may not obtain appropriate or necessary regulatory approvals to achieve our business plan;
- products that appeared promising to us in research or clinical trials may not demonstrate anticipated efficacy, safety or cost savings in subsequent pre-clinical or clinical trials;
- we may encounter problems with our suppliers and manufacturers;
- we may encounter unanticipated internal control deficiencies or weaknesses or ineffective disclosure controls and procedures;
- HDF therapy may not be accepted in the United States and/or our technology and products may not be accepted in current or future target markets, which could lead to failure to achieve market penetration of our products;
- we may not be able to effectively market our products, including our HDF system;
- we may not be able to sell our chronic renal failure therapy or water filtration products at competitive prices or profitably;
- we may not be able to secure or enforce adequate legal protection, including patent protection, for our products; and
- we may not be able to achieve sales growth in key geographic markets.

More detailed information about us and the risk factors that may affect the realization of forward-looking statements, including the forward-looking statements in this Quarterly Report on Form 10-Q, is set forth in our filings with the

SEC, including our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and our other periodic reports filed with the SEC. We urge investors and security holders to read those documents free of charge at the SEC's web site at [www.sec.gov](http://www.sec.gov). We do not undertake to publicly update or revise our forward-looking statements as a result of new information, future events or otherwise, except as required by law.

### **Off-Balance Sheet Arrangements**

We did not engage in any off-balance sheet arrangements during the six month periods ended June 30, 2012 and 2011.



**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Not Required.

**Item 4. Controls and Procedures.**

**Evaluation of Disclosure Controls and Procedures**

We maintain a system of disclosure controls and procedures, as defined in Rule 13a-15(e) or Rule 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which is designed to provide reasonable assurance that information required to be disclosed in our reports filed pursuant to the Exchange Act is accumulated and communicated to management in a timely manner. Management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives. Because there are inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud have been or will be detected. At the end of the period covered by this Quarterly Report on Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, regarding the effectiveness of our disclosure controls and procedures pursuant to Securities and Exchange Act Rule 13a-15(b). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report were effective.

**Changes in Internal Control Over Financial Reporting**

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has concluded that there were no changes in our internal control over financial reporting, that occurred during the quarter ended June 30, 2012, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Through the evaluation of the Sarbanes-Oxley internal control assessment, a more structured approach, including checklists, reconciliations and analytical reviews, has been implemented to reduce risk in the financial reporting process.

## **PART II – OTHER INFORMATION**

### **Item 1. Legal Proceedings**

There are no currently pending legal proceedings and, as far as we are aware, no governmental authority is contemplating any proceeding to which we are a party or to which any of our properties is subject.

### **Item 1A. Risk Factors**

Our Annual Report on Form 10-K for the year ended December 31, 2011 includes a detailed discussion of our risk factors under the heading Item 1.A. “Risk Factors.” There were no material changes to our risk factors as discussed in Item 1.A. “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2011.

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

On June 27, 2012, a warrant holder of the Company exercised a warrant to purchase 80,854 shares of the Company’s common stock and paid the Company approximately \$32,000 in payment of the exercise price. The Company issued these shares in a transaction exempt from registration under section 4(2) of the Securities Act of 1933, as amended.

### **Item 6. Exhibits**

#### **EXHIBIT INDEX**

10.1 License and Supply Agreement dated as of April 23, 2012 between Nephros, Inc. and Medica S.p.A. (1)

10.2 Employment Agreement dated as of April 20, 2012 between Nephros, Inc. and John C. Houghton. (2)

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31.1 Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications by the Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive Data File.

(1) Incorporated by reference to Exhibit 10.1 to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on April 26, 2012.

(2) Incorporated by reference to Exhibit 10.2 to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on April 26, 2012.

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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.

NEPHROS, INC.

Date: August 14, 2012 By: /s/ John C. Houghton

Name: John C. Houghton

Title: President and Chief Executive Officer (Principal Executive Officer)

Date: August 14, 2012 By: /s/ Gerald J. Kochanski

Name: Gerald J. Kochanski

Chief Financial Officer (Principal Financial and

Accounting Officer)

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