

NEPHROS INC
Form 10-K/A
April 28, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K/A
Amendment No. 1

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

For the fiscal year ended December 31, 2010

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 specified in its charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

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

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

(201) 343-5202
(Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act:

(Title of Class)
Common Stock, \$.001 par value per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a smaller reporting company. See 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 Smaller reporting company
(Do not check if a 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

The aggregate market value of the voting stock held by non-affiliates of the registrant, as of June 30, 2010, was approximately \$9,860,000. Such aggregate market value was computed by reference to the closing price of the common stock as reported on the Over the Counter Bulletin Board on June 30, 2010. For purposes of making this calculation only, the registrant has defined affiliates as including only directors and executive officers and shareholders holding greater than 10% of the voting stock of the registrant as of June 30, 2010.

As of March 28, 2011 there were 10,065,117 shares of the registrant's common stock, \$0.001 par value, outstanding.

EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 10-K/A for Nephros, Inc. amends our Annual Report on Form 10-K for the year ended December 31, 2010 initially filed with the Securities and Exchange Commission on March 29, 2011 (the “Original Filing”).

This Amendment No. 1 is being filed to amend Item 8—Financial Statements and Supplementary Data to correct several erroneous numbers contained in the consolidated balance sheets, consolidated statements of operations and consolidated statements of changes in stockholders’ equity in the Original Filing.

This Amendment No. 1 includes currently dated certifications from the Company’s Acting Chief Executive Officer and Chief Financial Officer, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, attached as Exhibits 31.1, 31.2, 32.1 and 32.2 to this Amendment No. 1.

Except as set forth above, the Original Filing has not been amended, updated or otherwise modified. This Amendment No. 1 does not reflect events occurring after March 29, 2011, the date of the Original Filing, or modify or update those disclosures that may have been affected by subsequent events.

NEPHROS, INC. AND SUBSIDIARY

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PART II

Item 8. Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Nephros, Inc.

We have audited the accompanying consolidated balance sheets of Nephros, Inc. and Subsidiary (collectively, “the Company”) as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders’ equity and cash flows for each of the years then ended. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Nephros, Inc. and Subsidiary as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has incurred negative cash flow from operations and net losses since inception. These conditions, among others, raise substantial doubt about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note 2. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ ROTHSTEIN, KASS & COMPANY, P.C.

Roseland, New Jersey
March 28, 2011

NEPHROS, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts)

December 31, 2010 December 31, 2009

ASSETS

Current assets:

| | | |
|---|----------|----------|
| Cash and cash equivalents | \$ 240 | \$ 1,004 |
| Accounts receivable | 326 | 629 |
| Inventory, less allowances of \$18 | 726 | 653 |
| Prepaid expenses and other current assets | 190 | 135 |
| Total current assets | 1,482 | 2,421 |
| Property and equipment, net | 108 | 210 |
| Other assets | - | 21 |
| Total assets | \$ 1,590 | \$ 2,652 |

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:

| | | |
|---------------------------|--------|------|
| Short-term borrowings | \$ 500 | \$ - |
| Accounts payable | 441 | 455 |
| Accrued expenses | 481 | 239 |
| Deferred revenue | 33 | - |
| Total current liabilities | 1,455 | 694 |
| Total liabilities | 1,455 | 694 |

Commitments and Contingencies (Note 10)

Stockholders' equity:

| | | |
|---|-----------|-----------|
| Preferred stock, \$.001 par value; 5,000,000 shares authorized at December 31, 2010 and 2009; no shares issued and outstanding at December 31, 2010 and 2009 | - | - |
| Common stock, \$.001 par value; 4,500,000 authorized at December 31, 2010 and 2009; 2,090,552 and 2,080,240 shares issued and outstanding at December 31, 2010 and 2009, respectively | 2 | 2 |
| Additional paid-in capital | 92,019 | 91,855 |
| Accumulated other comprehensive income | 22 | 76 |
| Accumulated deficit | (91,908) | (89,975) |
| Total stockholders' equity | 135 | 1,958 |
| Total liabilities and stockholders' equity | \$ 1,590 | \$ 2,652 |

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

NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Share and Per Share Amounts)

| | Years Ended December 31 | |
|---|-------------------------|------------|
| | 2010 | 2009 |
| Product revenue | \$2,938 | \$2,661 |
| Cost of goods sold | 1,816 | 1,744 |
| Gross margin | 1,122 | 917 |
| Operating expenses: | | |
| Research and development | 362 | 280 |
| Depreciation and amortization | 129 | 231 |
| Selling, general and administrative | 2,520 | 2,812 |
| Total operating expenses | 3,011 | 3,323 |
| Loss from operations | (1,889) | (2,406) |
| Interest income | 1 | 9 |
| Interest expense | (15) | (2) |
| Amortization of debt issuance costs | (50) | - |
| Other income | 20 | 373 |
| Net loss | \$(1,933) | \$(2,026) |
| Net loss per common share, basic and diluted | \$(0.93) | \$(1.02) |
| Weighted average common shares outstanding, basic and diluted | 2,087,068 | 1,981,467 |

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

NEPHROS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(In Thousands, Except Share Amounts)

| | Common Stock | | Additional | Accumulated | | |
|--|--------------|--------|------------|---------------|-------------|----------|
| | Shares | Amount | Paid-in | Other | Accumulated | Total |
| | | | Capital | Income (Loss) | Deficit | |
| Balance, December 31, 2008 | 1,908,269 | \$ 2 | \$ 90,411 | \$ 70 | \$ (87,949) | \$ 2,534 |
| Comprehensive income: | | | | | | |
| Net loss | | | | | (2,026) | (2,026) |
| Net unrealized income on foreign currency translation | | | | 6 | | 6 |
| Comprehensive loss | | | | | | (2,020) |
| Cashless exercise of warrants | 91,473 | | | | | - |
| Private placement sale of common stock | 67,258 | | 1,251 | | | 1,251 |
| Exercise of stock options | 13,239 | | 85 | | | 85 |
| Noncash stock-based compensation | | | 108 | | | 108 |
| Balance, December 31, 2009 | 2,080,239 | \$ 2 | \$ 91,855 | 76 | \$ (89,975) | \$ 1,958 |
| Comprehensive income: | | | | | | |
| Net loss | | | | | (1,933) | (1,933) |
| Net unrealized losses on foreign currency translation | | | | (54) | | (54) |
| Comprehensive loss | | | | | | (1,987) |
| Exercise of stock options | 10,313 | | 72 | | | 72 |
| Noncash stock-based compensation | | | 92 | | | 92 |
| Balance, December 31, 2010 | 2,090,552 | \$ 2 | \$ 92,019 | 22 | \$ (91,908) | \$ 135 |

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

NEPHROS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

| | Years Ended December 31, | |
|--|--------------------------|------------|
| | 2010 | 2009 |
| Operating activities: | | |
| Net loss | \$(1,933) | \$(2,026) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation of property and equipment | 129 | 231 |
| Deferred revenue | 33 | - |
| Noncash stock-based compensation | 92 | 108 |
| Amortization of debt issuance costs | 50 | - |
| Noncash interest | 15 | - |
| Inventory reserve | - | 18 |
| (Increase) decrease in operating assets: | | |
| Accounts receivable | 283 | (220) |
| Inventory | (98) | 57 |
| Prepaid expenses and other current assets | (55) | 27 |
| Other assets | 21 | - |
| Increase (decrease) in operating liabilities: | | |
| Accounts payable and accrued expenses | 171 | (702) |
| Accrued severance expense | - | (105) |
| Net cash used in operating activities | (1,292) | (2,612) |
| Investing activities | | |
| Purchase of property and equipment | (30) | (28) |
| Maturities of short-term investments | - | 7 |
| Net cash used in investing activities | (30) | (21) |
| Financing activities | | |
| Proceeds from short-term borrowings | 500 | - |
| Proceeds from stock options exercised | 72 | 85 |
| Proceeds from issuance of common stock | - | 1,251 |
| Net cash provided by financing activities | 572 | 1,336 |
| Effect of exchange rates on cash | (14) | (5) |
| Net decrease in cash | (764) | (1,302) |
| Cash, beginning of year | 1,004 | 2,306 |
| Cash, end of year | \$ 240 | \$ 1,004 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest | \$ - | \$ 2 |
| Cash paid for taxes | \$ 2 | \$ 6 |

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

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Organization and Nature of Operations

Nephros, Inc. (“Nephros” or the “Company”) was incorporated under the laws of the State of Delaware on April 3, 1997. Nephros was founded by health professionals, scientists and engineers affiliated with Columbia University to develop advanced End Stage Renal Disease (“ESRD”) therapy technology and products. The Company has three products in various stages of development in the hemodiafiltration, or HDF, modality to deliver improved therapy for ESRD patients. These are the OLpur™ MDHDF filter series or “dialyzers,” designed expressly for HDF therapy, the OLpur™ H2H™, an add-on module designed to allow the most common types of hemodialysis machines to be used for HDF therapy, and the OLpur™ NS2000 system, a stand-alone hemodiafiltration machine and associated filter technology. In 2006, the Company introduced its Dual Stage Ultrafilter (“DSU”) water filter system, which represents a new and complementary product line to the Company’s existing ESRD therapy business. The DSU incorporates the Company’s unique and proprietary dual stage filter architecture.

On June 4, 2003, Nephros International Limited was incorporated under the laws of Ireland as a wholly-owned subsidiary of the Company. In August 2003, the Company established a European Customer Service and financial operations center in Dublin, Ireland.

Note 2 — Summary of Significant Accounting Policies

On January 10, 2011, the Company’s stockholders voted to implement a 1:20 reverse stock split of the Company’s common stock. The reverse split became effective on March 11, 2011. All of the share and per share amounts discussed in these financial statements on Form 10-K have been adjusted to reflect the effect of this reverse split.

Principles of Consolidation and Basis of Presentation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, Nephros International Limited. All intercompany accounts and transactions have been eliminated in consolidation.

These financial statements were approved by management and the Board of Directors and are available for issuance as of the date of the audit opinion. Subsequent events have been evaluated through this date.

Use of Estimates in the Preparation of Financial Statements

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 amounts of revenues and expenses, during the reporting period. Actual results could differ 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 consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. Based on

the Company's current cash flow projections, it will need to raise additional funds through either the licensing or sale of its technologies or additional public or private offerings of its securities. The Company continues to investigate strategic funding opportunities as they are identified. However, there is no guarantee that the Company will be able to obtain further financing. If it is unable to raise additional funds on a timely basis or at all, the Company would not be able to continue its operations.

The Company has incurred significant losses in its operations in each quarter since inception. For the years ended December 31, 2010 and 2009, the Company has incurred net losses of approximately \$1,933,000 and \$2,026,000, respectively. In addition, the Company has not generated positive cash flow from operations for the years ended December 31, 2010 and 2009. 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, the Company's results of operations and financial condition will be materially and adversely affected.

The Company's current operating plans primarily include the continued development and support of the Company's business in the European market, organizational changes necessary to begin the commercialization of the Company's water filtration business and the completion of current year milestones which are included in the Office of Naval Research appropriation.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Summary of Significant Accounting Policies – (continued)

On October 1, 2010, the Company issued a senior secured note to Lambda Investors LLC in the principal amount of \$500,000. The note bears interest at the rate of 12% per annum and matures on April 1, 2011, at which time all principal and accrued interest will be due. However, the Company has agreed to and did prepay amounts due under the note with the cash proceeds from the rights offering prior to the maturity date. On March 10, 2011 in connection with the completion of the rights offering as discussed below, the Company repaid in full the \$500,000 of principal and \$26,650 of accrued interest on the senior secured note issued to Lambda Investors LLC on October 1, 2010.

On October 1, 2010, the Company filed with the Securities and Exchange Commission a Registration Statement on Form S-1 relating to the proposed rights offering to raise up to \$3.5 million from its existing stockholders. The Company's registration statement on Form S-1 for its previously announced rights offering to its existing stockholders was declared effective on January 31, 2011 by the Securities and Exchange Commission.

On March 10, 2011 Nephros announced the completion of its rights offering and private placement that together resulted in gross proceeds of approximately \$3.2 million to Nephros. The aggregate net proceeds received by the Company from the rights offering and private placement are estimated to be approximately \$2.3 million, after deducting:(i) the estimated aggregate expenses of these transactions,(ii) the repayment of the \$500,000 note (noted above) plus all accrued interest thereon, issued to Lambda Investors, LLC, Nephros' largest stockholder, in October 2010 in connection with its loan to the Company,(iii) the payment of an 8% sourcing/transaction fee (\$40,000) in respect of the note and (iv)an aggregate of \$100,000 for reimbursement of Lambda Investors' legal fees incurred in connection with the loan and the rights offering.

The Company's stockholders subscribed for 4,964,854 (99,297,082 units pre-stock split) units in its previously announced rights offering and the Company accepted all basic subscription rights and oversubscription privileges. The units were sold at a per unit purchase price of \$0.40. Gross proceeds to the Company from the sale of these units in the rights offering was approximately \$2.0 million. The Company issued an aggregate of 4,964,854 (99,297,082 units pre-stock split) shares of its common stock and warrants to purchase an aggregate of approximately 4.6 million shares (approximately 92 million pre-stock split) of its common stock to stockholders who subscribed.

Simultaneously with the closing of the rights offering, Lambda Investors, LLC purchased in a private placement 3,009,711 units (60,194,220 units pre-stock split) at the same per unit purchase price of \$0.40, pursuant to a purchase agreement between the Company and Lambda Investors. The Company issued to Lambda Investors an aggregate of 3,009,711 shares (60,194,226 shares pre-stock split) of its common stock and warrants to purchase an aggregate of 2,782,579 shares (55,651,580 shares pre-stock split) of its common stock. The Company received approximately \$1.2 million in gross proceeds from its sale of units to Lambda Investors.

The Company effected a reverse stock split, in which every 20 shares of the Company's common stock issued and outstanding immediately prior to the effective time, which was 5:00 p.m. on March 11, 2011, were be converted into one share of common stock. Fractional shares were not issued and stockholders who otherwise would have been entitled to receive a fractional share as a result of the reverse stock split received an amount in cash equal to \$0.04 per pre-split share for such fractional interests. The number of shares of the Company's common stock issued and outstanding was reduced from approximately 201,300,000 pre-split to approximately 10,100,000 post-split. The reverse stock split was effected in connection with the Company's rights offering and private placement.

The reverse stock split was approved by the Company's stockholders at the Company's annual meeting held on January 10, 2011. The number of shares of common stock subject to outstanding stock warrants and options, and the exercise prices and conversion ratios of those securities, were automatically proportionately adjusted for the 1-for-20 ratio provided for by the reverse stock split.

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 CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Summary of Significant Accounting Policies – (continued)

Cash and Cash Equivalents

The Company invests its excess cash in bank deposits and money market accounts. The Company considers all highly liquid investments purchased with original maturities of three months or less from the date of purchase to be cash equivalents. Cash equivalents are carried at fair value, which approximate cost, and primarily consist of money market funds maintained at major U.S. financial institutions.

Accounts Receivable

The Company provides credit terms to customers in connection with purchases of the Company's products. Management periodically reviews customer account activity in order to assess the adequacy of the allowances provided for potential collection issues and returns. Factors considered include economic conditions, each customer's payment and return history and credit worthiness. Adjustments, if any, are made to reserve balances following the completion of these reviews to reflect management's best estimate of potential losses. There were no allowances for doubtful accounts at December 31, 2010 or 2009. There was no allowance for sales returns at December 31, 2010 or 2009. There were no write offs of accounts receivable to bad debt expense during 2010 or 2009.

Inventory

The Company engages third parties to manufacture and package inventory held for sale, takes title to certain inventory once manufactured, and warehouses such goods until packaged for final distribution and sale. Inventory consists of finished goods and raw materials (fiber) held at the manufacturers' facilities, and are valued at the lower of cost or market using the first-in, first-out method.

Patents

The Company has filed numerous patent applications with the United States Patent and Trademark Office and in foreign countries. All costs and direct expenses incurred in connection with patent applications have been expensed as incurred.

Property and Equipment, net

Property and equipment, net is stated at cost less accumulated depreciation. These assets are depreciated over their estimated useful lives of three to seven years using the straight line method.

Impairment for Long-Lived Assets

The Company adheres to ASC Topic 360 and periodically evaluates whether current facts or circumstances indicate that the carrying value of its depreciable assets to be held and used may be recoverable. If such circumstances are determined to exist, an estimate of undiscounted future cash flows produced by the long-lived assets, or the appropriate grouping of assets, is compared to the carrying value to determine whether impairment exists. If an asset is determined to be impaired, the loss is measured based on the difference between the asset's fair value and its carrying value. An estimate of the asset's fair value is based on quoted market prices in active markets, if available. If

quoted market prices are not available, the estimate of fair value is based on various valuation techniques, including a discounted value of estimated future cash flows. The Company reports an asset to be disposed of at the lower of its carrying value or its estimated net realizable market value. There were no impairment losses for long-lived assets recorded for the years ended December 31, 2010 and December 31, 2009.

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value due to the short-term maturity of these instruments.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Summary of Significant Accounting Policies – (continued)

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 of 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. All shipments are currently received directly by the Company's customers.

Shipping and Handling Costs

Shipping and handling costs are recorded as cost of goods sold and are approximately \$25,000 and \$19,000 for the years ended December 31, 2010 and 2009, respectively.

Research and Development Costs

Research and development costs are expensed as incurred.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with ASC Topic 718 by recognizing the fair value of stock-based compensation in the statement of operations. The fair value of the Company's stock option awards are estimated using a Black-Scholes option valuation model. This model requires the input of highly subjective assumptions and elections including expected stock price volatility and the estimated life of each award. In addition, the calculation of compensation costs requires that the Company estimate the number of awards that will be forfeited during the vesting period. The fair value of stock-based awards is amortized over the vesting period of the award. For stock-based awards that vest based on performance conditions (e.g. achievement of certain milestones), expense is recognized when it is probable that the condition will be met.

Amortization of Debt Issuance Costs

The Company accounts for debt issuance costs in accordance with ASC 835, which requires that these costs be reported in the balance sheet as deferred charges and amortized over the term of the associated debt. Amortization of debt issuance costs of \$50,000 for the year ended December 31, 2010 is associated with the senior secured note issued to Lambda Investors LLC. These capitalized costs will be fully amortized by the first quarter of 2011. There was no amortization of debt issuance costs in the year ended December 31, 2009.

Other Income

Other income in the amount of approximately \$20,000 for the year ended December 31, 2010 resulted primarily from a reversal of a prior year's accrual of approximately \$18,000 determined to no longer be necessary. Other income in

the amount of approximately \$373,000 for the year ended December 31, 2009 resulted primarily from receipt of New York State Qualified Emerging Technology Company tax refunds for years 2006 and 2007.

Income Taxes

The Company accounts for income taxes in accordance with ASC Topic 740, which requires accounting for deferred income taxes under the asset and liability method. Deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable in future years to differences between the financial statement carrying amounts and the tax basis of existing assets and liabilities.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Summary of Significant Accounting Policies – (continued)

For financial reporting purposes, the Company has incurred a loss in each period since its inception. Based on available objective evidence, including the Company's history of losses, management believes it is more likely than not that the net deferred tax assets will not be fully realizable. Accordingly, the Company provided for a full valuation allowance against its net deferred tax assets at December 31, 2010 and December 31, 2009.

ASC Topic 740 prescribes, among other things, a recognition threshold and measurement attributes for the financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a company's income tax return. ASC 740 utilizes a two-step approach for evaluating uncertain tax positions. Step one or recognition, requires a company to determine if the weight of available evidence indicates a tax position is more likely than not to be sustained upon audit, including resolution of related appeals or litigation processes, if any. Step two or measurement, is based on the largest amount of benefit, which is more likely than not to be realized on settlement with the taxing authority. The Company is subject to income tax examinations by major taxing authorities for all tax years subsequent to 2007. The adoption of the provisions of ASC 740 did not have a material impact on the Company's consolidated financial statements. During the years ended December 31, 2010 and 2009, the Company recognized no adjustments for uncertain tax positions. However, management's conclusions regarding this policy may be subject to review and adjustment at a later date based on factors including, but not limited to, on-going analyses of and changes to tax laws, regulation and interpretations, thereof.

Loss per Common Share

In accordance with ACS 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. The following securities have been excluded from the dilutive per share computation as they are antidilutive.

| | 2010 | 2009 |
|---------------|---------|---------|
| Stock options | 44,664 | 94,289 |
| Warrants | 409,591 | 409,591 |

Foreign Currency Translation

Foreign currency translation is recognized in accordance with ASC Topic 830. The functional currency of Nephros International Limited is the Euro and its translation gains and losses are included in accumulated other comprehensive income. The balance sheet is translated at the year-end rate. The statement of operations is translated at the weighted average rate for the year.

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 unrealized gains or losses on securities classified as available-for-sale and foreign currency translation adjustments. For the years ended December 31, 2010 and 2009, the comprehensive loss was approximately \$1,987,000 and \$2,020,000, respectively.

Recently Adopted Accounting Pronouncements

In December 2009, the FASB issued ASU No. 2009-17, Consolidations (Topic 810)-Improvements to Financial Reporting By Enterprises Involved with Variable Interest Entities (ASU No. 2009-17). ASU No. 2009-17 requires a qualitative approach for determining the primary beneficiary of a variable interest entity and replaces the quantitative evaluation previously set forth under FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities . This approach is focused on identifying the reporting entity that has the ability to direct the activities of a variable interest entity that most significantly affects the entity's economic performance and has the obligation to absorb the entity's losses or has the right to receive benefits from the entity. ASU No. 2009-17, among other things, will require enhanced disclosures about a reporting entity's involvement in variable interest entities. The Company adopted the pronouncement on January 1, 2010 resulting in no impact to the Company's consolidated financial statements.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 2 — Summary of Significant Accounting Policies – (continued)

In April 2010, the FASB issued an ASU, Revenue Recognition – Milestone Method, to provide guidance on (i) defining a milestone, and (ii) determining when it may be appropriate to apply the milestone method of revenue recognition for research and development transactions. The guidance becomes effective on a prospective basis for research and development milestones achieved in fiscal years beginning on or after June 15, 2010, with early adoption and retrospective application permitted. The Company does not expect that adoption will have a material effect on its results of operations and cash flows or financial position.

In February 2010, the FASB issued an amendment which requires that an SEC filer, as defined, evaluate subsequent events through the date that the financial statements are issued. The update also removed the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated. The adoption of this guidance on January 1, 2010 did not have a material effect on the Company's consolidated financial statements.

In January 2010, the FASB issued an amendment to ASC Topic 820- Improving Disclosures about Fair Value Measurements, which amends the existing fair value measurement and disclosure guidance currently included in ASC Topic 820, Fair Value Measurements and Disclosures, to require additional disclosures regarding fair value measurements. Specifically, the amendment to ASC Topic 820 requires entities to disclose the amounts of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers, the reasons for any transfer in or out of Level 3 and information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. In addition, this amendment also clarifies the requirement for entities to disclose information about both the valuation techniques and inputs used in estimating Level 2 and Level 3 fair value measurements. This amendment is effective for interim and annual reporting periods beginning after December 15, 2009, except for additional disclosures related to Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010. The adoption of this amendment did not impact the Company's consolidated financial statements.

Note 3 — Inventory

The Company's inventory components as of December 31, 2010 and 2009 were as follows:

| | December 31, | |
|-------------------------|--------------|------------|
| | 2010 | 2009 |
| Raw Materials | \$ 264,000 | \$ 257,000 |
| Finished Goods | 480,000 | 414,000 |
| Total Gross Inventory | 744,000 | 671,000 |
| Less: Inventory reserve | (18,000) | (18,000) |
| Total Inventory | \$ 726,000 | \$ 653,000 |

Note 4 — Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets as of December 31, 2010 and 2009 were as follows:

| | December 31, | |
|--|--------------|------|
| | 2010 | 2009 |

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| | | |
|---|------------|------------|
| Prepaid insurance premiums | \$ 120,000 | \$ 126,000 |
| Deferred debt issuance costs | 40,000 | - |
| Security deposit | 21,000 | - |
| Other | 9,000 | 9,000 |
| Prepaid expenses and other current assets | \$ 190,000 | \$ 135,000 |

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Property and Equipment, Net

Property and equipment as of December 31, 2010 and 2009 was as follows:

| | Life | December 31, | |
|--------------------------------|-----------|--------------|--------------|
| | | 2010 | 2009 |
| Manufacturing equipment | 3-5 years | \$ 2,029,000 | \$ 2,115,000 |
| Research equipment | 5 years | 91,000 | 91,000 |
| Computer equipment | 3-4 years | 60,000 | 62,000 |
| Furniture and fixtures | 7 years | 39,000 | 39,000 |
| Property and equipment, gross | | 2,219,000 | 2,307,000 |
| Less: accumulated depreciation | | 2,111,000 | 2,097,000 |
| Property and equipment, net | | \$ 108,000 | \$ 210,000 |

The Company contracts with a contract manufacturer (“CM”) to manufacture the Company’s ESRD therapy products. The Company owns certain manufacturing equipment located at CM’s manufacturing plant.

Depreciation expense for the years ended December 31, 2010 and 2009 was approximately \$129,000 and \$231,000, respectively, including amortization expense relating to research and development assets.

Note 6 — Accrued Expenses

Accrued expenses as of December 31, 2010 and 2009 were as follows:

| | December 31, | |
|--|--------------|------------|
| | 2010 | 2009 |
| Accrued Management Bonus | \$ — | \$ 31,000 |
| Accrued Directors’ Compensation | 77,000 | 66,000 |
| Accrued Accounting | 40,000 | 63,000 |
| Accrued Legal | 127,000 | 19,000 |
| Accrued Debt Issuance Costs and Rights Offering fees | 140,000 | — |
| Accrued Interest | 15,000 | — |
| Accrued Proxy and Annual Report fees | 42,000 | — |
| Accrued Other | 40,000 | 60,000 |
| Accrued Expenses | \$ 481,000 | \$ 239,000 |

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 — Income Taxes

A reconciliation of the income tax provision computed at the statutory tax rate to the Company's effective tax rate is as follows:

| | 2010 | 2009 |
|--|----------|----------|
| U.S. federal statutory rate | 35.00% | 35.00% |
| State & local taxes | (0.07)% | 5.90% |
| Tax on foreign operations | 1.24% | (0.88)% |
| State research and development credits | 1.02% | (14.93)% |
| Other | 5.05% | 0.79% |
| Valuation allowance | (42.24)% | (40.81)% |
| Effective tax rate | — | (14.93)% |

Significant components of the Company's deferred tax assets as of December 31, 2010 and 2009 are as follows:

| | 2010 | 2009 |
|--|---------------|---------------|
| Deferred tax assets: | | |
| Net operating loss carry forwards | \$ 23,706,000 | \$ 23,135,000 |
| Research and development credits | 994,000 | 974,000 |
| Nonqualified stock option compensation expense | 1,566,000 | 1,553,000 |
| Other temporary book – tax differences | 112,000 | (34,000) |
| Total deferred tax assets | 26,378,000 | 25,628,000 |
| Valuation allowance for deferred tax assets | (26,378,000) | (25,628,000) |
| Net deferred tax assets | \$ — | \$ — |

A valuation allowance has been recognized to offset the Company's net deferred tax asset as it is more likely than not that such net asset will not be realized. The Company primarily considered its historical loss and potential Internal Revenue Code Section 382 limitations to arrive at its conclusion that a valuation allowance was required.

At December 31, 2010, the Company had Federal, New York State and New York City income tax net operating loss carryforwards of \$64,173,000 each and foreign income tax net operating loss carryforwards of \$8,523,000. The Company also had Federal research tax credit carryforwards of \$994,000 at December 31, 2010 and \$974,000 at December 31, 2009. The Federal net operating loss and tax credit carryforwards will expire at various times between 2012 and 2026 unless utilized. During 2009, the Company received \$303,000 payroll based research and development credits from New York State.

Implementation of ASC 740 did not result in a cumulative effect adjustment to the accumulated deficit.

It is the Company's policy to report interest and penalties, if any, related to unrecognized tax benefits in income tax expense.

Note 8 — Stock Plans, Share-Based Payments and Warrants

Stock Plans

In 2000, the Company adopted the Nephros 2000 Equity Incentive Plan. In January 2003, the Board of Directors adopted an amendment and restatement of the plan and renamed it the Amended and Restated Nephros 2000 Equity Incentive Plan (the “2000 Plan”), under which 106,538 shares of common stock had been authorized for issuance upon exercise of options granted.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Stock Plans, Share-Based Payments and Warrants – (continued)

As of December 31, 2010 and 2009, 2,053 options had been issued to non-employees under the 2000 Plan and were outstanding. Such options expire at various dates through March 15, 2014, all of which are fully vested. As of December 31, 2010 and 2009, 7,230 options had been issued to employees under the 2000 Plan and were outstanding. Such options expire at various dates between January 22, 2013 and March 15, 2014, all of which are fully vested.

The Board retired the 2000 Plan in June 2004, and thereafter no additional awards may be granted under the 2000 Plan.

In 2004, the Board of Directors adopted and the Company's stockholders approved the Nephros, Inc. 2004 Stock Incentive Plan, and, in June 2005, the Company's stockholders approved an amendment to such plan (as amended, the "2004 Plan"), that increased to 40,000 the number of shares of the Company's common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan. In May 2007, the Company's stockholders approved an amendment to the 2004 Plan that increased to 65,000 the number of shares of the Company's common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan. In addition, in June 2008, the Company's stockholders approved an amendment to the 2004 Plan that increased to 134,849 the number of shares of the Company's common stock that are authorized for issuance by the Company pursuant to grants of awards under the 2004 Plan.

As of December 31, 2009, 75,879 options had been issued to employees under the 2004 Plan and were outstanding. The options expire on various dates between January 5, 2016 and December 31, 2019, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years. At December 31, 2009, there were 77,194 shares available for future grants under the 2004 Plan. As of December 31, 2009, 9,128 options had been issued to non-employees under the 2004 Plan and were outstanding. Such options expire at various dates between November 11, 2014 and August 14, 2019, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

As of December 31, 2010, 22,129 options had been issued to employees under the 2004 Plan and were outstanding. The options expire on various dates between January 5, 2016 and December 31, 2019, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years. At December 31, 2010, there were 82,535 shares available for future grants under the 2004 Plan. As of December 31, 2010, 13,253 options had been issued to non-employees under the 2004 Plan and were outstanding. Such options expire at various dates between November 11, 2014 and January 8, 2020, and vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

Share-Based Payment

Prior to the Company's initial public offering, options were granted to employees, non-employees and non-employee directors at exercise prices which were lower than the fair market value of the Company's stock on the date of grant. After the date of the Company's initial public offering, stock options are granted to employees, non-employees and non-employee directors at exercise prices equal to the fair market value of the Company's stock on the date of grant. Stock options granted have a life of 10 years. Unvested options as of December 31, 2010 currently vest upon a combination of the following: immediate vesting or straight line vesting of two or four years.

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Expense is recognized, net of expected forfeitures, over the vesting period of the options. For options that vest upon the achievement of certain milestones, expense is recognized when it is probable that the condition will be met. Stock based compensation expense recognized for the years ended December 31, 2010 and 2009 was approximately \$92,000 or less than \$0.05 per share and approximately \$108,000 or less than \$0.06 per share, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the below assumptions related to risk-free interest rates, expected dividend yield, expected lives and expected stock price volatility.

| Grant Year | Option Pricing Assumptions | | | |
|--------------------------|----------------------------|---|--------------|---|
| | 2010 | | 2009 | |
| Stock Price Volatility | 96 | % | 93% - 96 | % |
| Risk-Free Interest Rates | 2.85 | % | 2.51% - 3.04 | % |
| Expected Life (in years) | 5.75 | | 5.75 - 6.25 | |
| Expected Dividend Yield | 0 | % | 0 | % |

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Stock Plans, Share-Based Payments and Warrants – (continued)

Expected volatility is based on historical volatility of the Company's common stock at the time of grant. The risk-free interest rate is based on the U.S. Treasury yields in effect at the time of grant for periods corresponding with the expected life of the options. For the expected life, the Company is using the simplified method as described in the SEC Staff Accounting Bulletin 107. This method assumes that stock option grants will be exercised based on the average of the vesting periods and the option's life.

The total fair value of options vested during the fiscal year ended December 31, 2010 was approximately \$87,000. The total fair value of options vested during the fiscal year ended December 31, 2009 was approximately \$157,000.

The following table summarizes information about stock options outstanding and exercisable at December 31, 2010:

| Range of Exercise Price | Options Outstanding | | | Options Exercisable | | |
|--------------------------|--|--|---------------------------------|--|---------------------------------|--|
| | Number Outstanding as of December 31, 2010 | Weighted Average Remaining Contractual Life in Years | Weighted Average Exercise Price | Number Exercisable as of December 31, 2010 | Weighted Average Exercise Price | |
| \$2.60 | 1,650 | 8.02 | \$ 2.60 | 413 | \$ 2.60 | |
| \$15.00 | 12,500 | 7.25 | \$ 15.00 | 6,250 | \$ 15.00 | |
| \$15.40 – \$46.40 | 17,638 | 7.88 | \$ 21.10 | 9,714 | \$ 23.20 | |
| \$47.80 – \$96.00 | 12,876 | 2.97 | \$ 51.40 | 12,877 | \$ 51.40 | |
| Total Outstanding | 44,664 | | \$ 27.40 | 29,254 | \$ 33.60 | |

The number of new options granted in 2010 and 2009 is 4,125 and 25,354, respectively. The weighted-average fair value of options granted in 2010 and 2009 is \$0.73 and \$0.69, respectively.

The following table summarizes the option activity for the years ended December 31, 2010 and 2009:

| | Shares | Weighted Average Exercise Price |
|---|---------------|---------------------------------|
| Outstanding at December 31, 2009 | 94,289 | \$ 17.00 |
| Options granted | 4,125 | 19.00 |
| Options exercised | (10,313) | 7.00 |
| Options forfeited | (43,437) | 9.40 |
| Outstanding at December 31, 2010 | 44,664 | 27.40 |
| Expected to vest at December 31, 2010 | 43,770 | \$ 27.60 |
| Exercisable at December 31, 2010 | 29,254 | \$ 33.60 |

The aggregate intrinsic value of stock options outstanding at December 31, 2010 and the stock options vested or expected to vest is \$0. A stock option has intrinsic value, at any given time, if and to the extent that the exercise price of such stock option is less than the market price of the underlying common stock at such time. The weighted-average remaining contractual life of options vested or expected to vest is 6.3 years.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Stock Plans, Share-Based Payments and Warrants – (continued)

As of December 31, 2010, the total remaining unrecognized compensation cost related to non-vested stock options amounted to \$129,000 and will be amortized over the weighted-average remaining requisite service period of 2.0 years.

Warrants

Class D Warrants — The Company issued Class D Warrants to purchase an aggregate of 455,628 shares of the Company's common stock to the Investors upon conversion of the purchased notes. The Company recorded the issuance of the Class D Warrants at their approximate fair market value of \$3,763,000. The value of the Class D Warrants was computed using the Black-Scholes option pricing model.

Placement Agent Warrants — The Company issued placement agent warrants to purchase an aggregate of 87,819 shares of the Company's common stock to the Company's placement agents in connection with their roles in the Company's fall 2007 financing ("the 2007 Financing"). The Company recorded the issuance of the placement agent warrants at their approximate fair market value of \$1,047,000. The value of the placement agent warrants was computed using the Black-Scholes option pricing model.

The following table summarizes certain terms of all of the Company's outstanding warrants at December 31, 2010 and 2009:

Total Outstanding Warrants at December 31, 2010

| Title of Warrant | Date Issued | Expiry Date | Exercise Price | Total Common Shares Issuable | |
|--------------------------------|-------------|-------------|----------------|------------------------------|---------|
| | | | | 2010 | 2009 |
| Class D Warrants | 11/14/2007 | 11/14/2012 | \$ 14.10 | 369,478 | 369,478 |
| Placement Agent Warrants | 11/14/2007 | 11/14/2012 | \$ 18.00 | 6,484 | 6,484 |
| July 2009 Warrants | 7/24/2009 | 7/24/2014 | \$ 22.40 | 33,629 | 33,629 |
| Total all Outstanding Warrants | | | | 409,591 | 409,591 |

(1) Weighted average exercise price is \$14.84 for December 31, 2010 and 2009.

Issuance of Common Stock due to Class D Warrants' Cashless Exercise Provision

The Series D warrants have a cashless exercise provision which states, "If, and only if, at the time of exercise pursuant to this Section 1 there is no effective registration statement registering, or no current prospectus available for, the sale of the Warrant Shares to the Holder or the resale of the Warrant Shares by the Holder and the VWAP (as defined below) is greater than the Per Share Exercise Price at the time of exercise, then this Warrant may also be exercised at such time and with respect to such exercise by means of a "cashless exercise" in which the Holder shall be entitled to receive a certificate for the number of Warrant Shares equal to the quotient obtained by dividing (i) the result of (x) the difference of (A) minus (B), multiplied by (y) (C), by (ii) (A), where:

(A) =

the VWAP (as defined below) on the Trading Day (as defined below) immediately preceding the date of such election;

(B) =the Per Share Exercise Price of this Warrant, as adjusted; and

(C)the number of Warrant Shares issuable upon exercise of this Warrant in accordance with the terms of this =Warrant by means of a cash exercise rather than a cashless exercise.

“VWAP” means, for any date, the price determined by the first of the following clauses that applies: (a) if the Common Stock is then listed or quoted for trading on the New York Stock Exchange, American Stock Exchange, NASDAQ Capital Market, NASDAQ Global Market, NASDAQ Global Select Market or the OTC Bulletin Board, or any successor to any of the foregoing (a “ Trading Market ”), the daily volume weighted average price of the Common Stock on the Trading Market on which the Common Stock is then listed or quoted for trading as reported by Bloomberg L.P. for such date if such date is a date on which the Trading Market on which the Common Stock is then listed or quoted for trading (a “ Trading Day ”) or the nearest preceding Trading Date (based on a Trading Day from 9:30 a.m. (New York City time) to 4:02 p.m. (New York City time)); (b) if the Common Stock is not then listed or quoted for trading on a Trading Market and if prices for the Common Stock are then reported in the “Pink Sheets” published by Pink Sheets, LLC (or a similar organization or agency succeeding to its functions of reporting prices), the most recent bid price per share of the Common Stock so reported; or (c) in all other cases, the fair market value of a share of Common Stock as determined by an independent appraiser selected in good faith by the Holder and reasonably acceptable to the Company.”

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 8 — Stock Plans, Share-Based Payments and Warrants – (continued)

The Company did not have an effective registration statement or a current prospectus available for the sale of the warrant shares to the holder or the resale of the warrant shares by the holder and the VWAP (as defined above) was greater than the per share exercise price from June 8 through August 26, 2009.

A Class D warrant holder elected to exercise 86,150 of the 455,628 Class D Warrants outstanding as of June 2009 pursuant to the cashless exercise provision of the warrant. As a result, 54,561 shares of common stock were issued to this Class D warrant holder in August 2009. The number of shares outstanding in the December 31, 2010 balance sheet and the number of shares outstanding used in the earnings per share calculation for the twelve months ended December 31, 2010 include these shares.

Issuance of Common Stock due to Placement Agent Warrants' Cashless Exercise Provision

National Securities Corporation ("NSC") and Dinosaur Securities, LLC ("Dinosaur" and together with NSC, the "Placement Agents") acted as co-placement agents in connection with the 2007 Financing pursuant to an Engagement Letter, dated June 6, 2007 and a Placement Agent Agreement dated September 18, 2007. The Placement Agents received (i) an aggregate cash fee equal to 8% of the face amount of the notes purchased in the 2007 Financing ("the Purchased Notes") and paid 6.25% to NSC and 1.75% to Dinosaur, and (ii) warrants ("Placement Agent Warrant") with a term of five years from the date of issuance to purchase 10% of the aggregate number of shares of the Company's common stock issued upon conversion of the Purchased Notes with an exercise price per share of the Company's common stock equal to \$14.10. The Company issued Placement Agents Warrants to purchase an aggregate of 87,819 shares of the Company's common stock to the Placement Agent in November 2007 in connection with their roles in the 2007 Financing.

The Placement Agent Warrants have a cashless exercise provision identical to that in the Series D Warrants.

The Company did not have an effective registration statement or a current prospectus available for the sale of the warrant shares to the holders or the resale of the warrant shares by the holders and the VWAP (as defined above) was greater than the per share exercise price from June 8 through August 26, 2009. Several Placement Agents elected to exercise the cashless exercise provision of their warrants.

Placement Agents elected to exercise 67,435 of the 87,819 Placement Agent Warrants outstanding in June 2009. All elected the Cashless Exercise provision of their warrants. As a result, 29,725 shares of common stock were issued to the Placement Agents in June 2009.

Placement Agents elected to exercise 13,900 of the 20,384 Placement Agent Warrants outstanding in June 2009. All elected the cashless exercise provision of their warrants. As a result, 7,188 shares of common stock were issued to the Placement Agents. As of December 31, 2010 there were 6,484 Placement Agent Warrants outstanding.

July 2009 Private Placement

On July 24, 2009, the Company raised gross proceeds of \$1,251,000 through the private placement to eight accredited investors of an aggregate of 67,258 shares of its common stock and warrants to purchase an aggregate of 33,629 shares of its common stock, representing 50% of the shares of common stock purchased by each investor. The

Company sold the shares to investors at a price per share equal to \$18.60. The warrants have an exercise price of \$22.40, are exercisable immediately and will terminate on July 24, 2014.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 — 401(k) Plan

The Company has established a 401(k) deferred contribution retirement plan (the “401(k) Plan”) which covers all employees. The 401(k) Plan provides for voluntary employee contributions of up to 15% of annual earnings, as defined. As of January 1, 2004, the Company began matching 100% of the first 3% and 50% of the next 2% of employee earnings to the 401(k) Plan. The Company contributed and expensed \$24,000 and \$25,000 in 2010 and 2009, respectively.

Note 10 — Commitments and Contingencies

Manufacturing and Suppliers

The Company does not intend to manufacture any of its products or components. The Company has entered into an agreement dated May 12, 2003, and amended on March 22, 2005 with a contract manufacturer (“CM”), a developer and manufacturer of medical products, to assemble and produce the Company’s OLpur MD190, MD220 or other filter products at the Company’s option. The agreement requires the Company to purchase from CM the OLpur MD190s and MD220s or other filter products that the Company directly markets in Europe, or are marketed by our distributor. In addition, CM will be given first consideration in good faith for the manufacture of OLpur MD190s, MD220s or other filter products that the Company does not directly market. No less than semiannually, CM will provide a report to representatives of both parties to the agreement detailing any technical know-how that CM has developed that would permit them to manufacture the filter products less expensively and both parties will jointly determine the actions to be taken with respect to these findings. If the fiber wastage with respect to the filter products manufactured in any given year exceeds 5%, then CM will reimburse the Company up to half of the cost of the quantity of fiber represented by excess wastage. CM will manufacture the OLpur MD190 or other filter products in accordance with the quality standards outlined in the agreement. Upon recall of any OLpur MD190 or other filter product due to CM having manufactured one or more products that fail to conform to the required specifications or having failed to manufacture one or more products in accordance with any applicable laws, CM will be responsible for the cost of recall. The agreement also requires that the Company maintain certain minimum product-liability insurance coverage and that the Company indemnify CM against certain liabilities arising out of the Company’s products that they manufacture, providing they do not arise out of CM’s breach of the agreement, negligence or willful misconduct. The term of the agreement is through May 12, 2010, with successive automatic one-year renewal terms, until either party gives the other notice that it does not wish to renew at least 90 days prior to the end of the term. The agreement may be terminated prior to the end of the term by either party upon the occurrence of certain insolvency-related events or breaches by the other party. Although the Company has no separate agreement with respect to such activities, CM has also been manufacturing the Company’s DSU in limited quantities.

The Company entered into an agreement in December 2003, and amended in June 2005, with a fiber supplier (“FS”), a manufacturer of medical and technical membranes for applications like dialysis, to continue to produce the fiber for the OLpur MDHDF filter series. Pursuant to the agreement, FS is the Company’s exclusive provider of the fiber for the OLpur MDHDF filter series in the European Union as well as certain other territories. On January 18, 2010 the FS notified the Company that they are exercising their right to terminate the supply agreement. Termination of the supply agreement was effective on July 18, 2010. The FS has continued to sell fiber to the Company while negotiations on terms of a new supply agreement have continued.

Contractual Obligations

At December 31, 2010, the Company had an operating lease that will expire on November 30, 2011 for the rental of its U.S. office and research and development facilities. The term of the rental agreement is for three years commencing December 2008 with a monthly cost of approximately \$7,423.

At December 31, 2010, the Company had an operating lease with a six month term expiring on July 1, 2011 and is renewable for six month terms with a two month notice to discontinue. The monthly cost is 500 Euro (approximately \$700).

Rent expense for the years ended December 31, 2010 and 2009 totaled \$101,000 and \$111,000, respectively.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 10 — Commitments and Contingencies (continued)

Contractual Obligations and Commercial Commitments

The following tables summarize our approximate minimum contractual obligations and commercial commitments as of December 31, 2010:

| | Total | Payments Due in Period | | | |
|----------------------|------------|------------------------|----------------|----------------|----------------------|
| | | Within 1 Year | Years 1 – 3 | Years 3 – 5 | More than 5 Years |
| Leases | \$ 87,000 | \$ 87,000 | \$ — | \$ — | — |
| Employment Contracts | 49,000 | 49,000 | | | |
| Total | \$ 136,000 | \$ 136,000 | \$ — | \$ — | — |

Note 11 — Concentration of Credit Risk

Cash and cash equivalents are financial instruments which potentially subject the Company to concentrations of credit risk. The Company deposits its cash in financial institutions. At times, such deposits may be in excess of insured limits. To date, the Company has not experienced any impairment losses on its cash and cash equivalents.

Major Customers

For the year ended December 31, 2010 and 2009, two customers accounted for 79% and 87%, respectively, of the Company's sales. In addition, as of December 31, 2010 and 2009, those customers accounted for 84% and 78%, respectively, of the Company's accounts receivable.

Note 12 — Subsequent Event

On March 10, 2011 Nephros announced the completion of its rights offering and private placement that together resulted in gross proceeds of approximately \$3.2 million to Nephros. The aggregate net proceeds received by the Company from the rights offering and private placement are estimated to be approximately \$2.3 million, after deducting the estimated aggregate expenses of these transactions, the repayment of the \$500,000 note, plus \$26,650 of accrued interest thereon, issued to Lambda Investors, LLC, Nephros' largest stockholder, in October 2010 in connection with its loan to the Company, the payment of an 8% sourcing/transaction fee (\$40,000) in respect of the note and an aggregate of \$100,000 for reimbursement of Lambda Investors' legal fees incurred in connection with the loan and the rights offering.

The Company's stockholders subscribed for 4,964,854 units (99,297,082 units pre-stock split) in the rights offering and the Company accepted all basic subscription rights and oversubscription privileges. The units were sold at a per unit purchase price of \$0.40. Gross proceeds to the Company from the sale of these units in the rights offering was approximately \$2.0 million. The Company issued an aggregate of 4,964,854 shares (99,297,082 shares pre-stock split) of its common stock and warrants to purchase an aggregate of approximately 4.6 million shares of its common stock to stockholders who subscribed.

NEPHROS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 12 — Subsequent Event (continued)

Simultaneously with the closing of the rights offering, Lambda Investors, LLC purchased in a private placement 3,009,711 units (60,194,226 units pre-stock split) at the same per unit purchase price of \$0.40, pursuant to a purchase agreement between the Company and Lambda Investors. The Company issued to Lambda Investors an aggregate of 3,009,711 shares (60,194,226 shares pre-stock split) of its common stock and warrants to purchase an aggregate of 2,782,579 shares of its common stock. The Company received approximately \$1.2 million in gross proceeds from its sale of units to Lambda Investors.

The Company effected a reverse stock split, in which every 20 shares of the Company's common stock issued and outstanding immediately prior to the effective time, which was 5:00 p.m. on March 11, 2011, were converted into one share of common stock. Fractional shares were not issued and stockholders who otherwise would have been entitled to receive a fractional share as a result of the reverse stock split received an amount in cash equal to \$0.04 per pre-split share for such fractional interests. The number of shares of the Company's common stock issued and outstanding was reduced from approximately 201,300,000 pre-split to approximately 10,100,000 post-split. The reverse stock split was effected in connection with the Company's rights offering and private placement.

The reverse stock split was approved by the Company's stockholders at the Company's annual meeting held on January 10, 2011. The number of shares of common stock subject to outstanding stock warrants and options, and the exercise prices and conversion ratios of those securities, were automatically proportionately adjusted for the 1-for-20 ratio provided for by the reverse stock split.

On March 24, 2011 the Board of Directors approved the grant of additional ten-year stock options for an aggregate of 613,500 shares to employees and Directors of the Company. The options' exercise price was set as the closing market price on March 24, 2011. The vesting schedule of the granted options are 40% immediate vesting with the remainder to be vested equally over a three year period.

On March 24, 2011 the Board of Directors approved salary adjustments and awarded bonuses to employees of the Company, including the Chief Financial Officer, effective April 1, 2011.

On March 25, 2011, the Company and Mr. Kochanski, CFO, Treasurer and Secretary executed a new three year Employment Agreement effective April 1, 2011.

Item 15. Exhibits

EXHIBIT INDEX

| Exhibit No. | Description |
|-------------|---|
| 3.1 | Fourth Amended and Restated Certificate of Incorporation of the Registrant.(5) |
| 3.2 | Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant. (13) |
| 3.3 | Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant. (13) |
| 3.4 | Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of State on November 13, 2007. (14) |
| 3.5 | Certificate of Amendment to the Fourth amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of state on October 26, 2009.(23) |
| 3.6 | Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of State on March 10, 2011. (24) |
| 3.7 | Certificate of Amendment to the Fourth Amended and Restated Certificate of Incorporation of the Registrant as filed with the Delaware Secretary of State on March 11, 2011. (24) |
| 3.8 | Second Amended and Restated By-Laws of the Registrant.(16) |
| 4.1 | Specimen of Common Stock Certificate of the Registrant.(1) |
| 4.2 | Form of Underwriter's Warrant.(1) |
| 4.3 | Warrant for the purchase of shares of common stock dated January 18, 2006, issued to Marty Steinberg, Esq., as Court-appointed Receiver for Lancer Offshore, Inc. (17) |
| 4.4 | Form of Series A 10% Secured Convertible Note due 2008 convertible into Common Stock and Warrants. (15) |
| 4.5 | Form of Series B 10% Secured Convertible Note due 2008 convertible into Common Stock.(15) |
| 4.6 | Form of Class D Warrant.(15) |
| 4.7 | Form of Placement Agent Warrant.(15) |
| 4.8 | Form of Investor Warrant issued on July 24, 2009.(22). |
| 4.9 | Form of Warrant Certificate. (27) |
| 4.10 | Form of Warrant Agreement between Nephros, Inc. and Continental Stock Transfer & Trust Company. (27) |
| 4.11 | Form of Subscription Rights Certificate. (27) |
| 10.1 | Amended and Restated 2000 Nephros Equity Incentive Plan.(1)(2) |
| 10.2 | 2004 Nephros Stock Incentive Plan.(1)(2) |
| 10.3 | Amendment No. 1 to 2004 Nephros Stock Incentive Plan.(2)(5) |
| 10.4 | Amendment No. 2 to the Nephros, Inc. 2004 Stock Incentive Plan.(14) |
| 10.5 | Form of Subscription Agreement dated as of June 1997 between the Registrant and each Purchaser of Series A Convertible Preferred Stock. (1) |
| 10.6 | Amendment and Restatement to Registration Rights Agreement, dated as of May 17, 2000 and amended and restated as of June 26, 2003, between the Registrant and the holders of a majority of Registrable Shares (as defined therein). (1) |
| 10.7 | Employment Agreement dated as of November 21, 2002 between Norman J. Barta and the Registrant. (1)(2) |
| 10.8 | Amendment to Employment Agreement dated as of March 17, 2003 between Norman J. Barta and the Registrant. (1)(2) |
| 10.9 | Amendment to Employment Agreement dated as of May 31, 2004 between Norman J. Barta and the Registrant. (1)(2) |

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- 10.10 Employment Agreement effective as of July 1, 2007 between Nephros, Inc. and Norman J. Barta. (14)
- 10.11 Form of Employee Patent and Confidential Information Agreement.(1)
- 10.12 Form of Employee Confidentiality Agreement.(1)
- 10.13 Settlement Agreement and Mutual Release dated June 19, 2002 between Plexus Services Corp. and the Registrant.(1)
- 10.14 Settlement Agreement dated as of January 31, 2003 between Lancer Offshore, Inc. and the Registrant. (1)
- 10.15 Settlement Agreement dated as of February 13, 2003 between Hermitage Capital Corporation and the Registrant. (1)
- 10.16 Supply Agreement between Nephros, Inc. and Membrana GmbH, dated as of December 17, 2003. (1)(3)

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| Exhibit No. | Description |
|-------------|---|
| 10.17 | Amended Supply Agreement between Nephros, Inc. and Membrana GmbH dated as of June 16, 2005. (3)(7) |
| 10.18 | Manufacturing and Supply Agreement between Nephros, Inc. and Medica s.r.l., dated as of May 12, 2003. (1)(3) |
| 10.19 | Manufacturing and Supply Agreement between Nephros, Inc. and Medica s.r.l., dated as of March 22, 2005. Supersedes prior Agreement dated May 12, 2003. (3)(8) |
| 10.20 | HDF-Cartridge License Agreement dated as of March 2, 2005 between Nephros, Inc. and Asahi Kasei Medical Co., Ltd. (4) |
| 10.21 | Subscription Agreement dated as of March 2, 2005 between Nephros, Inc. and Asahi Kasei Medical Co., Ltd. (4) |
| 10.22 | Non-employee Director Compensation Summary.(2)(6) |
| 10.23 | Named Executive Officer Summary of Changes to Compensation.(2)(6) |
| 10.24 | Stipulation of Settlement Agreement between Lancer Offshore, Inc. and Nephros, Inc. approved on December 19, 2005. (8) |
| 10.25 | Consulting Agreement, dated as of January 11, 2006, between the Company and Bruce Prashker. (2)(8) |
| 10.26 | Summary of Changes to Chief Executive Officer's Compensation.(2)(8) |
| 10.27 | Offer of Employment Agreement, dated as of February 28, 2006, between the Company and Mark W. Lerner. (2)(8) |
| 10.28 | Form of 6% Secured Convertible Note due 2012 for June 1, 2006 Investors.(9) |
| 10.29 | Form of Common Stock Purchase Warrant.(9) |
| 10.30 | Form of Subscription Agreement, dated as of June 1, 2006.(9) |
| 10.31 | Form of Registration Rights Agreement, dated as of June 1, 2006.(9) |
| 10.32 | Form of 6% Secured Convertible Note due 2012 for June 30, 2006 Investors.(10) |
| 10.33 | Form of Subscription Agreement, dated as of June 30, 2006.(10) |
| 10.34 | Employment Agreement between Nephros, Inc. and William J. Fox, entered into on August 2, 2006. (2)(11) |
| 10.35 | Addendum to Commercial Contract between Nephros, Inc. and Bellco S.p.A, effective as of January 1, 2007. (3)(12) |
| 10.36 | Form of Subscription Agreement between Nephros and Subscriber.(15) |
| 10.37 | Exchange Agreement, dated as of September 19, 2007, between Nephros and the Holders. (15) |
| 10.38 | Registration Rights Agreement, dated as of September 19, 2007, among Nephros and the Holders. (15) |
| 10.39 | Investor Rights Agreement, dated as of September 19, 2007, among Nephros and the Covered Holders as defined therein. (15) |
| 10.40 | Placement Agent Agreement, dated as of September 18, 2007, among Nephros, NSC and Dinosaur. (15) |
| 10.41 | License Agreement, dated October 1, 2007, between the Trustees of Columbia University in the City of New York, and Nephros. (17) |
| 10.42 | Employment Agreement, dated as of April 1, 2008, between Nephros, Inc. and Gerald Kochanski. (2) (18) |
| 10.43 | Separation Agreement and Release, dated as of April 28, 2008, between Nephros, Inc. and Mark W. Lerner. (2)(18) |
| 10.44 | Separation Agreement and Release, dated as of September 15, 2008, between Nephros, Inc. and Norman J. Barta. (2) (19) |
| 10.45 | Employment Agreement, dated as of September 15, 2008, between Nephros, Inc. and Ernest A. Elgin III. (2)(19) |
| 10.46 | Lease Agreement between Nephros, Inc. and 41 Grand Avenue, LLC dated as of November 20, 2008. (20) |
| 10.47 | Distribution Agreement between Nephros, Inc. and OLS, dated as of November 26, 2008.(21) |

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- 10.48 Lease Agreement between Nephros International LTD and Coldwell Banker Penrose & O'Sullivan dated November 30, 2008.(21)
- 10.49 Distribution Agreement between Nephros, Inc. and Aqua Services, Inc., dated as of December 3, 2008.(21)
- 10.50 Sales Management Agreement between Nephros, Inc. and Steve Adler, dated as of December 16, 2008.(21)
- 10.51 Amendment No. 3 to the Nephros, Inc. 2004 Stock Incentive Plan.(21)
- 10.52 Form of Subscription Agreement between Nephros, Inc. and various investors , dated July 24, 2009.(22)
- 10.53 Consulting Agreement between Nephros, Inc. and John Shallman, dated as of January 2, 2009. (25)
- 10.54 Authorized Representative Services Agreement between Nephros, Inc. and Donawa Lifescience Consulting Srl, dated as of June 1, 2009. (25)

- 10.55 Consulting Agreement between Nephros, Inc. and Barry A. Solomon, PhD., dated as of December 8, 2009. (25)
 - 10.56 Separation, Release and Consulting Agreement between Nephros, Inc. and Ernest A. Elgin III. (26)
 - 10.57 Senior Secured Note dated October 1, 2010 issued to Lambda Investors LLC. (27)
 - 10.58 Form of Registration Rights Agreement, dated as of September 30, 2010, by and between the Registrant and Lambda Investors LLC. (27)
 - 10.59 Purchase Agreement, dated as of October 1, 2010, by and between the Registrant and Lambda Investors LLC. (27)
 - 21.1 Subsidiaries of Registrant.(12)
 - 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 Certification by the 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 by the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
-
- (1) Incorporated by reference to Nephros, Inc.'s Registration Statement on Form S-1, File No. 333-116162.
 - (2) Management contract or compensatory plan arrangement.
 - (3) Portions omitted pursuant to a request for confidential treatment.
 - (4) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K Filed with the Securities and Exchange Commission on March 3, 2005.
 - (5) Incorporated by reference to Nephros, Inc.'s Registration Statement on Form S-8 (No. 333-127264), as filed with the Securities and Exchange Commission on August 5, 2005.
 - (6) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-QSB, filed with the Securities and Exchange Commission on May 16, 2005.
 - (7) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-QSB, filed with the Securities and Exchange Commission on August 15, 2005.
 - (8) Incorporated by reference to Nephros, Inc.'s Annual Report on Form 10-KSB, filed with the Securities and Exchange Commission on April 20, 2006.
 - (9) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on June 2, 2006.
 - (10) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on July 7, 2006.
 - (11) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on August 4, 2006.

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- (12) Incorporated by reference to Nephros, Inc.'s Annual Report on Form 10-KSB for the year ended December 31, 2006, filed with the Securities and Exchange Commission on April 10, 2007.
- (13) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-QSB for the quarter ended June 30, 2007, filed with the Securities and Exchange Commission on August 13, 2007.
- (14) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-QSB for the quarter ended September 30, 2007, filed with the Securities and Exchange Commission on November 13, 2007.

- (15) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on September 25, 2007.
- (16) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on December 3, 2007.
- (17) Incorporated by reference to Nephros, Inc.'s Annual Report on Form 10-KSB for the year ended December 31, 2007, filed with the Securities and Exchange Commission on March 31, 2008.
- (18) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2008, filed with the Securities and Exchange Commission on May 15, 2008.
- (19) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2008, filed with the Securities and Exchange Commission on November 14, 2008.
- (20) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on November 20, 2008.
- (21) Incorporated by reference to Nephros, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2008, filed with the Securities and Exchange Commission on March 31, 2009.
- (22) Incorporated by reference to Nephros, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2009, filed with the Securities and Exchange Commission on August 14, 2009.
- (23) Incorporated by reference to Nephros, Inc.'s Registration Statement on Form S-1 (No. 333-162781), as filed with the Securities and Exchange Commission on October 30, 2009.
- (24) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on March 16, 2011.
- (25) Incorporated by reference to Nephros, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2009, filed with the Securities and Exchange Commission April 2, 2010.
- (26) Incorporated by reference to Nephros, Inc.'s Current Report on Form 8-K filed with the Securities and Exchange Commission on March 30, 2010.
- (27) Incorporated by reference to Nephros, Inc.'s Registration statement on Form S-1 (No. 333-169728), as filed with the Securities and Exchange Commission on October 1, 2010.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant caused this Amendment No. 1 to the report to be signed on its behalf by the undersigned, thereunto duly authorized.

NEPHROS, INC.

Date: April 28, 2011

By: /s/ Gerald J. Kochanski

Name: Gerald J. Kochanski
Title: Chief Financial Officer