Neuralstem, Inc.
Form 10-Q
May 08, 2015

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

x Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2015

Or

¨ Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 000-1357459

NEURALSTEM, INC.

(Exact name of registrant as specified in its charter)

Delaware	**52-2007292**
State or other jurisdiction of incorporation or organization	(I.R.S. Employer Identification No.)

20271 Goldenrod Lane
Germantown, Maryland **20876**
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code **(301)-366-4841**

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. x 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). x 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.

Large accelerated filer ¨ Accelerated filer x

Non-accelerated filer ¨ (Do not check if a small 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 x No

As of April 30, 2015, there were 90,336,643 shares of common stock, $.01 par value, issued and outstanding.

Neuralstem, Inc.

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PART I

FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Neuralstem, Inc.

Unaudited Condensed Consolidated Balance Sheets

	March 31, 2015	December 31, 2014
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$13,593,461	$12,518,980
Short-term investments	15,032,419	15,007,478
Trade and other receivables	8,173	225,524
Deferred financing fees, current portion	130,677	135,694
Prepaid expenses	388,065	274,106
Total current assets	29,152,795	28,161,782
Property and equipment, net	282,057	301,265
Patents, net	1,242,026	1,233,172
Deferred financing fees, net of current portion	62,992	89,143
Other assets	59,098	58,713
Total assets	$30,798,968	$29,844,075
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable and accrued expenses	$2,129,199	$2,504,978
Accrued bonuses	225,321	646,960
Current portion of long-term debt, net of discount	1,929,010	730,012
Other current liabilities	52,856	126,745
Total current liabilities	4,336,386	4,008,695
Long-term debt, net of discount and current portion	6,954,895	8,056,470
Other long-term liabilities	146,165	59,574
Total liabilities	11,437,446	12,124,739

Commitments and contingencies (Note 6)

STOCKHOLDERS' EQUITY		
Preferred stock, 7,000,000 shares authorized, zero shares issued and outstanding	-	-
Common stock, $0.01 par value; 300 million shares authorized, 90,336,643 and 87,789,679 shares outstanding in 2015 and 2014, respectively	903,366	877,897
Additional paid-in capital	174,560,069	167,890,220
Accumulated other comprehensive income	6,013	6,000
Accumulated deficit	(156,107,926)	(151,054,781)
Total stockholders' equity	19,361,522	17,719,336
Total liabilities and stockholders' equity	$30,798,968	$29,844,075

See accompanying notes to unaudited condensed consolidated financial statements.

Neuralstem, Inc.

Unaudited Condensed Consolidated Statements of Operations and Comprehensive Loss

	Three Months Ended March 31,	
	2015	**2014**
Revenues	$ 2,917	$ 4,167
Operating expenses:		
Research and development expenses	3,182,823	1,630,365
General and administrative expenses	1,433,074	3,550,703
Total operating expenses	4,615,897	5,181,068
Operating loss	(4,612,980)	(5,176,901)
Other income (expense):		
Interest income	13,569	24,718
Interest expense	(453,734)	(432,741)
Loss from change in fair value of derivative instruments	-	(334,133)
Other income	-	-
Total other income (expense)	(440,165)	(742,156)
Net loss	$ (5,053,145)	$ (5,919,057)
Net loss per share - basic and diluted	$ (0.06)	$ (0.07)
Weighted average common shares outstanding - basic and diluted	89,654,634	85,750,298
Comprehensive loss:		
Net loss	$ (5,053,145)	$ (5,919,057)
Foreign currency translation adjustment	13	(1,264)
Comprehensive loss	$ (5,053,132)	$ (5,920,321)

See accompanying notes to unaudited condensed consolidated financial statements.

Neuralstem, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

	Three Months Ended March 31,	
	2015	**2014**
Cash flows from operating activities:		
Net loss	$ (5,053,145)	$ (5,919,057)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	83,773	90,488
Share based compensation expense	689,857	2,440,999
Amortization of deferred financing fees and debt discount	215,182	224,795
Loss from change in fair value of derivative instruments	-	334,133
Changes in operating assets and liabilities:		
Trade and other receivables	217,351	(1,359)
Prepaid expenses	(71,207)	(64,963)
Other assets	(357)	-
Accounts payable and accrued expenses	(375,988)	492,156
Accrued bonuses	(421,639)	(307,411)
Other current liabilities	(3,648)	626
Other long term liabilities	-	(3,231)
Net cash used in operating activities	(4,719,821)	(2,712,824)
Cash flows from investing activities:		
Purchases of short-term investments	(15,032,419)	(15,000,000)
Maturity of short-term investments	15,007,478	-
Patent costs	(57,283)	(112,068)
Purchase of property and equipment	(16,052)	(111,087)
Net cash used in investing activities	(98,276)	(15,223,155)
Cash flows from financing activities:		
Proceeds from issuance of common stock from warrants exercised, net	3,073,537	1,391,466
Proceeds from issuance of common stock from options exercised	-	113,000
Proceeds from sale of common stock and warrants, net of issuance costs	2,931,925	19,101,034
Payment of fees for future financing	(42,758)	-
Payment of taxes on stock option exercise	-	(426,212)
Payments of long-term debt	-	(704,818)
Payments of short-term notes payable	(70,241)	(40,772)
Net cash provided by financing activities	5,892,463	19,433,698
Effects of exchange rates on cash	115	(1,035)
Net increase in cash and cash equivalents	1,074,481	1,496,684

Cash and cash equivalents, beginning of period	12,518,980	16,846,052
Cash and cash equivalents, end of period	$ 13,593,461	$ 18,342,736
Supplemental disclosure of cash flows information:		
Cash paid for interest	$ 238,552	$ 214,622
Supplemental schedule of non cash investing and financing activities:		
Issuance of common stock for cashless exercise of warrants and options	$ 201,720	$ 1,073,663

See accompanying notes to unaudited condensed consolidated financial statements.

NEURALSTEM, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2015 AND 2014

Note 1. Basis of Presentation and Liquidity

In management's opinion, the accompanying condensed financial statements include all adjustments, consisting of normal recurring adjustments, which are necessary to present fairly our financial position, results of operations and cash flows. The condensed consolidated balance sheet at December 31, 2014, has been derived from audited financial statements as of that date. The interim results of operations are not necessarily indicative of the results that may occur for the full fiscal year. Certain information and footnote disclosure normally included in the financial statements prepared in accordance with generally accepted accounting principles in the United States of America (U.S. GAAP) have been condensed or omitted pursuant to instructions, rules and regulations prescribed by the U.S. Securities and Exchange Commission (SEC). We believe that the disclosures provided herein are adequate to make the information presented not misleading when these condensed financial statements are read in conjunction with the Financial Statements and Notes included in our Annual Report on Form 10-K for the year ended December 31, 2014, filed with the SEC, and as may be amended. Certain prior period amounts have been reclassified to conform to current year classifications. Specifically, depreciation and amortization expense is no longer shown as a separate line item; patent amortization is now included in research and development expense and fixed asset depreciation is included in general and administrative expense. Management feels that this reclassification better represents the expenses in their functional categories.

Neuralstem, Inc. is referred to as "Neuralstem," the "Company," "us," or "we" throughout this report. Our wholly-owned and controlled subsidiary located in China is consolidated in our condensed consolidated financial statements and all intercompany activity has been eliminated.

Our operations currently do not generate significant cash. Our management does not know when or if this will change. We have spent and will continue to spend substantial funds in the research, development, clinical and pre-clinical testing of the our stem cell and small molecule product candidates with the goal of ultimately obtaining approval from the United States Food and Drug Administration (the "FDA"), to market and sell our products. While we believe our long-term cash position is inadequate to fund all of the costs associated with the full range of testing and clinical trials required by the FDA for our core product candidates, we anticipate that our available cash and expected income will be sufficient to finance our current activities at least through March 31, 2016.

No assurance can be given that (i) FDA approval will ever be granted for us to market and sell our product candidates, or (ii) that if FDA approval is granted, that we will ever be able to sell our products or be profitable.

Note 2. Significant Accounting Policies and Recent Accounting Pronouncements

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP 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. The condensed financial statements include significant estimates for the expected economic life and value of our licensed technology, our net operating loss and related valuation allowance for tax purposes and our stock-based compensation related to employees and directors, consultants and investment banks, among other things. Because of the use of estimates inherent in the financial reporting process, actual results could differ significantly from those estimates.

Fair Value Measurements

The carrying amounts of our short-term financial instruments, which primarily include cash and cash equivalents, other short-term investments, accounts payable and accrued expenses, approximate their fair values due to their short maturities. The fair value of our long-term indebtedness is estimated based on the quoted prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities. The fair values of our derivative instruments were estimated using level 3 unobservable inputs. See Note 3 for further details.

Foreign Currency Translation

The functional currency of our wholly owned foreign subsidiary is its local currency. Assets and liabilities of our foreign subsidiary are translated into United States dollars based on exchange rates at the end of the reporting period; income and expense items are translated at the weighted average exchange rates prevailing during the reporting period. Translation adjustments for subsidiaries that have not been sold, substantially liquidated or otherwise disposed of are accumulated in other comprehensive income or loss, a component of stockholders' equity. Transaction gains or losses are included in the determination of net loss.

Cash, Cash Equivalents, Short-Term Investments and Credit Risk

Cash equivalents consist of investments in low risk, highly liquid money market funds and certificates of deposit with original maturities of 90 days or less. Cash deposited with banks and other financial institutions may exceed the amount of insurance provided on such deposits. If the amount of a deposit at any time exceeds the federally insured amount at a bank, the uninsured portion of the deposit could be lost, in whole or in part, if the bank were to fail.

Short-term investments consist entirely of fixed income certificates of deposit ("CDs") with original maturities of greater than 90 days and not more than one year.

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash equivalents and short-term investments. Our investment policy, approved by our Board of Directors, limits the amount we may invest in any one type of investment issuer, thereby reducing credit risk concentrations. In addition, our certificates of deposit are invested through the Certificate of Deposit Account Registry Service ("CDARS") program which reduces or eliminates our risk related to concentrations of investments above FDIC insurance levels. We limit our credit and liquidity risks through our investment policy and through regular reviews of our portfolio against our policy. To date, we have not experienced any loss or lack of access to cash in our operating accounts or to our cash equivalents and short-term investments.

Research and Development

Research and development costs are expensed as they are incurred. Research and development expenses consist primarily of costs associated exclusively with the pre-clinical development and clinical trials of our product candidates.

Income (Loss) per Common Share

Basic income (loss) per common share is computed by dividing total net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period.

For periods of net income when the effects are dilutive, diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding and the dilutive impact of all dilutive potential common shares. Dilutive potential common shares consist primarily of stock options, restricted stock units and common stock purchase warrants. The dilutive impact of potential common shares resulting from common stock equivalents is determined by applying the treasury stock method. Our unvested restricted shares contain non-forfeitable rights to dividends, and therefore are considered to be participating securities; the calculation of basic and diluted income per share excludes net income attributable to the unvested restricted shares from the numerator and excludes the impact of the shares from the denominator.

For all periods of net loss, diluted loss per share is calculated similarly to basic loss per share because the impact of all dilutive potential common shares is anti-dilutive due to the net losses; accordingly, diluted loss per share is the same as basic loss per share for the three-month periods ended March 31, 2015 and 2014. A total of approximately 39.1 million and 39.8 million potential dilutive shares have been excluded in the calculation of diluted net income per share for the three-month periods ended March 31, 2015 and 2014, respectively, as their inclusion would be anti-dilutive.

Share-Based Compensation

We account for share-based compensation at fair value. Share-based compensation cost for stock options and warrants granted to employees and board members is generally determined at the grant date while awards granted to non-employee consultants are generally valued at the vesting date using an option pricing model that uses level 3 unobservable inputs; share-based compensation cost for restricted stock and restricted stock units is determined at the grant date based on the closing price of our common stock on that date. The value of the award that is ultimately expected to vest is recognized as expense on a straight-line basis over the requisite service period.

Intangible and Long-Lived Assets

We evaluate our long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. We assess this recoverability by comparing the carrying amount of the asset to the estimated undiscounted future cash flows to be generated by the asset. If an asset is deemed to be impaired, we estimate the impairment loss by determining the excess of the asset's carrying amount over the estimated fair value. During the three months ended March 31 2015 and 2014, no significant impairment losses were recognized.

Income Taxes

We account for income taxes using the asset and liability approach, which requires the recognition of future tax benefits or liabilities on the temporary differences between the financial reporting and tax bases of our assets and liabilities. A valuation allowance is established when necessary to reduce deferred tax assets to the amounts expected to be realized. We also recognize a tax benefit from uncertain tax positions only if it is "more likely than not" that the position is sustainable based on its technical merits. Our policy is to recognize interest and penalties on uncertain tax positions as a component of income tax expense.

Significant New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued *ASU 2014-09 – Revenue from Contracts with Customers*. This guidance is effective for fiscal years beginning after December 15, 2016 and early adoption is not permitted. This guidance is to be applied retrospectively. We have not yet determined the effects of this new guidance on our financial statements.

In April 2015, the FASB issued *ASU 2015-03 – Interest-Imputation of Interest, Simplifying the Presentation of Debt Issuance Costs*. This guidance requires that deferred debt issuance costs related to a recognized debt liability be presented in the balance sheet as a deduction of the carrying amount of the debt liability (similar to debt discounts). This guidance is effective for fiscal years beginning after December 15, 2015 and early adoption is permitted. This guidance is to be applied retrospectively. This new pronouncement will result in our reclassifying amounts currently reflected as current and long-term assets to a contra-liability, which will reduce the carrying value of the associated debt instruments.

We have evaluated all additional Accounting Standards Updates through the date the financial statements were issued and believe the adoption of any new accounting and disclosure requirements will not have a material impact to our results of operations or financial position.

Note 3. Fair Value Measurements

Fair value is the price that would be received from the sale of an asset or paid to transfer a liability assuming an orderly transaction in the most advantageous market at the measurement date. U.S. GAAP establishes a hierarchical disclosure framework which prioritizes and ranks the level of observability of inputs used in measuring fair value. These levels are:

- *Level 1* – inputs are based upon unadjusted quoted prices for identical instruments traded in active markets.

- *Level 2* – inputs are based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques (e.g. the Black-Scholes model) for which all significant inputs are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign exchange rates, and forward and spot prices for currencies and commodities.

- *Level 3* – inputs are generally unobservable and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability. The fair values are therefore determined using model-based techniques, including option pricing models and discounted cash flow models. Our Level 3 non-derivative assets

primarily comprise investments in certain corporate bonds and goodwill when it is recorded at fair value due to an impairment charge.

Financial Assets and Liabilities Measured at Fair Value on a Recurring Basis

We have segregated our financial assets and liabilities that are measured at fair value into the most appropriate level within the fair value hierarchy based on the inputs used to determine the fair value at the measurement date.

The inputs used in measuring the fair value of cash and cash equivalents are considered to be Level 1 in accordance with the three-tier fair value hierarchy. The fair market values are based on period-end statements supplied by the various banks and brokers that held the majority of our funds.

We had no financial assets or liabilities measured at fair value on a recurring basis at March 31, 2015 or December 31, 2014.

The following table presents the activity for those items measured at fair value on a recurring basis using Level 3 inputs for the three months ended March 31, 2014:

	Derivative Instruments – Stock Purchase Warrants
Balance at December 31, 2013	$ 1,417,527
Change in fair value	334,133
Exercise of underlying warrants	(1,751,660)
Balance at March 31, 2014	$ -

The (gains) losses resulting from the changes in the fair value of the derivative instruments are classified as the “change in the fair value of derivative instruments” in the accompanying condensed statements of operations. The fair value of the common stock purchase warrants is determined based on the Black-Scholes option pricing model for “plain vanilla” stock options and other option pricing models as appropriate, and includes the use of unobservable inputs such as the expected term, anticipated volatility and expected dividends. Changes in any of the assumptions related to the unobservable inputs identified above may change the embedded conversion options’ fair value; increases in expected term, anticipated volatility and expected dividends generally result in increases in fair value, while decreases in these unobservable inputs generally result in decreases in fair value.

Non-Financial Assets and Liabilities Measure at Fair Value on a Recurring Basis

We have no non-financial assets or liabilities that are measured at fair value on a recurring basis.

Non-Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

We measure our long-lived assets, including property and equipment and patent assets, at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. No such fair value impairment was recognized in the three-months ended March 31, 2015 or 2014.

Note 4. Debt

In March 2013, we entered into a loan and security agreement for an initial $8 million term loan with an additional $2 million of borrowing capacity if certain conditions involving new partnerships were met. The loan is collateralized by substantially all of our assets, including our intellectual property.

The loan provided for interest at a variable rate based on prime with a floor of 11% and matured in June 2016. The variable rate was 11% and did not change during the period through the loan amendment. The loan provided for interest only payments through December 2013 at which time monthly principal and interest payments of approximately $300,000 were due through maturity. The loan resulted in net proceeds of approximately $7,551,000 after origination and other cash fees and expenses related to the closing of the loan.

In conjunction with the loan agreement, we issued the lender a five-year common stock purchase warrant to purchase 648,809 shares of common stock at an exercise price of $1.0789 per share. This warrant contained non-standard anti-dilution protection and, consequently, was being accounted for as a derivative instrument, recorded at fair market value each period (see Note 3). The allocation of proceeds to this warrant resulted in a debt discount which was amortized as interest expense over the term of the debt using the effective interest method. The warrant was exercised in the first quarter of 2014.

We also incurred expenses with various third parties in connection with the debt issuance, consisting of approximately $449,000 in cash, 350,650 shares of common stock valued at approximately $396,000, and a five-year common stock purchase warrant to purchase 648,798 shares at an exercise price of $1.07892 per share. The warrant is classified as equity. Fees related to the debt offering are recorded as deferred financing fees and are being amortized as interest expense over the term of the debt using the effective interest method.

The loan agreement provided for a conversion feature whereby the lender or the Company could each convert up to a maximum of $1 million in principal payments into common stock of the Company. In 2014, the lender elected to convert the maximum principal payments of $1 million into 805,972 shares of our common stock in accordance with the terms of the loan and security agreement.

In October 2014, we entered into an agreement with the existing lender to refinance and amend the terms of our loan and security agreement. The amended loan provided for refinancing of approximately $5.6 million of outstanding balance of the initial loan along with approximately $4.4 million of new principal for a total of $10 million in principal. The amended loan provides for a variable interest rate based on prime with a floor of 10% and matures in April 2017. The loan provides for interest only payments through September 2015; payments of principal and interest of approximately $461,000 from October 2015 through March 2017 and a final balloon payment of approximately $2.1 million in April 2017. The loan amendment generated approximately $4.3 million in net proceeds after fees and expenses. The loan amendment is accounted for as a debt extinguishment in accordance with guidance provided for in *ASC 470, Debt* resulting in a loss on extinguishment of approximately $446,000. In conjunction with the loan amendment we recorded a debt discount relating to the beneficial conversion feature. Such discount is being amortized as interest expense over the term of the debt using the effective interest method.

In conjunction with the loan amendment, we issued the lender a five-year common stock purchase warrant to purchase 75,188 shares of common stock at an exercise price of $2.66 per share. The warrant contains standard anti-dilution protection but does not contain any anti-dilution price protection for subsequent offerings. The value of the warrant was accounted for in calculating the loss on extinguishment.

We also incurred expenses with various third parties in connection with the loan amendment, consisting of approximately $86,000 in cash, 28,119 shares of common stock valued at approximately $80,000, and a three-year common stock purchase warrant to purchase 58,141 shares at an exercise price of $2.66 per share. The warrant is classified as equity and has terms substantially similar to the lender warrant. These fees related to the loan amendment are recorded as deferred financing fees and are being amortized as interest expense over the term of the debt using the effective interest method.

Note 5. Stockholders' Equity

We have granted share-based compensation awards to employees, board members and service providers. Awards may consist of common stock, restricted common stock, restricted common stock units, warrants, or stock options. Our stock options and warrants have lives of up to ten years from the grant date. The stock options and warrants vest either upon the grant date or over varying periods of time. The stock options we grant provide for option exercise prices equal to or greater than the fair market value of the common stock at the date of the grant. Restricted stock units grant the holder the right to receive fully paid common shares with various restrictions on the holder's ability to transfer the shares. Vesting of the restricted stock units is similar to that of stock options. As of March 31, 2015, we have approximately 42.7 million shares of common stock reserved for issuance upon the exercise of such awards.

Share-based compensation expense included in the statements of operations for the three months ended March 31, 2015 and 2014 was as follows:

	Three Months Ended March 31,	
	2015	**2014**
Research and development expenses	$ 278,180	$ 233,573
General and administrative expenses	411,677	2,207,426
Total	$ 689,857	$ 2,440,999

Included in general and administrative expenses for the three months ended March 31, 2014 is approximately $2.0 million related to the extension of the term of a common stock purchase warrant based on the holder achieving certain performance based milestones.

No income tax benefit was recognized in the consolidated statements of operations for stock-based compensation for the years presented due to the Company's net loss position.

Stock Options A summary of stock option activity during the three months ended March 31, 2015 and related information is included in the table below:

	Number of Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2015	18,986,395	$ 1.89	5.1	$ 2,306,807
Granted	490,901	$ 3.80		
Exercised	(9,935)	$ 2.40		$ 30,600
Forfeited	(35,065)	$ 2.40		
Outstanding at March 31, 2015	19,432,296	$ 1.94	5.0	$ 10,661,919
Exercisable at March 31, 2015	15,268,586	$ 2.03	4.2	$ 7,816,368
Vested and expected to vest	18,809,910	$ 1.97	4.9	$ 10,078,814

Range of Exercise Prices	Number of Options Outstanding	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
$0.50 - $1.00	7,000,000	$ 0.80	5.3	$ 7,700,000
$1.01 - $2.00	4,171,336	$ 1.19	6.4	2,961,919
$2.01 - $3.00	2,123,333	$ 2.50	4.5	-
$3.01 - $5.00	6,137,627	$ 3.56	3.1	-
	19,432,296	$ 1.94	5.0	$ 10,661,919

The Company uses the Black-Scholes option pricing model for “plain vanilla” options and other pricing models as appropriate to calculate the fair value of options. Significant assumptions used in these models include:

	Three Months Ended March 31,	
	2015	2014
Annual dividend	-	-
Expected life (in years)	6.0	4.0 - 8.5
Risk free interest rate	1.70% - 1.78%	1.12% - 2.50%
Expected volatility	69.3% - 69.4%	68.8% - 100.0%

The options granted in the three months ended March 31, 2015 and 2014 had weighted average grant date fair values of $2.38 and $2.09, respectively.

Unrecognized compensation cost for unvested stock option awards outstanding at March 31, 2015 was approximately $4,956,000 to be recognized over approximately 2.3 years.

RSUs We have granted restricted stock units (RSUs) to certain employees that entitle the holders to receive shares of our common stock upon vesting and subject to certain restrictions regarding the exercise of the RSUs. The fair value of RSUs granted is based upon the market price of the underlying common stock as if they were vested and issued on the date of grant.

A summary of our restricted stock unit activity for the three months ended March 31, 2015 is as follows:

	Number of RSU's	Weighted-Average Grant Date Fair Value
Outstanding at January 1, 2015	447,275	$ 2.18
Granted	-	$ -
Vested and converted to common shares	-	$ -
Forfeited	-	$ -
Outstanding at March 31, 2015	447,275	$ 2.18
Exercisable at March 31, 2015	444,150	$ 2.17

Unrecognized compensation cost for unvested RSUs outstanding at March 31, 2015 was approximately $7,000 to be recognized over approximately 0.1 years.

Stock Purchase Warrants Warrants to purchase common stock were issued to certain officers, directors, stockholders and service providers. We have also issued warrants in conjunction with debt offerings and equity raises and at various times replacement warrants were issued in conjunction with warrant exercises.

A summary of warrant activity for the three months ended March 31, 2015 follows:

	Number of Warrants	Weighted-Average Exercised Price	Weighted-Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at January 1, 2015	21,422,346	$ 2.30	3.8	$15,984,739
Granted	-			
Exercised	(1,724,606)	$ 1.94		
Forfeited	(24,794)	$ 2.13		
Outstanding at March 31, 2015	19,672,946	$ 2.34	3.8	$6,618,385
Exercisable at March 31, 2015	19,635,446	$ 2.34	3.8	$6,618,385

The stock purchase warrants granted in the three months ended March 31, 2014 had a weighted average grant date fair value of $2.08.

Common Stock

In January, 2014, we closed a registered direct offering of 6,872,859 shares of common stock at a price of $2.91 per share. We received aggregate gross proceeds of $20 million and net proceeds of approximately $18,630,000 from the offering. In connection with the offering, we also issued 3,436,435 common stock purchase warrants; the warrants have an exercise price of $3.64, a term of five years and are classified within equity. This offering was made pursuant to our $50 million shelf registration statement declared effective by the SEC on September 13, 2013 (Registration No. 333-190936). Additionally, as a result of this transaction an advisor to the Company met certain capital raising milestones and consequently, the term of their common stock purchase warrant was extended to 5 years.

In 2014, we issued 249,163 shares of common stock as a result of sales under our At the Market Offering Agreement. The shares were sold at an average price of $3.55 per share and we received approximately $838,000 in net proceeds.

In 2014, we issued a total of 1,234,428 shares of our common stock upon the exercise of outstanding common stock purchase warrants and stock options. The warrants and options were exercised at an average exercise price of $1.44. We received approximately $1,714,000 of net proceeds from the exercises.

In the 2014, we issued a total of 712,539 shares of our common stock upon the cashless and partial-cashless exercise of 1,194,372 outstanding common stock purchase warrants and stock options. The warrants and options were exercised at an average price of $1.03. We received approximately $20,000 of net proceeds from the exercises.

In 2014, we issued 568 shares of common stock upon conversion of certain outstanding RSU's. We received no proceeds from this transaction.

In 2014, we issued 805,972 shares of common stock upon the conversion by the lender of $1 million of principal payments due under our March 2013 long-term debt in accordance with the terms of the loan and security agreement (see Note 4). We received no such proceeds from this conversion.

In October 2014, we issued 28,119 shares of common stock and common stock purchase warrants to purchase 133,329 to various parties in conjunction with our loan amendment (see Note 4).

In the three months ended March 31, 2015, we issued 812,423 shares of common stock as a result of sales under our At the Market Offering Agreement. The shares were sold at an average price of $3.77 per share and we received approximately $2,932,000 in net proceeds.

In the three months ended March 31, 2015, we issued 1,705,400 shares of common stock upon the exercise of outstanding common stock purchase warrants. The warrants were exercised at an average exercise price of $1.94. We received approximately $3,074,000 of net proceeds from the exercises.

In the three months ended March 31, 2015, we issued 29,141 shares of our common stock upon the cashless exercise of 89,000 outstanding common stock purchase warrants and stock options. The warrants and options were exercised at an average price of $2.27. We received no proceeds from the exercises.

Note 6. Commitments and Contingencies

We are parties to legal proceedings that we believe to be ordinary, routine litigation incidental to the business of present or former operations. It is management's opinion, based on the advice of counsel, that the ultimate resolution of such litigation will not have a material adverse effect on our financial condition, results of operations or cash flows.

On May 7, 2008, we filed suit against StemCells, Inc., StemCells California, Inc. (collectively "StemCells") and Neurospheres Holding Ltd. in U.S. District Court for the District of Maryland, alleging that U.S. Patent No. 7,361,505 (the "'505 patent") is invalid, not infringed, and unenforceable. See Civil Action No. 08-1173. On May 13, 2008 we filed an Amended Complaint seeking declaratory judgment that U.S. Patent No. 7,155,418 (the "'418 patent") is invalid and not infringed and that certain statements made by our CEO are not trade libel or do not constitute unfair competition. On September 11, 2008, StemCells filed its answer asserting counterclaims of infringement for the '505

patent, the '418 patent, and state law claims for trade libel and unfair competition. This case was consolidated with the 2006 litigation discussed below and it is not known when, nor on what basis, this matter will be concluded.

On July 28, 2006, StemCells, Inc., filed suit against Neuralstem, Inc. in the U.S. District Court in Maryland, alleging that Neuralstem has been infringing, contributing to the infringement of, and or inducing the infringement of four patents allegedly owned by or exclusively licensed to StemCells. See Civil Action No. 06-1877. We answered the Complaint denying infringement, asserting that the patents are invalid, asserting that we have intervening rights based on amendments made to the patents during reexamination proceedings, and further asserting that some of the patents are unenforceable due to inequitable conduct. Neuralstem has also asserted counterclaims that StemCells has engaged in anticompetitive conduct in violation of antitrust laws. On February 28, 2011, Neuralstem filed a Motion to Dismiss for lack of standing and concurrently filed a Motion for Leave to Amend its Answer and Counterclaim to allege that StemCells is not the exclusive licensee of the patents-in-suit and also that Neuralstem has obtained a non-exclusive license to the patents-in-suit. In addition, before the Court decided Neuralstem's Motion to Dismiss for lack of standing, StemCells filed a motion for summary judgment on the issue standing. Neuralstem responded to that motion and cross-moved for summary judgment on the issue of standing. The Court further issued its Markman Order (an order ruling on the scope and meaning of disputed patent claim language regarding the patents at issue) on August 12, 2011. On August 26, 2011, StemCells moved for reconsideration of two terms construed in the Markman Order and that motion remains pending. On April 6, 2012 the Court granted Neuralstem's Motion for Leave to Amend to assert lack of standing and denied Neuralstem's Motion to Dismiss and Motion for Summary Judgment without prejudice. The Court also denied StemCells' Motion for Summary Judgment with prejudice. The Court stayed all other matters pending resolution of the question of standing. The case was then reassigned to Judge Roger W. Titus.

Judge Titus held a bench trial on the issue of standing and inventorship on December 9, 11, and 12, 2014. The parties filed their post-trial briefs on January 16, 2015. Judge Titus is expected to issue an order that will either resolve the case in its entirety or will allow the case to move forward to expert discovery.

Note 7. Subsequent Events

On May 5, 2015, we announced the appointment of Jonathan Lloyd Jones to the position of Chief Financial Officer, effective May 18, 2015. Mr. Lloyd Jones brings to the position more than 25 years of corporate finance and business development experience. He previously served as Chief Financial Officer at Columbia Laboratories (Juniper Pharmaceuticals), CFO and VP of Corporate Development at TetraLogic, and Senior Director, Corporate Development at Genzyme Corporation (Sanofi-Aventis). Mr. Lloyd Jones is a Chartered Accountant who holds a MBA degree from the Wharton School of the University of Pennsylvania a BS from the University of Bradford.

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

Statements in this Quarterly Report that are not strictly historical are forward-looking statements and include statements about products in development, results and analyses of pre-clinical studies, clinical trials and studies, research and development expenses, cash expenditures, and alliances and partnerships, among other matters. You can identify these forward-looking statements because they involve our expectations, intentions, beliefs, plans, projections, anticipations, or other characterizations of future events or circumstances. These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties that may cause actual results to differ materially from those in the forward-looking statements as a result of any number of factors. These factors include, but are not limited to, risks relating to our ability to conduct and obtain successful results from ongoing clinical trials, commercialize our technology, obtain regulatory approval for our product candidates, contract with third parties to adequately test and manufacture our proposed therapeutic products, protect our intellectual property rights and obtain additional financing to continue our development efforts. Some of these factors are more fully discussed, as are other factors, in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014, filed with the SEC, as well as in the section of this Quarterly Report entitled "Risk Factors" and elsewhere herein. We do not undertake to update any of these forward-looking statements or to announce the results of any revisions to these forward-looking statements except as required by law.

We urge you to read this entire Quarterly Report on Form 10-Q, including the "Risk Factors" section, the financial statements, and related notes. As used in this Quarterly Report, unless the context otherwise requires, the words "we," "us," "our," "the Company," "Neuralstem" and "Registrant" refers to Neuralstem, Inc. and its subsidiaries. Also, any reference "common shares," "common stock," or "shares" refers to our $.01 par value common stock. The information contained herein is current as of the date of this Quarterly Report (March 31, 2015), unless another date is specified. We prepare our interim financial statements in accordance with U.S. GAAP. Our financials and results of operations for the three-month period ended March 31, 2015 are not necessarily indicative of our prospective financial condition and results of operations for the pending full fiscal year ending December 31, 2015. The interim financial statements presented in this Quarterly Report as well as other information relating to our company contained in this Quarterly Report should be read in conjunction and together with the reports, statements and information filed by us with the United States Securities and Exchange Commission or SEC.

Our Management's Discussion and Analysis of Financial Condition and Results of Operations or MD&A, is provided in addition to the accompanying financial statements and notes to assist readers in understanding our results of operations, financial condition and cash flows. Our MD&A is organized as follows:

- *Executive Overview* — Discussion of our business and overall analysis of financial and other highlights affecting the Company in order to provide context for the remainder of MD&A.

- *Trends & Outlook* — Discussion of what we view as the overall trends affecting our business and overall strategy.

- *Critical Accounting Policies*— Accounting policies that we believe are important to understanding the assumptions and judgments incorporated in our reported financial results and forecasts.

- *Results of Operations*— Analysis of our financial results comparing the three-month periods ended March 31, 2015 to the comparable period of 2014.

- *Liquidity and Capital Resources*— An analysis of cash flows and discussion of our financial condition and future liquidity needs.

Executive Overview

We are focused on the development and commercialization of regenerative medicine treatments based on our human neuronal stem cells and our small molecule compounds. We are headquartered in Germantown, Maryland and have a wholly-owned and consolidated subsidiary in China, Suzhou Sun-Now Biopharmaceutical Co. Ltd., or NeuralStem China.

We have developed and maintain a portfolio of patents and patent applications that form the proprietary base for our research and development efforts. We own or exclusively license ninety-six (96) U.S. and foreign issued patents and fifty-three (53) U.S. and foreign patent applications in the field of regenerative medicine, related to our stem cell technologies as well as our small molecule compounds. At times we have licensed the use of our intellectual property to third parties.

We believe our technology, in combination with our know-how, and collaborative projects with major research institutions, will facilitate the development and commercialization of products for use in the treatment of a wide array of neurodegenerative conditions and in regenerative repair of acute disease.

Regenerative medicine is still an emerging field. Regenerative medicine is the process of creating living, functional tissues to repair or replace tissue or organ function lost due to age, disease, damage, or congenital defects. There can be no assurances that we will ultimately produce any viable commercialized products and processes. Even if we are able to produce a commercially viable product, there are strong competitors in this field and our products may not be able to successfully compete against them.

All of our research efforts to date are at the pre-clinical or clinical stage of development. We are focused on leveraging our key assets, including our intellectual property, our scientific team and our facilities, to advance our technologies. In addition, we are pursuing strategic collaborations with members of academia and industry.

Clinical Programs

We have devoted substantially all our efforts to the development of our stem cell and small molecule compounds and their pre-clinical and clinical development. Below is a description of our five most advanced clinical programs, their intended indication, current stage of development and our expected development plans:

Program	Indication	Development Status	Development Plan
NSI - 566	Amyotrophic Lateral Sclerosis (ALS)	Completion of Phase II clinical trial primarily evaluating safety.	Preparation for a controlled Phase II trial expected to commence in 2015.
NSI – 566	Chronic Spinal Cord Injury	Ongoing Phase I clinical trials.	The Phase I trial is ongoing.
NSI – 566	Motor deficits due to ischemic stroke	Completion of Phase I clinical trial evaluating safety.	The Phase II trial is expected to commence in 2015.
NSI – 189	Major Depressive Disorder	Phase II preparation underway.	The Phase II trial is expected to commence in mid 2015.
NSI-189	Cognitive Deficit in Schizophrenia	Phase Ib preparation.	The Phase Ib trial is expected to commence in 2015.

NSI - 566 (Stem Cells)

Amyotrophic Lateral Sclerosis (ALS)

Amyotrophic lateral sclerosis, or ALS, is a disease of the nerve cells in the brain and spinal cord that control voluntary muscle movement. In ALS, nerve cells (neurons) waste away or die, and can no longer send messages to muscles. This eventually leads to muscle weakening, twitching, and an inability to move the arms, legs, and body. The condition slowly gets worse. When the muscles in the chest area stop working, it becomes hard or impossible to breathe. NSI-566 is under development as a potential treatment for ALS by providing cells designed to nurture and protect the patients' remaining motor neurons; and possibly repair some of the diseased motor neurons which have not yet died. Neuralstem received orphan designation by the FDA for NSI-566 in ALS which allows more imminent FDA reviews and responses.

We commenced the Phase I trial of NSI-566 in ALS at Emory University in Atlanta Georgia. The purpose of the Phase I trial was to evaluate the safety and transplantation technique of our proposed treatment and procedure specifically in the lumbar region of the spinal cord. The last cohort received both lumbar and cervical injections. The dosing of patients in the Phase I trial, as designed, was completed in August of 2012. We commenced our Phase II clinical trial for ALS in September of 2013 primarily evaluating safety of NSI-566 cells and cervical surgeries. The Phase II dose escalation trial enrolled 15 ambulatory patients in five different dosing cohorts, under an accelerated dosing and treatment schedule for a total of 18 surgeries. Each patient in the final cohort received transplantation in both the cervical and lumbar areas with 20 injections of 400,000 cells per injection; what we consider to be the maximum safe tolerated dose. The completion of the Phase II observation period of six months after the last surgery concluded in January 2015. In March, the company announced topline data concluding that the Phase II ALS clinical trial met the primary safety endpoints and established what we believe to be the maximum safe tolerated dose of 16 million cells delivered in 40 injections. Secondary efficacy endpoints such as the Amyotrophic Lateral Sclerosis Functional Rating Scale, or ALSFRS, and grip strength were evaluated at nine months post-surgery to assess the potential therapeuitic benefit of disease stabilization. The company will proceed to a larger Phase II controlled study. Although we believe the initial data from the Phase I and II trials appears promising, any future trials may ultimately be unsuccessful.

Chronic Spinal Cord Injury

A spinal cord injury, or SCI, generally refers to any injury to the spinal cord that is caused by trauma instead of disease although in some cases, it can be the result of diseases. Chronic spinal cord injury refers to the time after the initial hospitalization. Spinal cord injuries are most often traumatic, caused by lateral bending, dislocation, rotation, axial loading, and hyperflexion or hyperextension of the cord or cauda equina. Motor vehicle accidents are the most common cause of SCIs, while other causes include falls, work-related accidents, sports injuries, and penetrations such as stab or gunshot wounds. In certain instances, SCIs can also be of a non-traumatic origin, as in the case of cancer, infection, intervertebral disc disease, vertebral injury and spinal cord vascular disease. We believe that NSI-566 may provide an effective treatment for chronic spinal cord injury by “bridging the gap” in the spinal cord circuitry created in traumatic spinal cord injury and providing new cells to help transmit the signal from the brain to points at or below the point of injury.

During the first quarter of 2013, we received authorization from the United States Food and Drug Administration, or FDA, to commence our proposed Phase I clinical trial to treat chronic spinal cord injury. The entire trial will take place at The University of California, San Diego. The trial commenced during the third quarter of 2014 and the first patient was treated in October 2014. We expect to complete enrollment in the first half of 2015 and data is expected in the fourth quarter of 2015.

Motor Deficits Due to Ischemic Stroke

Ischemic strokes, the most common type of stroke, occur as a result of an obstruction within a blood vessel supplying blood to the brain. Post-stroke motor deficits include paralysis in arms and legs and can be permanent. We believe that NSI-566 may provide an effective treatment for restoring motor deficits resulting from ischemic stroke by both creating new circuitry in the area of injury and through repairing and or nurturing diseased cells to improve function in patients.

In September of 2012, we received authorization from the FDA to commence a human clinical trial for treatment of motor deficits due to ischemic stroke. The trial is being conducted by Neuralstem China, at BaYi Brain Hospital in Beijing, China utilizing our spinal cord stem cells. The trial authorization encompasses a combined phase I/II/III design and will test direct injections of NSI-566 into the brain, the same cell product used in our recently-completed Phase II ALS trial in the United States. The trial commenced in the fourth quarter of 2013 and is designed to enroll up to 118 patients. The first phase of the trial is structured to confirm the maximum safe tolerated dose and has been fully enrolled. We expect to begin the Phase II portion of the trial in 2015.

Acute Spinal Cord Injury

In the fourth quarter of 2013 we filed an investigatory new drug application, or IND, with the Ministry of Food and Drug Safety in Korea, or MFDS, to start a trial for treatment of acute spinal cord injury (within several weeks of the injury) in Seoul Korea. If approved as submitted, this trial will treat complete patients, who are those who have no sensory or motor function below the point of the injury and also progressively incomplete patients, who have varying degrees of each. We now anticipate this trial being authorized by MFDS in 2015.

NSI - 189 (Small Molecule Pharmaceutical Compound)

Major Depressive Disorder (MDD)

Major depressive disorder, or MDD (also known as recurrent depressive disorder, clinical depression, major depression, unipolar depression, or unipolar disorder), is a mental disorder characterized by episodes of all-encompassing low mood accompanied by low self-esteem and loss of interest or pleasure in normally enjoyable activities. NSI-189 is being developed for the treatment of major depressive disorder and other psychiatric and/or cognitive impairment indications associated with hippocampal atrophy. NSI-189 is the lead compound in our neurogenic small molecule drug platform. We believe that NSI-189 may provide an effective treatment for patients suffering from MDD by structurally rebuilding the hippocampus.

In February of 2011, we commenced a Phase I clinical trial (Phase Ia portion), NSI-189, at California Clinical Trials, LLC, in Glendale, California. The purpose of the Phase Ia portion of the trial was to evaluate the safety of the drug in healthy volunteers. The Phase Ia portion tested a single oral administration of NSI-189 in 24 healthy volunteers and was completed in October of 2011. In December of 2011, we received authorization from the FDA to commence the Phase Ib randomized, dose-escalating, placebo controlled clinical trial for the treatment of MDD. The primary end points of the Phase Ib portion of the clinical trial were to determine the drug safety and tolerability in three dosages in diagnosed MDD patients. Secondary endpoints included traditional depression scales tests, cognition testing and testing for both electrophysiological and traditional plasma biomarkers for Depression. The Phase Ib trial entailed patients with MDD receiving daily doses, or placebo for 28 consecutive days followed by an eight week post dose observation period. The trial was completed and data was presented at two conferences: the American Society of Clinical Psychopharmacology Annual Meeting in Hollywood, Florida and at the International College of Neuropyschopharmacology Annual Meeting in Vancouver Canada. We are currently preparing regulatory and clinical protocol for a Phase II approximately 150 patient, multi-site clinical trial that is expected to commence in 2015. Although we believe data from the Phase Ia/b appears promising, any future trials may ultimately be unsuccessful.

Cognitive Deficit in Schizophrenia

We have expanded the NSI-189 program to include a second indication for the treatment of cognitive deficit in schizophrenia. Cognitive deficit is a prominent characteristic of schizophrenia that is correlated with the occurrence of hippocampal atrophy in this patient population. We expect the Phase Ib trial to commence in 2015.

Technology

Stem Cells

Our technology enables the isolation and large-scale expansion of human neural stem cells from all areas of the developing human brain and spinal cord, thus enabling the generation of physiologically relevant human neurons of all types. We believe that our stem cell technology will assist the body in producing new cells to replace malfunctioning or dead cells as a way to treat disease and injury. Many significant and currently untreatable human diseases arise from the loss or malfunction of specific cell types in the body. Our focus is the development of effective methods to generate replacement cells from neural stem cells. We believe that replacing damaged, malfunctioning or dead neural cells with fully functional ones may be a useful therapeutic strategy in treating many diseases and conditions of the central nervous system. We own or exclusively license thirty-eight (38) U.S. and foreign issued patents and thirty-seven (37) U.S. and foreign patent applications related to our stem cell technologies.

Small Molecule Pharmaceutical Compounds

We have developed and patented a series of small molecule compounds. We believe the low molecular weight organic compounds can efficiently cross the blood/brain barrier. In mice, research indicated that the small molecule compounds both stimulate neurogenesis of the hippocampus and increase its volume. Our collaborators at Massachusetts General Hospital have presented the human data from the MDD trial which showed clinically meaningful and statistically significant improvement in depressive and cognitive scales. We believe the small molecule compounds may assist in reversing atrophy in the human hippocampus documented in indications such as MDD and schizophrenia.

Our small molecule compounds are covered by fifty-eight (58) exclusively owned U.S. and foreign issued patents and sixteen (16) exclusively owned U.S. and foreign patent applications related to our small molecule compounds.

Research

Substantial resources are devoted to our research programs in order to isolate and develop a series of neural stem cell banks that we believe can serve as a basis for our therapeutic product candidates. Our efforts are directed at developing therapies utilizing our stem cells and small molecule regenerative drug candidates. This research is conducted internally, through the use of third party laboratories and consulting companies under our direct supervision, and through collaboration with academic institutes.

Operating Strategy

We generally employ an outsourcing strategy where we outsource our Good Laboratory Practices, or GLP, preclinical development activities and Good Manufacturing Practices, or GMP, Good Tissue Practices, or GTP, if applicable, and clinical development activities to contract research organizations or CROs and contract manufacturing organizations or CMOs as well as all non-critical corporate functions. Manufacturing is also outsourced to organizations with approved facilities and manufacturing practices. This outsource model allows us to better manage cash on hand and minimize non-vital expenditures. It also allows for us to operate with relatively fewer employees and lower fixed costs than that required by other companies conducting similar business.

Manufacturing

We currently manufacture our cells both in-house and on an outsourced basis. We outsource the manufacturing of our pharmaceutical compounds to third party manufacturers. We manufacture, in-house, cells that are not required to meet stringent FDA requirements. We use these cells in our research and collaborative programs. During 2015, we are beginning the process of bringing the manufacturing of our spinal cord stem cells, in-house to better assure availability of our stem cells as the number of patients in our trials increase. We will also continue to outsource manufacturing and storage of our stem cells and pharmaceuticals compound to be used in clinical and pre-clinical work studies to Charles River Laboratories, Inc., of Wilmington, Massachusetts, or Charles River, (stem cells) and Albany Molecular Resources, Inc., or AMRI, (small molecule). We believe both the Charles River and AMRI facilities have the capacity to be used for manufacturing under the FDA's cGMP and GTP standards, as applicable, in quantities sufficient for our current and anticipated pre-trial and clinical trial needs. We have no quantity or volume commitment with either Charles River Laboratories or AMRI and our cells and pharmaceutical compounds are ordered and manufactured on an as needed basis. As part of our plan to bring a portion of the manufacturing of our stem cells in house, we relocated our headquarters to a facility with GMP manufacturing capability. We anticipate the facility will be ready to commence manufacturing of our stem cells for our clinical trials by the second quarter of 2015. Such increased manufacturing will supplement our current outsource supply of both stem cells and pharmaceutical compounds. We believe such additional manufacturing capacity will be beneficial as our clinical trials expand by indication, geographic region and to larger patient populations and will allow us to begin to build the infrastructure in-house as we move towards complete internal control of our cell manufacturing needs.

Employees

As of March 31, 2015, we had 21 full-time employees and four (4) full-time independent contractors. Of these full-time employees and contractors, 18 work on research and development and seven (7) in administration. We also use the services of numerous outside consultants in business and scientific matters.

Our Corporate Information

We were incorporated in Delaware in 2001. Our principal executive offices are located at 20271 Goldenrod Lane, Germantown, Maryland 20876, and our telephone number is (301) 366-4841. Our website is located at www.neuralstem.com.

In addition to announcing material financial information through our investor relations website, press releases, SEC filings and public conference calls and webcasts, we also intend to use the following social media channels as a means of disclosing information about the company, its services and other matters and for complying with our disclosure

obligations under Regulation FD:

- Neuralstem's Twitter Account (https://twitter.com/Neuralstem_Inc)
- Neuralstem's Facebook Page (https://www.facebook.com/Neuralstem)
- Neuralstem's Company Blog (http://neuralstem.com/neuralstem-ceo-blog)
- Neuralstem's Google+ Page (https://plus.google.com/u/0/b/104875574397171789280/104875574397171789280/posts)
- Neuralstem's LinkedIn Company Page (http://www.linkedin.com/company/neuralstem-inc-)
- Neuralstem Asia's Tencent Weibo Account (http://t.qq.com/neuralstem)

The information we post through these social media channels may be deemed material. Accordingly, investors should monitor these accounts and the blog, in addition to following the company's press releases, SEC filings and public conference calls and webcasts. This list may be updated from time to time.

We have not incorporated by reference into this report the information in, or that can be accessed through, our website or social media channels, and you should not consider it to be a part of this report.

Trends & Outlook

Revenue

We generated no revenues from the sale of our proposed therapies for any of the periods presented. We are mainly focused on successfully managing our current clinical trials related to our stem cell technology and small molecule compounds. We are also pursuing pre-clinical studies on other central nervous system indications in preparation for potential future clinical trials.

In the first quarter of 2013 and the third quarter of 2012, we licensed the use of certain of our intellectual property to third parties. During the three-months ended March 31, 2015 and 2014, we recognized approximately $3,000 and $4,000 of revenue, respectively, related to ongoing fees under these licenses.

On a long-term basis, we anticipate that our revenue will be derived primarily from licensing fees and sales of our cell based therapy and small molecule compounds. Because we are at such an early stage in the clinical trials process, we are not yet able to accurately predict when we will have a product ready for commercialization, if ever.

Research and Development Expenses

Our research and development expenses consist primarily of contractor and personnel expenses associated with clinical trials and regulatory submissions; costs associated with preclinical activities such as proof of principle for new indications; toxicology studies; costs associated with cell processing and process development; facilities-related costs and supplies. Clinical trial expenses include payments to research organizations, contract manufacturers, clinical trial sites, consultants and laboratories for testing clinical samples.

We focus on the development of treatment candidates with potential uses in multiple indications, and use employee and infrastructure resources across several projects. Accordingly, many of our costs are not attributable to a specifically identified product and we do not account for internal research and development costs on a project-by-project basis.

For a further description of these clinical trials, see the section of this report entitled “Clinical Programs” contained in Item 2.

We expect that research and development expenses, which include expenses related to our ongoing clinical trials, will increase in the future, as funding allows and we proceed into our anticipated Phase II trials. To the extent that it is practical, we will continue to outsource much of our efforts, including product manufacture, proof of principle and pre-clinical testing, toxicology, tumorigenicity, dosing rationale, and development of clinical protocol and IND applications. This approach allows us to use the best expertise available for each task and permits staging new research projects to fit available cash resources.

We have formed a wholly owned subsidiary in the People’s Republic of China. We anticipate that this subsidiary will primarily: (i) conduct pre-clinical research with regard to proposed stem cells therapies, and (ii) oversee our approved future clinical trials in China, including the current trial to treat motor deficits due to ischemic stroke.

General and Administrative Expenses

General and administrative expenses are primarily comprised of salaries, benefits and other costs associated with our operations including, finance, human resources, information technology, public relations, legal fees, facilities and other external general and administrative services.

Critical Accounting Policies

Our consolidated financial statements have been prepared in accordance with U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Note 2 of the Notes to Condensed Consolidated Financial Statements included elsewhere herein describes the significant accounting policies used in the preparation of the financial statements. Certain of these significant accounting policies are considered to be critical accounting policies, as defined below.

A critical accounting policy is defined as one that is both material to the presentation of our financial statements and requires management to make difficult, subjective or complex judgments that could have a material effect on our financial condition and results of operations. Specifically, critical accounting estimates have the following attributes: (1) we are required to make assumptions about matters that are highly uncertain at the time of the estimate; and (2) different estimates we could reasonably have used, or changes in the estimate that are reasonably likely to occur, would have a material effect on our financial condition or results of operations.

Estimates and assumptions about future events and their effects cannot be determined with certainty. We base our estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as our operating environment changes. These changes have historically been minor and have been included in the financial statements as soon as they became known. Based on a critical assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes that our financial statements are fairly stated in accordance with U.S. GAAP, and present a meaningful presentation of our financial condition and results of operations. We believe the following critical accounting policies reflect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

Use of Estimates - Our financial statements prepared in accordance with U.S. GAAP require us to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Specifically, we have estimated the expected economic life and value of our patent technology, our net operating loss carryforward and related valuation allowance for tax purposes and our stock -based compensation expenses related to employees, directors, consultants and investment banks. Actual results could differ from those estimates.

Long Lived Intangible Assets - Our long lived intangible assets consist of our intellectual property patents including primarily legal fees associated with the filings and in defense of our patents. The assets are amortized on a straight-line basis over the expected useful life which we define as ending on the expiration of the patent group. These assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. We assess this recoverability by comparing the carrying amount of the asset to the estimated undiscounted future cash flows to be generated by the asset. If an asset is deemed to be impaired, we estimate the impairment loss by determining the excess of the asset's carrying amount over the estimated fair value. These determinations use assumptions that are highly subjective and include a high degree of uncertainty. During the three months ended March 31 2015 and 2014, no significant impairment losses were recognized.

Fair Value Measurements - The carrying amounts of our short-term financial instruments, which primarily include cash and cash equivalents, other short-term investments, accounts payable and accrued expenses, approximate their fair values due to their short maturities. The fair value of our long-term indebtedness is estimated based on the quoted prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities. The fair values of our derivative instruments were estimated using Level 3 unobservable inputs.

Share-Based Compensation - We account for share-based compensation at fair value; accordingly we expense the estimated fair value of share-based awards over the requisite service period. Share-based compensation cost for stock options and warrants issued to employees and board members is determined at the grant date while awards granted to non-employee consultants are generally valued at the vesting date using an option pricing model. Option pricing models require us to make assumptions, including expected volatility and expected term of the options. If any of the assumptions we use in the model were to significantly change, stock based compensation expense may be materially different. Share-based compensation cost for restricted stock and restricted stock units issued to employees and board members is determined at the grant date based on the closing price of our common stock on that date. The value of the award that is ultimately expected to vest is recognized as expense on a straight-line basis over the requisite service period.

RESULTS OF OPERATIONS

Comparison of Three Months Ended March 31, 2015 and 2014

Revenue

We did not generate any revenues from the sale of our products in any of the periods presented. For the three months ended March 31, 2015 and 2014, we recognized approximately $3,000 and $4,000, respectively related to the licensing of certain intellectual properties to third parties.

Operating Expenses

Operating expenses for the three months ended March 31, 2015 and 2014 were as follows:

	Three Months Ended March 31,		**Increase (Decrease)**	
	2015	**2014**	**$**	**%**
Operating Expenses				
Research and development expenses	$ 3,182,823	$ 1,630,365	$ 1,552,458	95 %
General and administrative expenses	1,433,074	3,550,703	(2,117,629)	(60)%
Total operating expenses	$ 4,615,897	$ 5,181,068	$ (565,171)	(11)%

Research and Development Expenses

The increase of approximately $1,552,000 or 95% in research and development expenses was primarily attributable to a $1,151,000 increase in project and lab expenses, a $274,000 increase in payroll and related expenses due to increased salaries and headcount and a $75,000 increase in travel and related expenses. These increased expenses are related to the expansion of our pre-clinical and clinical trial efforts and are expected to continue into subsequent periods.

General and Administrative Expenses

The decrease of approximately $2,118,000 or 60% was primarily due to a decrease of $1,796,000 in non-cash stock based compensation largely the result of an expense in the first quarter of 2014 related to a consultant achieving a performance based milestone coupled with a $466,000 decrease in legal fees primarily resulting from insurance claims related to litigation expense. These decreases are partially offset by an $86,000 increase in consulting expenses and a $74,000 increase in payroll and related expenses due to increased salaries and headcount.

Other expense

Other expense totaled approximately $440,000 and $742,000 for the three months ended March 31, 2015 and 2014, respectively. Other expense in 2015 consisted of $454,000 of interest expense principally related to our long-term debt partially offset by $14,000 of interest income.

Other expense in 2014 consisted primarily of $432,000 of interest expense principally related to our long-term debt and a $334,000 expense related to the change in fair value of the Company's warrant liabilities partially offset by $25,000 in interest income.

Liquidity and Capital Resources

Since our inception, we have financed our operations through the sales of our securities, issuance of long term debt, the exercise of investor warrants, and to a lesser degree from grants and research contracts. In January 2014, we received approximately $20 million of gross proceeds from the sale or our securities pursuant to a registered direct offering.

We will require additional capital to conduct research and development, establish and conduct clinical and pre-clinical trials, enter into commercial-scale manufacturing arrangements and to provide for marketing and distribution of our products. We cannot assure you that we will be able to secure such additional financing or that the expected income will materialize. Several factors will affect our ability to raise additional funding, including, but not limited to market conditions, interest rates and, more specifically, our progress in our exploratory, preclinical and future clinical development programs.

	Three Months Ended March 31,		Increase (Decrease)	
	2015	2014	$	%
Net cash used in operating activities	$ (4,719,821)	$ (2,712,824)	$ (2,006,997)	(74)%
Net cash used in investing activities	$ (98,276)	$ (15,223,155)	$ 15,124,879	99 %
Net cash provided by financing activities	$ 5,892,463	$ 19,433,698	$ (13,541,235)	(70)%

Our cash and short-term investment balances was approximately $28,626,000 at March 31, 2015 compared to $27,526,000 at December 31, 2014. The increase of $1,100,000 was primarily due to our raising $6,005,000, net from the issuance of our common stock from warrant exercises and from the sale of our common stock largely offset by our cash used in operations.

Net Cash Used in Operating Activities

We used approximately $4,720,000 and $2,713,000 of cash in our operating activities for the three months ended March 31, 2015 and 2014, respectively. The increase in our use of cash of approximately $2,007,000 was primarily due to an increase in our net loss as adjusted for stock based compensation coupled with changes in our operating assets and liabilities.

Net Cash Used in Investing Activities

We used approximately $98,000 and $15,223,000 of cash in connection with investment activities for the three months ended March 31, 2015 and 2014, respectively. The decrease in our use of cash of approximately $15,125,000 was primarily due to our purchase of short-term investments using the proceeds from our January 2014 registered direct offering.

Net Cash Provided by Financing Activities

Proceeds from financing activities were approximately $5,892,000 and $19,434,000 in the three months ended March 31, 2015 and 2014, respectively. The decrease of $13,541,000 was primarily the result of raising approximately $19,101,000, net from our registered direct offering and other sales of common stock and warrants in 2014 as compared to raising $2,932,000, net from the sales of our common stock in 2015. In addition, we raised approximately $3,074,000 and $1,391,000 in 2015 and 2014, respectively from the issuance of our common stock from warrant exercises. In 2014 we also made $705,000 of payments on our long term debt compared to no principal payments being due or made in 2015.

Future Liquidity and Needs

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenue to achieve or sustain profitability in the future. We do not expect to be profitable in the next several years, but rather expect to incur additional operating losses. We have limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for general and administrative expenses and other working capital requirements. We rely on cash balances and the proceeds from the offering of our securities, exercise of outstanding warrants and grants to fund our operations.

We intend to pursue opportunities to obtain additional financing in the future through the sale of our securities and additional research grants. We currently have two shelf registration statements that are effective. On June 19, 2014, our shelf registration statement registering the sale of up to $100 million of our securities was declared effective by the SEC. To date, we have not sold any securities under this shelf registration statement. On September 13, 2013, our shelf registration statement (Registration No. 333-190936) registering the sale of up to $50 million of our securities was declared effective by the SEC. To date, through March 31, 2015 we have sold or reserved for sale upon the exercise of outstanding warrants approximately $48.2 million of securities under this shelf registration statement. Additionally, securities sold pursuant to our At the Market Offering Agreement (see below) are being sold pursuant to this registration statement and accordingly, we have reserved the balance of approximately $1.8 million of securities pursuant thereto. We anticipate conducting financing in the future based on our shelf registration statement when and if financing opportunities arise.

In October 2013, we entered into an At the Market Offering Agreement with T.R. Winston & Company as our sales agent pursuant to which we can sell up to $25 million of our common stock. The At the Market Offering Agreement was entered into pursuant to a takedown from our shelf registration statement declared effective on September 13, 2013 (Registration No. 333-190936). To date through March 31, 2015 we have sold 2,202,580 shares under such agreement at an average price per share of $3.16 resulting in gross proceeds of approximately $6,965,000 and net proceeds of approximately $6,666,000. Future sales under our agreement are limited to approximately $1.8 million which is the amount available under our shelf registration of which the At the Market Offering Agreement is part of.

The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed, at all, or on terms acceptable to us. Lack of necessary funds may require us, among other things, to delay, scale back or eliminate some or all of our research and product development programs, planned clinical trials, and/or our capital expenditures or to license our potential products or technologies to third parties.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Financial instruments that potentially subject us to concentrations of credit risk consist of cash and cash equivalents which are held at highly rated United States financial institutions and at times maintain the balances of our deposits in excess of federally insured limits. We invest our cash in instruments with short-term maturities with the objective of preserving capital. Because of the short-term maturities, we do not believe that a one-half percentage point increase or decrease in interest rates would have had a material effect on our interest income.

We are subject to interest rate risk for our long-term debt which contains a floating interest rate based on Wall Street Journal published prime rate. For the full year ended December 31, 2015 a one percentage point increase in the prime rate would increase our interest expense by approximately $90,000.

Our foreign operations in China subject us to changes in foreign exchange rates. Changes in exchange rates for the year ended December 31, 2015 are not expected to have a material effect as the operations are expected to be limited. Future changes to foreign exchange rates could have a material effect on us as our clinical trial activity increases.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Disclosure controls and procedures are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported, within the time period specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports filed under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer (CEO) who is also our acting Chief Financial Officer (CFO), as appropriate, to allow timely decisions regarding required disclosure.

Based on management's evaluation (with the participation of our CEO, who is also our acting CFO), as of the end of the period covered by this report, our CEO has concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met, and therefore, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. We do not expect that our disclosure controls and procedures or our internal control over financial reporting are able to prevent with certainty all errors and all fraud.

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are parties to legal proceedings that we believe to be ordinary, routine litigation incidental to the business of present or former operations. It is management's opinion, based on the advice of counsel, that the ultimate resolution of such litigation will not have a material adverse effect on our financial condition, results of operations or cash flows.

On May 7, 2008, we filed suit against StemCells, Inc., StemCells California, Inc. (collectively "StemCells") and Neurospheres Holding Ltd. in U.S. District Court for the District of Maryland, alleging that U.S. Patent No. 7,361,505 (the "'505 patent") is invalid, not infringed, and unenforceable. See Civil Action No. 08-1173. On May 13, 2008 we filed an Amended Complaint seeking declaratory judgment that U.S. Patent No. 7,155,418 (the "'418 patent") is invalid and not infringed and that certain statements made by our CEO are not trade libel or do not constitute unfair competition. On September 11, 2008, StemCells filed its answer asserting counterclaims of infringement for the '505 patent, the '418 patent, and state law claims for trade libel and unfair competition. This case was consolidated with the 2006 litigation discussed below and it is not known when, nor on what basis, this matter will be concluded.

On July 28, 2006, StemCells, Inc., filed suit against Neuralstem, Inc. in the U.S. District Court in Maryland, alleging that Neuralstem has been infringing, contributing to the infringement of, and or inducing the infringement of four patents allegedly owned by or exclusively licensed to StemCells. See Civil Action No. 06-1877. We answered the Complaint denying infringement, asserting that the patents are invalid, asserting that we have intervening rights based on amendments made to the patents during reexamination proceedings, and further asserting that some of the patents are unenforceable due to inequitable conduct. Neuralstem has also asserted counterclaims that StemCells has engaged in anticompetitive conduct in violation of antitrust laws. On February 28, 2011, Neuralstem filed a Motion to Dismiss for lack of standing and concurrently filed a Motion for Leave to Amend its Answer and Counterclaim to allege that StemCells is not the exclusive licensee of the patents-in-suit and also that Neuralstem has obtained a non-exclusive license to the patents-in-suit. In addition, before the Court decided Neuralstem's Motion to Dismiss for lack of standing, StemCells filed a motion for summary judgment on the issue standing. Neuralstem responded to that motion and cross-moved for summary judgment on the issue of standing. The Court further issued its Markman Order (an order ruling on the scope and meaning of disputed patent claim language regarding the patents at issue) on August 12, 2011. On August 26, 2011, StemCells moved for reconsideration of two terms construed in the Markman Order and that motion remains pending. On April 6, 2012 the Court granted Neuralstem's Motion for Leave to Amend to assert lack of standing and denied Neuralstem's Motion to Dismiss and Motion for Summary Judgment without prejudice. The Court also denied StemCells' Motion for Summary Judgment with prejudice. The Court stayed all other matters pending resolution of the question of standing. The case was then reassigned to Judge Roger W. Titus.

Judge Titus held a bench trial on the issue of standing and inventorship on December 9, 11, and 12, 2014. The parties filed their post-trial briefs on January 16, 2015. Judge Titus is expected to issue an order that will either resolve the case in its entirety or will allow the case to move forward to expert discovery.

ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. We have described below a number of uncertainties and risks which, in addition to uncertainties and risks presented elsewhere in this Quarterly Report, may adversely affect our business, operating results and financial condition. The uncertainties and risks enumerated below as well as those presented elsewhere in this Quarterly Report, and those included in our Annual Report on Form 10-K for the year ended December 31, 2014, filed with the SEC should be considered carefully in evaluating our company and our business and the value of our securities.

Risks Relating to Our Stage of Development and Capital Structure

We have a history of losses.

Since inception in 1996 and through March 31, 2015, we have accumulated losses totaling approximately $156,108,000. On March31, 2015, we had a working capital surplus of approximately $24,816,000 and stockholders' equity of approximately $19,362,000. Our net losses for the two most recent fiscal years have been approximately $22,629,000 and $19,832,000 for 2014 and 2013, respectively while our loss for the three months ended March 31, 2015 was approximately $5,053,000. We had no revenue from the sales of our products during the three months ended March 31, 2015 or 2014.

Our ability to generate revenues and achieve profitability will depend upon our ability to complete the development of our proposed products, obtain the required regulatory approvals, manufacture and market and ultimately sell our proposed products. To date, none of our proposed products have been approved for sale and we have not generated any revenue from the commercial sale of our proposed products. No assurances can be given as to exactly when, if at all, we will be able to fully develop, receive regulatory approval, commercialize, market, sell and/or derive any, let alone material, revenues from our proposed products.

We will need to raise additional capital to continue operations.

Since our inception, we have funded our operations through the sale of our securities, credit facilities, the exercise of options and warrants, and to a lesser degree, from grants and research contracts and other revenue generating activities such as licensing. As of March 31, 2015, we had cash, cash equivalents and short-term investments on hand of approximately $28,626,000. We cannot assure you that we will be able to secure additional capital through financing transactions, including issuance of debt, licensing agreements or grants. Our inability to license our intellectual property, obtain grants or secure additional financing will materially impact our ability to fund our current and planned operations.

We have spent and expect to continue spending substantial cash in the research, development, clinical and pre-clinical testing of our proposed products with the goal of ultimately obtaining FDA approval to market such products. We will require additional capital to conduct research and development, establish and conduct clinical and pre-clinical trials, enter into commercial-scale manufacturing arrangements and to provide for marketing and distribution of our products. We cannot assure you that financing will be available if needed. If additional financing is not available, we may not be able to fund our operations, develop or enhance our technologies, take advantage of business opportunities or respond to competitive market pressures. If we exhaust our cash reserves and are unable to secure adequate additional financing, we may be unable to meet operating obligations which could result in us initiating bankruptcy

proceedings or delaying, or eliminating some or all of our research and product development programs.

We will need to raise additional capital to pay our indebtedness as it comes due.

We have a substantial level of debt. As of March 31, 2015, we had approximately $9.5 million in aggregate principal outstanding of long-term indebtedness. Under our amended loan and security agreement, we are required to make monthly interest only payments through September 2015; interest and principal payments of approximately $460,000 per month from October 2015 through March 2017 and a balloon payment for the remaining principal in April 2017. As security for such indebtedness, we have pledged substantially all of our assets, including our intellectual property. If we are unable to make the required payments, or if we fail to comply with the various requirements and covenants of our indebtedness, we will be in default, which would permit the holders of our indebtedness to accelerate the maturity and require immediate repayment which could lead to the potential foreclosure on the assets securing the debt. Any default under our indebtedness would have a material adverse effect on our business, operating results and financial condition. Additionally, our amended loan and security agreement governing our $10 million credit facility also contains a number of affirmative and restrictive covenants, including reporting requirements and other collateral limitations, certain limitations on liens and indebtedness, dispositions, mergers and acquisitions, restricted payments and investments, corporate changes and limitations on waivers and amendments to certain agreements, our organizational documents, and documents relating to debt that is subordinate to our obligations under the credit facility. Our failure to comply with the covenants in the amended loan and security agreement could result in an event of default that, if not cured or waived, could result in the acceleration of all or a substantial portion of our debt and potential foreclosure on the assets securing the debt. If we are unable to refinance or repay our indebtedness as it becomes due, including upon an event of default, we may become insolvent and be unable to continue operations.

Risks Relating to Our Business

Our business is dependent on the successful development of our product candidates and our ability to raise additional capital.

Our business is significantly dependent on our product candidates which are currently at different phases of pre-clinical and clinical development. The process to approve our product candidates is time-consuming, involves substantial expenditures of resources, and depends upon a number of factors, including the availability of alternative treatments, and the risks and benefits demonstrated in our clinical trials. Our success will depend on our ability to achieve scientific and technological advances and to translate such advances into FDA-approvable, commercially competitive products on a timely basis. Failure can occur at any stage of the process. If we are not successful in developing our product candidates, we will have invested substantial amounts of time and money without developing revenue-producing products. As we enter a more extensive clinical program for our product candidates, the data generated in these studies may not be as compelling as the earlier results. This, in turn, could adversely impact our ability to raise additional capital and pursue our business plan and planned research and development efforts.

Our proposed products are not likely to be commercially available for at least several years, if at all. Our development schedules for our proposed products may be affected by a variety of factors, including technological difficulties, clinical trial failures, regulatory hurdles, competitive products, intellectual property challenges and/or changes in governmental regulation, many of which will not be within our control. Any delay in the development, introduction or marketing of our product candidates could result either in such products being marketed at a time when their cost and performance characteristics would not be competitive in the marketplace or in the shortening of their commercial lives. In light of the long-term nature of our projects, the unproven technology involved and the other factors described elsewhere in this section, there can be no assurance that we will be able to successfully complete the development or marketing of any of our proposed product candidates.

Our business relies on technologies that we may not be able to commercially develop and we are unable to predict when or if we will be able to earn revenues.

We have allocated the majority of our resources to the development of our stem cell and small molecule technologies. Our ability to generate revenue and operate profitably will depend on being able to develop these technologies for human applications. These are emerging technologies that may have limited human application. We cannot guarantee that we will be able to develop our technologies or that if developed, our technologies will result in commercially viable products or have any commercial utility or value. We anticipate that the commercial sale of our proposed products and/or royalty/licensing fees related to our technologies, will be our primary sources of revenue. We recognized revenue of approximately $19,000 nd regulatory drivers initiated by the Chinese government, such as State Ordinance 458 and the Safe City program, which require many public places to install security systems, including city-wide surveillance systems, traffic conjunctions, critical government locations, cyber cafés, bars and discotheques.

The ongoing installation of these security systems as required by applicable Chinese law is being conducted by the affected constituents. In addition, economic development in China and the general rise in affluence of the population of China continue to contribute to increased demand for surveillance and safety products within various industries and organizations, such as residential real estate, factories and shopping centers. We believe that the financing proceeds from our recent public offering closed in May 2010, combined with our operating cash flows, will provide sufficient working capital and allow us to take advantage of the growth in market demand in the future.

The following are some financial highlights for the second quarter of 2010:

- *Revenues*: Revenues increased $26.43 million, or 18.6%, to $168.35 million for the second quarter of 2010, from $141.92 million for the same quarter of last year.
- *Gross margin*: Gross margin increased to 25.8% for the second quarter of 2010 from 21.9% for the same period in 2009.
- *Income from operations*: Income from operations increased $11.99 million, or 95.4%, to $24.56 million for the second quarter of 2010, from $12.57 million for the same period last year.
- *Operating margin*: Operating margin (the ratio of income from operations to revenues, expressed as a percentage) was 14.6% for the second quarter of 2010, compared to 8.9% during the same period in 2009.
- *Net income*: Net income increased $11.31 million, or 174.0%, to $17.81 million for the second quarter of 2010, from $6.50 million for the same period of last year.
- *Net margin*: Net margin (the ratio of net income attributable to the Company to revenues, expressed as a percentage) was 10.6% for the second quarter of 2010, compared to 4.6% for the same period in 2009.

- *Fully diluted net income per share*: Fully diluted net income per share was $0.23 for the second quarter of 2010, as compared to $0.13 for the same period last year.
- *Non-cash expenses*: Non-cash expenses were $8.31 million for the three months ended June 30, 2010, representing a decrease of $4.78 million, or 36.5% from $13.09 million during the same period last year. Non-cash expenses for the three months ended June 30, 2010 included (i) depreciation and amortization of $3.26 million, and (ii) non-cash employee compensation expense of $5.05 million.

Our net income for the three months ended June 30, 2010 and 2009 was approximately $17.81 million and $6.50 million, respectively. Our net income for the six months ended June 30, 2010 and 2009 was approximately $21.08 million and $8.50 million, respectively. Our net income was materially impacted by: (i) depreciation and amortization of long-lived assets in the subsidiaries we acquired; (ii) non-cash employee compensation recognized pursuant to Accounting Standard Codification (ASC) 718; and (iii) redemption accretion on convertible notes we issued in February and April 2007. In the table below, we have presented a non-GAAP financial disclosure to provide a quantitative analysis of the impact of the depreciation and amortization of long-lived assets in the subsidiaries we acquired, non-cash employee compensation and redemption accretion on convertible notes on our net income. Because these items do not require the use of current assets, management does not include these items in its analysis of our financial results or how we allocate our resources. Because of this, we deemed it meaningful to provide this non-GAAP disclosure of the impact of these significant items on our financial results.

The following table summarizes the Company s non-cash expenses during the three and six months ended June 30, 2010 and 2009.

(All amounts in millions of U.S. dollars)

Non-cash expenses	**Three Months Ended June 30,**		
	2010	**2009**	**Increase/ (Decrease)**
Depreciation and amortization	$ 3.01	$ 2.91	0.10
Depreciation and amortization (included in cost of goods sold)	0.25	0.24	0.01
Non-cash employee compensation	5.05	4.36	0.69
Redemption accretion on convertible notes	--	5.58	(5.58)
Total	$ 8.31	$ 13.09	(4.78)

Non-cash expenses	**Six Months Ended June 30,**		
	2010	**2009**	**Increase/ (Decrease)**
Depreciation and amortization	$ 5.99	$ 5.73	0.26
Depreciation and amortization (included in cost of goods sold)	0.50	0.48	0.02
Non-cash employee compensation	13.38	8.58	4.80
Redemption accretion on convertible notes	--	10.95	(10.95)
Total	$ 19.87	$ 25.74	(5.87)

Results of Operations

The following table sets forth key components of our results of operations for the periods indicated, in millions of U.S. dollars and as a percentage of revenues.

(All amounts, other than percentages, in millions of U.S. dollars)

	Three months ended June 30,				Six months ended June 30,			
	2010		2009		2010		2009	
Revenues	$ 168.35	100.0%	$ 141.92	100.0%	$ 288.54	100.0%	$ 238.33	100.0%
Cost of goods sold (including depreciation and amortization for the three and six months ended June 30, 2010 and 2009 of $0.25, $0.50, $0.24 and $0.48, respectively)	(124.99)	74.2%	(110.90)	78.1%	(216.20)	74.9%	(182.29)	76.5%
Gross profit	43.36	25.8%	31.02	21.9%	72.34	25.1%	56.04	23.5%
Selling and marketing	(3.13)	1.8%	(3.03)	2.1%	(5.85)	2.0%	(5.75)	2.4%
General and administrative	(7.61)	4.6%	(8.15)	5.7%	(15.60)	5.5%	(15.43)	6.5%
Non-cash employee compensation	(5.05)	3.0%	(4.36)	3.1%	(13.38)	4.6%	(8.58)	3.6%
Depreciation and amortization	(3.01)	1.8%	(2.91)	2.1%	(5.99)	2.1%	(5.73)	2.4%
Income from operations	24.56	14.6%	12.57	8.9%	31.52	10.9%	20.55	8.6%
Other income	0.44	0.3%	1.06	0.7%	0.77	0.3%	1.32	0.6%
Interest expense, Cash	(3.06)	1.8%	(1.00)	0.7%	(5.36)	1.9%	(1.67)	0.7%
Redemption accretion on convertible notes	--	--	(5.58)	3.9%	--	--	(10.95)	4.6%
Income before income taxes	21.94	13.1%	7.05	5.0%	26.93	9.3%	9.25	3.9%
Income taxes	(4.13)	2.5%	(0.55)	0.4%	(5.85)	2.0%	(0.75)	0.3%
Net income	$ 17.81	10.6%	$ 6.50	4.6%	$ 21.08	7.3%	$ 8.50	3.6%

Revenues

Our revenues are primarily generated from system installations, manufacturing and distribution of surveillance and safety products and providing surveillance and safety services. We experienced solid growth in revenues during the three and six months ended June 30, 2010. Revenues increased $26.43 million, or 18.6%, to $168.35 million for the three months ended June 30, 2010 from $141.92 million for the three months ended June 30, 2009. Revenues increased $50.21 million, or 21.1%, to $288.54 million for the six months ended June 30, 2010 from $238.33 million for the six months ended June 30, 2009. This increase was mainly attributable to growth in the surveillance and safety market in China, the increased market demand for our products, our increased brand recognition and the acquisition of several companies in 2008 and 2009 as discussed in detail below. Our strategic efforts to increase our distribution channels during 2008 and 2009 and adequate working capital from prior fund raising activities with banks also allowed us to successfully take advantage of the growth in market demand in this quarter. Historically, the first quarter has generally been a slow quarter for us due to the Chinese New Year holiday and the fourth quarter has generally been the strongest quarter. Management expects the same trend in 2010 and that revenue growth will remain strong for the remainder of 2010.

As the acquisition of Coson has surpassed the one-year anniversary, we have included the revenues contributed by Coson in our organic growth since the second quarter of 2010.

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The following table shows the revenues recognized in the second quarter of 2010:

(In millions of U.S. dollars)

Revenues from the Installation Segment recognized from installation contracts signed before March 31, 2010	$ 77.73
Revenues from the Installation Segment recognized from installation contracts signed in the second quarter of 2010	$ 51.62
Revenues from the Manufacturing Segment recognized from manufacturing contracts signed before March 31, 2010	$ 1.47
Revenues from the Manufacturing Segment recognized from manufacturing contracts signed in the second quarter of 2010	$ 20.51
Revenues from the Distribution Segment recognized from distribution contracts signed before March 31, 2010	$ 0.13
Revenues from the Distribution Segment recognized from distribution contracts signed in the second quarter of 2010	$ 13.54
Revenues from the Service Segment recognized from distribution contracts signed in the second quarter of 2010	$ 3.35
Total revenues recognized in the second quarter of 2010	$ 168.35
Revenues deferred	$ 2.41
Backlog of sales contracts signed before June 30, 2010 [(1)]	$ 213.12

(1) We have conservatively not included letters of intent, framework agreements and various other agreements in our backlog numbers as they are subject to final binding agreements to be entered into at later dates.

Our revenues are generated from four business segments: Installation Segment, Manufacturing Segment, Distribution Segment and Service Segment.

The following table shows the different segments comprising our total revenues for the three and six months ended June 30, 2010 and 2009.

(All amounts, except percentage of revenues, in millions of U.S. dollars)

	Three months ended June 30,			
Revenues	**2010**		**2009**	
Installation Segment	$ 129.35	76.8%	$ 108.14	76.2%
Manufacturing Segment	21.98	13.1%	20.49	14.4%
Distribution Segment	13.67	8.1%	13.29	9.4%
Service Segment	3.35	2.0%	--	--
Total	$ 168.35	100.0%	$ 141.92	100.0%

	Six months ended June 30,			
Revenues	**2010**		**2009**	
Installation Segment	$ 222.10	76.9%	$ 183.05	76.8%
Manufacturing Segment	37.99	13.2%	35.80	15.0%
Distribution Segment	25.10	8.7%	19.48	8.2%
Service Segment	3.35	1.2%	--	--
Total	$ 288.54	100.0%	$ 238.33	100.0%

For the three months ended June 30, 2010 and 2009, our Installation Segment generated revenues of $129.35 million and $108.14 million which represented 76.8% and 76.2% of our total revenues, respectively. For the six months ended June 30, 2010 and 2009, our Installation Segment generated revenues of $222.10 million and $183.05 million which

represented 76.9% and 76.8% of our total revenues, respectively. The increase in revenues was mainly due to the following factors: First, demand for surveillance and security products has grown in China, which we attribute in part to the general rise in affluence of population in China. The increased demand within various industries and organizations, such as residential real estate, factories and shopping centers, also contributed to increased demand for surveillance and safety products. Second, the Chinese government initiated several programs and regulatory drivers, such as State Ordinance 458 and the 3111 program, that require many public places, including city-wide surveillance systems, traffic surveillance systems, critical government locations, cyber cafés, bars and discotheques, to install security systems. Third, our strategic efforts to increase our distribution channels during 2008 and 2009 allowed us to successfully take advantage of the growth in market demand in the first half of 2010. Fourth, in November 2008, the Chinese government announced an economic stimulus package to invest RMB 4 trillion (approximately $586 billion) in infrastructure and social welfare by the end of 2010. The economic stimulus package increased the demand for surveillance and safety products in China. Fifth, we have been successful in raising sufficient working capital to facilitate expansion in the China market. Finally, our increased brand recognition also contributed to the growth in revenues.

For the three months ended June 30, 2010 and 2009, our Manufacturing Segment generated revenues of $21.98 million and $20.49 million, representing 13.1% and 14.4% of our total revenues, respectively. For the six months ended June 30, 2010 and 2009, our Manufacturing Segment generated revenues of $37.99 million and $35.80 million, representing 13.2% and 15.0% of our total revenues, respectively. Management believes that revenues from the installation projects will continue to be the Company s major revenue source in the next few years.

For the three months ended June 30, 2010 and 2009, our Distribution Segment generated revenues of $13.67 million and $13.29 million, representing 8.1% and 9.4% of our total revenues. For the six months ended June 30, 2010 and 2009, our Distribution Segment generated revenues of $25.10 million, representing 8.7% of our total revenues for the six months ended June 30, 2010, as compared to $19.48 million and 8.2% for the same period last year. Such increase was mainly due to a decrease of selling prices due to market competition which, in turn, increased sales volume.

With the acquisitions of 2008 and 2009, management believes that the percentage of revenues from the Manufacturing Segment and the Distribution Segment will increase in the future.

During second quarter of 2010, we established a new segment our Service Segment which generated revenues of $3.35 million, representing 2.0% of our total revenues.

Management expects growth in all four segments to remain strong in the remainder of 2010 due to (i) continued growth in the surveillance and safety market both within the corporate and government sectors, (ii) better capitalization of the Company to fuel its growth, (iii) continued enhancement of our brand and profile in China, and (iv) acquisition strategy intended to boost our market share and competitiveness.

Cost of goods sold

Our cost of goods sold is primarily comprised of the costs of our raw materials, labor and overhead. Cost of goods sold for the second quarter of 2010 increased by $14.09 million, or 12.7%, to $124.99 million, as compared to $110.90 million for the same period last year. Cost of goods sold for the six months ended June 30, 2010 increased by $33.91 million, or 18.6%, to $216.20 million, as compared to $182.29 million for the same period last year. The increase was mainly due to the increase of sales volume.

Gross profit and gross margin

Our gross profit is equal to the difference between our revenues and our cost of goods sold. Our gross profit increased $12.34 million, or 39.8%, to $43.36 million for the three months ended June 30, 2010, from $31.02 million for the same period last year. Gross margin for the three months ended June 30, 2010 was 25.8%, as compared to 21.9% for the same period of 2009. Our gross profit increased $16.30 million, or 29.1%, to $72.34 million for the six months ended June 30, 2009, from $56.04 million for the same period last year. Gross margin for the six months ended June 30, 2010 was 25.1%, as compared to 23.5% for the same period of 2009.

The following table shows the different segment components comprising our gross profit margin over the three and six months ended June 30, 2010 and 2009.

	Three months ended June 30,		**Six months ended June 30,**	
Gross Margin	**2010**	**2009**	**2010**	**2009**
Installation Segment	27.8%	21.5%	26.6%	23.3%
Manufacturing Segment	27.3%	27.8%	27.5%	27.7%
Distribution Segment	6.3%	15.4%	9.4%	18.0%
Service Segment	16.7%	--	16.7%	--
Total	25.8%	21.9%	25.1%	23.5%

For the three months ended June 30, 2010, gross margins of the Installation Segment, Manufacturing Segment, and Distribution Segment were approximately 27.8%, 27.3%, and 6.3%, respectively, compared to 21.5%, 27.8%, and 15.4% for the same period last year. The gross margin of the newly established Service Segment was 16.7% for the three months ended June 30, 2010. For the six months ended June 30, 2010, gross margins for the Installation Segment, Manufacturing Segment and Distribution Segment were approximately 26.6%, 27.5% and 9.4%, respectively, compared to 23.3%, 27.7% and 18.0% for the same period last year. The increase in our gross margin for

the Installment Segment was primarily driven by the high margins from larger scale projects resulting primarily from our marketing efforts. The decrease of gross margin for the Distribution Segment for the three and six months ended June 30, 2010 was mainly due to the decrease of products' selling prices.

Selling and marketing expenses

Our selling and marketing expenses are comprised primarily of sales commissions, the cost of advertising and promotional materials, salaries and fringe benefits of sales personnel, after-sale support services and other sales related costs. Our selling and marketing expenses increased $0.10 million, or 3.3%, to $3.13 million for the three months ended June 30, 2010 from $3.03 million for the same period in 2009. As a percentage of revenues, our selling and marketing expenses decreased to 1.8% for the three months ended June 30, 2010 from 2.1% for the same period in 2009. In the first six months of fiscal 2010, our selling and marketing expenses increased $0.10 million, or 1.7% to $5.85 million from $5.75 million. As a percentage of revenues, our selling and marketing expenses decreased to 2.0% for the six months ended June 30, 2010 from 2.4% for the same period in 2009. The slight percentage decrease was due to cost efficiency.

General and administrative expenses

General and administrative expenses consist primarily of compensation and benefits to our general management, finance and administrative staff, professional advisor fees, audit fees and other expenses incurred in connection with general operation. Our general and administrative expenses decreased $0.54 million, or 6.6%, to $7.61 million for the three months ended June 30, 2010 from $8.15 million of the same period in 2009. In the first six months of 2010, our general and administrative expenses increased $0.17 million, or 1.1% to $15.60 million from $15.43 million. As a percentage of revenues, general and administrative expenses decreased to 4.6% and 5.5% for the three and six months ended June 30, 2010 from 5.7% and 6.5% for the same periods in 2009. The percentage decrease was mainly due to economy of scale and management s cost control efforts.

Non-cash employee compensation

Non-cash employee compensation by segment for the three and six months ended June 30, 2010 and 2009 is as follows:

All amounts, except percentage of non-cash compensation, in millions of U.S. dollars

	Three months ended June 30,				
Non-cash employee compensation	**2010**			**2009**	
Installation Segment	$ 0.59	11.7%	$	0.51	11.7%
Manufacturing Segment	0.97	19.2%		0.73	16.7%
Distribution Segment	0.38	7.5%		0.35	8.0%
Service Segment	0.01	0.2%		--	--
Corporate and others	3.10	61.4%		2.77	63.6%
Total	$ 5.05	100.0%	$	4.36	100.0%

	Six months ended June 30,				
Non-cash employee compensation	**2010**			**2009**	
Installation Segment	$ 1.15	8.6%	$	1.02	11.9%
Manufacturing Segment	1.91	14.3%		1.47	17.1%
Distribution Segment	0.75	5.6%		0.70	8.2%
Service Segment	0.01	0.1%		--	--
Corporate and others	9.56	71.4%		5.39	62.8%
Total	$ 13.38	100.0%	$	8.58	100.0%

Effective February 7, 2007, our board of directors adopted the 2007 Equity Incentive Plan (the Plan) which was subsequently amended in February 2010. The Plan provides for grants of stock options, stock appreciation rights, performance units, restricted stock, restricted stock units, and performance shares. A total of 12,000,000 shares of our common stock may be issued under our Plan. The Plan has a 10-year term. During the three and six months ended

June 30, 2010, we granted an aggregate of 568,987, and 1,255,692 shares of restricted stock pursuant to the Plan to our employees and consultants, respectively. These shares will vest with respect to each of the employees and consultants over a period of four to five years.

Non-cash employee compensation for the three months ended June 30, 2010 increased to $5.05 million from $4.36 million for the same period in 2009. In the first six months of fiscal 2010, non-cash employee compensation increased to $13.38 million from $8.58 million, primarily because more shares were granted to employees and consultants under the Plan during the respective period.

Depreciation and amortization

Our depreciation and amortization costs increased $0.11 million, or 3.5%, to $3.26 million (including $0.25 million depreciation and amortization costs included under cost of goods sold) for the three months ended June 30, 2010 from $3.15 million for the same period in 2009. As a percentage of revenues, depreciation and amortization expenses decreased to 1.9% for the three months ended June 30, 2010 from 2.2% for the same period in 2009. In the first six months of fiscal 2010, our depreciation and amortization increased $0.28 million, or 4.5%, to $6.49 million (including $0.50 million depreciation and amortization costs included under cost of goods sold) from $6.21 million for the same period 2009. As a percentage of revenues, depreciation and amortization expenses decreased to 2.2% for the six months ended June 30, 2010 from 2.6% for the same period in 2009. This dollar increase was primarily due to the amortization of intangible assets from the acquisition of Stonesonic, Longhorn, Guanling, Jin Lin, DIT and Coson. Such percentage decrease was primarily due to the increase in incremental revenue in 2010.

Income from operations

Our income from operations increased $11.99 million, or 95.4%, to $24.56 million for the three months ended June 30, 2010 as compared to $12.57 million for the same period in 2009. As a percentage of revenues, income from operations increased to 14.6% for the three months ended June 30, 2010 from 8.9% for the same period in 2009. In the first six months of fiscal 2010, our income from operations increased $10.97 million, or 53.4%, to $31.52 million as compared to $20.55 million. As a percentage of revenues, income from operations increased to 10.9% for the six months ended June 30, 2010 from 8.6% for the same period in 2009.

The following table shows the different segments comprising our income from operations for the three and six months ended June 30, 2010 and 2009.

All amounts, except percentage of income from operations, in millions of U.S. dollars

	Three months ended June 30,			
Income from operations	**2010**		**2009**	
Installation Segment	$ 32.80	133.6%	$ 19.12	152.1%
Manufacturing Segment	0.19	0.8%	(0.17)	-1.3%
Distribution Segment	(1.01)	-4.1%	(0.17)	-1.3%
Service Segment	0.21	0.8%	--	--
Corporate and others	(7.63)	-31.1%	(6.21)	-49.5%
Total	$ 24.56	100.0%	$ 12.57	100.0%

	Six months ended June 30,			
Income from operations	**2010**		**2009**	
Installation Segment	$ 52.54	166.7%	$ 33.11	161.1%
Manufacturing Segment	(0.86)	-2.7%	(0.62)	-3.0%
Distribution Segment	(1.67)	-5.3%	(0.55)	-2.7%
Service Segment	0.21	0.7%	--	--
Corporate and others	(18.70)	-59.4%	(11.39)	-55.4%
Total	$ 31.52	100.0%	$ 20.55	100.0%

Income from operations related to the Installation Segment increased 71.5%, or $13.68 million, to $32.80 million for the three months ended June 30, 2010, compared to $19.12 million for the same period in 2009. In the first six months of fiscal 2010, income from operations related to the Installation Segment increased 58.7%, or $19.43 million, to $52.54 million, compared to $33.11 million. Such increase was mainly due to higher demand of total one-stop-shop installations from customers. We finished more projects with higher margin in 2010 as compared to the same period in 2009.

Income from operations related to the Manufacturing Segment was $0.19 million for the three months ended June 30, 2010, compared to operating loss of $0.17 million for the same period in 2009. Loss from operations related to the Manufacturing Segment was $0.86 million for the six months ended June 30, 2010, compared to loss from operations of $0.62 million for the same period in 2009. During the three months ended June 30, 2010, we hired additional staff to meet the anticipated growth of the Manufacturing Segment which, together with the increased non-cash expenses, more than offset the growth in revenues. We expect that the Manufacturing Segment s margin will increase as we integrate the recently completed acquisitions which will allow us to further benefit from economies of scale.

Loss from operations related to the Distribution Segment was $1.01 million for the three months ended June 30, 2010, compared to the operating loss of $0.17 million for the same period in 2009. Loss from operations related to the Distribution Segment was $1.67 million for the six months ended June 30, 2010, compared to loss from operations of $0.55 million for the same period in 2009. This increase was mainly due to the decrease of gross margin.

Income from operations related to the newly established Service Segment was $0.21 million for the three months ended June 30, 2010.

We also provide general corporate services to our segments. Costs attributable to these services are reported as corporate and other expenses. These costs include amortization, depreciation, and non-cash compensation for employees. Loss from operations related to the Corporate and others increased 22.9%, or $1.42 million, to $7.63 million for the three months ended June 30, 2010, compared to $6.21 million for the same period in 2009. Loss from operations related to Corporate and others increased 64.2%, or $7.31 million, to $18.70 million for the six months ended June 30, 2010, compared to $11.39 million for the same period in 2009. This increase was mainly due to the increase of non-cash compensation as discussed above and professional expenses related to the costs of being a public reporting company.

Other income

Our other income decreased $0.62 million, or 58.5%, to $0.44 million for the three months ended June 30, 2010 from $1.06 million for the same period in 2009. As a percentage of revenues, other income decreased to 0.3% for the three months ended June 30, 2010 from 0.7% for the same period in 2009. Our other income decreased $0.55 million, or 41.7%, to $0.77 million for the six months ended June 30, 2010 from $1.32 million for the same period in 2009. As a percentage of revenues, other income for the six months ended June 30, 2010 was 0.3%, as compared to 0.6% for the same period in 2009. The dollar and percentage decrease was mainly due to a one-time subsidy received from the local government in 2009. We did not receive any subsidy income in 2010.

Interest expense (excluding redemption accretion on convertible notes)

During the first half year of 2010, we borrowed funds under 21 short-term loans from banks and the product financing arrangements from financial institutions of which had incurred total interest expense of $3.06 million, as compared to $1.00 million for the same period in 2009. During the first half year of 2010, we incurred total interest expense of $5.36 million, as compared to $1.67 million for the same period in 2009. We incurred $0.73 million and $1.68 million in interest during the three and six months ended June 30, 2010 in connection with our outstanding Tranche B Zero Coupon Guaranteed Senior Unsecured Notes (the Tranche B Notes), respectively. We paid $0.28 million and $0.55 million in interest in connection with the guaranteed senior unsecured convertible notes due 2012 (the Convertible Notes) during the three and six months ended June 30, 2009, respectively. The Convertible Notes have been retired in 2009. This dollar increase in interest expenses was primarily due to the increase in the outstanding balances of our bank loans.

Redemption accretion on convertible notes

Redemption accretion on the Convertible Notes for the three and six months ended June 30, 2009 was $5.58 million and $10.95 million, respectively. We raised $110 million from the issuance of Convertible Notes in February and April 2007 which were retired and restructured into two new zero coupon interest notes on September 2, 2009.

Income before taxes

Our income before taxes increased $14.89 million, or 211.2%, to $21.94 million for the three months ended June 30, 2010 from $7.05 million for the same period in 2009. As a percentage of revenues, income before taxes for the three months ended June 30, 2010 increased to 13.1% from 5.0% for the same period in 2009. Our income before taxes increased $17.68 million, or 191.1%, to $26.93 million for the six months ended June 30, 2010 from $9.25 million for the same period in 2009. As a percentage of revenues, income before taxes for the six months ended June 30, 2010 increased to 9.3% from 3.9% for the same period in 2009. Such percentage increase was primarily due to increase of gross margin and decreased redemption accretion on convertible notes as discussed above.

Income Taxes

China Security & Surveillance Technology, Inc. is subject to the United States federal income tax at a tax rate of 34%. No provision for income taxes in the United States has been made as China Security & Surveillance Technology, Inc. had no United States taxable income during the three months ended June 30, 2010.

Our wholly owned subsidiary Safetech was incorporated in the British Virgin Island and, under the current laws of the British Virgin Islands, is not subject to income taxes.

Before January 1, 2008, foreign invested enterprises (FIEs) established in the PRC were generally subject to an enterprise income tax (EIT) rate of 33%, which included a 30% state income tax and a 3% local income tax. FIEs established in Shenzhen Special Economic Zone, such as our Chinese subsidiary, Golden, and certain high-technology companies were subject to a reduced tax rate. On March 16, 2007, the National People's Congress of China passed the new Enterprise Income Tax Law (EIT Law), and on November 28, 2007, the State Council of China passed the Implementing Rules for the EIT Law (Implementing Rules) which took effect on January 1, 2008. The EIT Law and Implementing Rules impose a unified EIT of 25% on all domestic-invested enterprises and FIEs, unless they qualify under certain limited exceptions. Therefore, nearly all FIEs are subject to the new tax rate alongside other domestic businesses rather than benefiting from the EIT, and its associated preferential tax treatments, beginning January 1, 2008.

Despite these changes, the EIT Law gives the Old FIEs a five-year grandfathering period during which they can continue to enjoy their existing preferential tax treatments. During this five-year grandfathering period, the Old FIEs which enjoyed tax rates lower than 25% under the original EIT Law shall gradually increase their EIT rate within 5 years until the tax rate reaches 25%. In addition, the Old FIEs that are eligible for the two-year exemption and three-year half reduction or five-year exemption and five-year half-reduction under the original EIT Law, are allowed to remain to enjoy their preference until these holidays expire. The discontinuation of any such special or preferential tax treatment or other incentives would have an adverse affect on any organization's business, fiscal condition and current operations in China.

In addition to the changes to the current tax structure, under the EIT Law, an enterprise established outside of China with de facto management bodies within China is considered a resident enterprise and will normally be subject to an EIT of 25% on its global income. The Implementing Rules define the term de facto management bodies as an establishment that exercises, in substance, overall management and control over the production, business, personnel, accounting, etc., of a Chinese enterprise. If the PRC tax authorities subsequently determine that the Company should be classified as a resident enterprise, then the organization s global income will be subject to PRC income tax of 25%.

Our subsidiary, Golden, is subject to an EIT rate of 22% for 2010. Hongtianzhi is located in Shenzhen and its 2010 EIT rate is 22% because it receives a lower tax rate as a high-technology company. Cheng Feng, HiEasy, Minking, and Stonesonic are each subject to an EIT rate of 15% in 2010 due to their high-technology or software company status. CSST PRC and Longhorn are located in Shenzhen and their 2010 EIT rate is 11% because they receive a lower tax rate as a high-technology company. Coson and Zhuhai DIT Digital Technology Limited are each subject to an EIT rate of 22% in 2010 due to their high-technology company status. Tsingvision and Jin Lin are subject to an EIT rate of 12.5% in 2010 due to their software company status. CSSM, CSSS, CSSD and Guanling are subject to an EIT rate of 25% in 2010.

Our income taxes increased $3.58 million to $4.13 million for the three months ended June 30, 2010 from $0.55 million for the same period of 2009. Our income taxes increased $5.10 million to $5.85 million for the six months ended June 30, 2010 from $0.75 million for the same period of 2009. In 2009, we fully utilized the tax exemption for our subsidiaries, CSST PRC, which was incorporated in 2006, and Jin Lin, which became our subsidiary in 2008. In addition, the income tax exemption of some of our major subsidiaries expired as of the beginning of 2010.

Net income

Net income increased $11.31 million, or 174.0%, to $17.81 million for the three months ended June 30, 2010 from $6.50 million for the same period in 2009. As a percentage of revenues, net income increased to 10.6% for the three months ended June 30, 2010 from 4.6% for the same period in 2009. Net income increased $12.58 million, or 148.0%, to $21.08 million for the six months ended June 30, 2010 from $8.50 million for the same period in 2009. As a percentage of revenues, net income increased to 7.3% for the six months ended June 30, 2010 from 3.6% for the same period in 2009. This percentage increase was mainly due to increase of gross margin and profit and the decrease of redemption accretion on our Convertible Notes and as discussed above.

Foreign Currency Translation Losses/Gains

Our operating subsidiaries are located in China. The operating subsidiaries purchase all products and render services in China, and receive payment from customers in China using RMB as the functional currency. We do not engage in currency hedging.

We incurred a foreign currency translation gain of $3.20 million for the three months ended June 30, 2010 as compared with the foreign currency translation loss of $0.16 million for the same period in 2009.

We incurred a foreign currency translation gain of $3.32 million for the six months ended June 30, 2010 as compared with the foreign currency translation loss of $0.11 million for the same period in 2009.

As we have done since China revalued RMB by 2.1 percent and allowed the RMB to appreciate as much as 0.3 percent per day against the U.S. dollar, we implemented different exchange rates in translating RMB into U.S. dollars in our financial statements for fiscal quarter ended June 30, 2010 and 2009.

For the three months ended June 30, 2010, the exchange rates of 6.79, 6.82 and 8.04 were implemented in calculating the assets and liabilities, revenue and expenses, and shareholders' equity, respectively, which results in a $3.20 million foreign currency translation gain in the second quarter of 2010. In the second quarter of 2009, the exchange rates of 6.83, 6.83 and 8.04 were implemented in calculating the assets and liabilities, revenue and expenses, and shareholders' equity, respectively, which results in $0.16 million foreign currency translation loss in this period.

Liquidity and Capital Resources

General

As of June 30, 2010, we had cash and cash equivalents of $208.07 million. The following table sets forth a summary of our net cash flows for the periods indicated.

CASH FLOW
(All amounts in millions of U.S. dollars)

	Six Months Ended June 30,	
	2010	**2009**
Net cash (used in) provided by operating activities	$ (56.46)	$ 17.76
Net cash used in investing activities	$ (32.30)	$ (7.44)
Net cash provided by financing activities	$ 140.51	$ 31.65
Effect of exchange rate changes on cash	$ 1.84	$ (0.28)
Net cash inflow	$ 53.59	$ 41.69

Operating Activities

Net cash used in operating activities in the six months ended June 30, 2010 totaled $56.46 million as compared to $17.76 million net cash provided by operating activities for the same period of 2009. The increase in net cash used in operating activities in the six months ended June 30, 2010 was primarily due to increases in accounts receivables and inventories.

Investing Activities

Our main uses of cash for investing activities during the first six months of 2010 were acquisitions of plant and equipment and deposits for the acquisition of subsidiaries.

Net cash used in investing activities for the six months ended June 30, 2010 was $32.30 million, which is an increase of $24.86 million from net cash used in investing activities of $7.44 million in the same period of 2009. This increase was primarily due to deposits for acquisitions of subsidiaries in the first half of 2010.

Financing Activities

Net cash provided by financing activities in the six months ended June 30, 2010 totaled $140.51 million as compared to net cash provided by financing activities of $31.65 million in the same period of 2009. The net cash provided by financing activities was mainly attributable to proceeds from our public offering, and additional bank loans obtained in the first six months of 2010. We completed a public offering of 17,250,000 shares of common stock in May 2010 and received net proceeds of approximately $64.57 million.

Loan Facilities

As of June 30, 2010, the amount, maturity date and term of each of our bank loans are as follows:

All amounts in millions of U.S. dollars

Lender	Amount	Maturity Date	Duration
China Zheshang Bank	$ 2.95	November 2010	6 months
China Everbright Bank	5.88	November 2010	6 months
Shanghai Pudong Development Bank	11.78	April 2011	1 year
Shanghai Pudong Development Bank	11.78	April 2011	1 year
China Merchants Bank	7.36	March 2011	1 year
China Citic Bank	13.25	March 2011	1 year

China Citic Bank	8.84	March 2011	1 year
Industrial and Commercial Bank of China	4.56	March 2011	1 year
Industrial and Commercial Bank of China	5.74	March 2011	1 year
China Construction Bank	7.36	March 2011	1 year
China Merchants Bank	6.04	March 2011	1 year
Bank of China	7.07	November 2010	9 months
Bank of China	11.04	February 2011	1 year
Societe Generale	3.98	August 2010	6 months
China Merchants Bank	8.69	February 2011	1 year
Industrial and Commercial Bank of China	2.95	January 2011	1 year
Bank of China	11.04	January 2011	1 year
Bank of Ningbo	4.42	December 2010	1 year
Industrial and Commercial Bank of China	7.36	November 2010	1 year
Shenzhen Development Bank	2.95	September 2010	1 year
China Construction Bank	4.42	August 2010	1 year
A Financial Institution	7.36	June 2013	3 years
A Financial Institution	0.65	February 2013	4 years
A Financial Institution	5.70	September 2012	3 years
A Financial Institution	2.90	July 2011	3 years
Total	$ 166.07		

a) Notes payable

On May 21, 2010, we entered into a loan agreement with China Zheshang Bank. We borrowed RMB20 million (approximately $2.95 million) with an annual interest rate equal to 110% benchmark lending rate (5.346% as of June 30, 2010) with interest payable on the 20th of each month. The loan is due in November 2010. The loan is guaranteed by our CEO and our subsidiaries.

On May 18, 2010, we entered into a loan agreement with China Everbright Bank Co., Ltd. We borrowed RMB40 million (approximately $5.88 million) with an annual interest rate equal to 4.86%, with interest payable on the 20th of each month. The loan is due in November 2010. The loan is guaranteed by our CEO, our subsidiary and Chuang Guan.

On April 16, 2010, we entered into a loan agreement with Shanghai Pudong Development Bank. We borrowed RMB80 million (approximately $11.78 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in April 2011. The loan is guaranteed by our CEO and our subsidiary, and is collateralized by the properties and land use rights of a subsidiary.

On April 15, 2010, we entered into a loan agreement with Shanghai Pudong Development Bank. We borrowed RMB80 million (approximately $11.78 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in April 2011. The loan is guaranteed by our CEO, and is collateralized by the properties and land use rights of a subsidiary.

On March 31, 2010, we entered into a loan agreement with China Merchants Bank. We borrowed RMB50 million (approximately $7.36 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by our CEO, his wife and our subsidiary, and is collateralized by the property and land use rights of a subsidiary.

On March 25, 2010, we entered into a loan agreement with China Citic Bank. We borrowed RMB90 million (approximately $13.25 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each

month. The loan is due in March 2011. The loan is guaranteed by our CEO, his wife and our subsidiary, and is collateralized by the properties of two subsidiaries.

On March 24, 2010, we entered into a loan agreement with China Citic Bank. We borrowed RMB60 million (approximately $8.84 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by our CEO, his wife and our subsidiary, and is collateralized by the properties of two subsidiaries.

On March 4, 2010, we entered into a loan agreement with Industrial and Commercial Bank of China. We borrowed RMB31 million (approximately $4.56 million) with an annual interest rate equal to 4.78%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by three of our subsidiaries, and is collateralized by property of a subsidiary.

On March 4, 2010, we entered into a loan agreement with Industrial and Commercial Bank of China. We borrowed RMB39 million (approximately $5.74 million) with an annual interest rate equal to 4.78%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by three of our subsidiaries, and is collateralized by property of a subsidiary.

On March 3, 2010, we entered into a loan agreement with China Construction Bank. We borrowed RMB50 million (approximately $7.36 million) with an annual interest rate equal to 5.58%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by our CEO and our subsidiary, and is collateralized by property of a subsidiary.

On March 2, 2010, we entered into a loan agreement with China Merchants Bank. We borrowed RMB41 million (approximately $6.04 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in March 2011. The loan is guaranteed by our CEO, his wife and our subsidiary, and is collateralized by the property and land use rights of a subsidiary.

On February 26, 2010, we entered into a loan agreement with Bank of China. We borrowed RMB48 million (approximately $7.07 million) with an annual interest rate equal to 5.04%, with interest payable on the 20th of each month. The loan is due in November 2010. The loan is guaranteed by our CEO and two of our subsidiaries, and is collateralized by the property and land use rights of a subsidiary.

On February 11, 2010, we entered into a loan agreement with Bank of China. We borrowed RMB75 million (approximately $11.04 million) with an annual interest rate equal to 5.84%, with interest payable on the 20th of each month. The loan is due in February 2011. The loan is guaranteed by our CEO and two of our subsidiaries, and is collateralized by the property and land use rights of a subsidiary.

On February 8, 2010, we entered into a loan agreement with Societe Generale. We borrowed RMB27 million (approximately $3.98 million) with an annual interest rate equal to 4.86%, with interest payable on the due date of the loan. The loan is due in August 2010. The loan is guaranteed by our subsidiary.

On February 3, 2010, we entered into a loan agreement with China Merchants Bank. We borrowed RMB59 million (approximately $8.69 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in February 2011. The loan is guaranteed by our CEO, his wife and our subsidiary, and is collateralized by the property and land use rights of a subsidiary.

On January 26, 2010, we entered into a loan agreement with Industrial and Commercial Bank of China. We borrowed RMB100 million (approximately $14.73 million) with an annual interest rate equal to 4.78%, with interest payable on the 20th of each month. The loan is due in January 2011. The Company repaid RMB80 million (approximately $11.78 million) in June 2010. The loan is guaranteed by our CEO.

On January 7, 2010, we entered into a loan agreement with Bank of China. We borrowed RMB75 million (approximately $11.04 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in January 2011. The loan is guaranteed by our CEO and two of our subsidiaries, and is collateralized by the property and land use rights of a subsidiary.

On December 25, 2009, we entered into a loan agreement with Bank of Ningbo. We borrowed RMB30 million (approximately $4.42 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in December 2010. The loan is guaranteed by our CEO and our subsidiary.

On November 6, 2009, we entered into a loan agreement with Industrial and Commercial Bank of China. We borrowed RMB50 million (approximately $7.36 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan is due in November 2010. The loan is guaranteed by three of our subsidiaries, and is collateralized by the land use rights and property of a subsidiary.

On September 30, 2009, we entered into a loan agreement with Shenzhen Development Bank. We borrowed RMB20 million (approximately $2.95 million) with an annual interest rate equal to 105% of benchmark lending rate (5.5755% as of June 30, 2010), with interest payable on the 20th of each month. The loan is due in September 2010. The loan is

guaranteed by our CEO and two of our subsidiaries, and is collateralized by the property of a subsidiary.

On August 13, 2009, we entered into a loan agreement with China Construction Bank. We borrowed RMB30 million (approximately $4.42 million) with an annual interest rate equal to 5.5755%, with interest payable on the 20th of each month. The loan is due in August 2010. The loan is collateralized by the property of a subsidiary. The loan was repaid in July 2010.

On May 20, 2009, we entered into a loan agreement with China Everbright Bank. We borrowed RMB40 million (approximately $5.88 million) with an annual interest rate equal to 5.31%, with interest payable on the 20th of each month. The loan was due and repaid in May 2010. The loan was guaranteed by our CEO, our subsidiary, and Chuang Guan.

b) Product financing arrangements

In June 2010, we entered into product financing arrangements with a financial institution. Under the terms of the agreements, we agreed to pay an annual interest rate of 8.23% on inventory financings. We borrowed RMB50 million (approximately $7.36 million). The loans expire in June 2013, and payments are due at the end of each quarter. As of June 30, 2010, the outstanding liability relating to this loan was RMB50.00 million (approximately $7.36 million).

In September 2009, we entered into product financing arrangements with a financial institution. Under the terms of the agreements, we agreed to pay an annual interest rate of 8.46% on inventory financings. We borrowed RMB50 million (approximately $7.32 million). The loans expire in September 2012, and payments are due at the end of each quarter. As of June 30, 2010, the outstanding liability relating to this loan was RMB38.66 million (approximately $5.70 million).

In February 2009, we entered into product financing arrangements with a financial institution. Under the terms of the agreements, we agreed to pay an annual interest rate of 10.5% on inventory financings. We borrowed RMB7.11 million (approximately $1.04 million). The loans expire in February 2013, and payments are due at the end of each quarter. As of June 30, 2010, the outstanding liability relating to this loan was RMB4.42 million (approximately $0.65 million).

In July 2008, we entered into product financing arrangements with a financial institution. Under the terms of the agreements, we agreed to pay an annual interest rate of 10% on inventory financings. We borrowed RMB53.49 million (approximately $7.85 million). These loans mature in July 2011. The interest is payable at the end of each quarter. As of June 30, 2010, the outstanding liability relating to these arrangements was RMB19.70 million (approximately $2.90 million).

c) Guaranteed senior unsecured notes payable

As of June 30, 2010, we have outstanding the Tranche B Notes. The Tranche B Notes have a principal amount of $84.00 million, zero coupon interest and a fair value of $78.44 million, resulting in a debt discount of $5.56 million and an effective interest rate of approximately 5%. The Tranche B Notes mature on September 2, 2012. We are to repay the principal amount in six consecutive semi-annual installments, starting March 2, 2010, with 46%, 46%, and 8% of the principal amount to be repaid in the first, second and third year, respectively. The Tranche B Notes are not convertible. We will be entitled to redeem the Tranche B Notes at any time with no premium or penalty at a redemption price equal to 100% of the principal amount of the Tranche B Notes to be redeemed, plus default interest, if any. The Tranche B Notes are guaranteed by our significant subsidiaries to the extent permitted under the applicable laws. We repaid $19.32 million of the principal on the Tranche B Notes in March 2010.

d) Others

In March 2009, Industrial and Commercial Bank of China (ICBC) confirmed that it would acquire all accounts receivable from our Kunming Safe City project and cash payment would be made without delay once the project is completed and passes inspection. The Kunming Municipal Government will then make full payment to ICBC in installments over a five-year period. We completed the Kunming Safe City project in March 2009.

On October 3, 2006, we signed a banking facility agreement with China Construction Bank under which the bank agreed to provide a new receivable-based facility to support our efforts in securing new contracts relating to the Safe City Project initiative, also known as Plan 3111. This facility will provide three possible financing options: (1) the government takes a loan from the bank to finance the project; (2) we sell the accounts receivable to the bank, 85% of the total account receivables value will be paid by the bank to the Company and the remaining 15% will be collected by the bank from the government; from the 15% collected from the government, the bank will retain certain finance charges and pay the remainder over to the Company; or (3) we take a loan from the bank to finance the project. As

part of this agreement, we will make periodic deposits with the bank, which, depending upon the specific project, will provide a maximum factoring capacity of five to ten times the amount deposited. None of the facility has been drawn down as of the date of this report.

We believe that our currently available working capital, after receiving the aggregate proceeds of our capital raising activities and the credit facilities referred to above, should be adequate to sustain our operations at our current levels through at least the next twelve months.

Obligations under Material Contracts

Below is a table setting forth our material contractual obligations as of June 30, 2010:

All amounts in millions of U.S. dollars

	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Debt Obligations	$ 232.68	$ 196.25	$ 36.43	$ --	$ --
Operating Lease Obligations	1.98	0.85	1.13	--	--
Total	$ 234.66	$ 197.10	$ 37.56	$ --	$ --

Recent Accounting Pronouncements

Accounting for Transfers of Financial Assets
(Included in ASC 860 Transfers and Serving)

This ASC guidance addresses information a reporting entity provides in its financial statements about: the transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor s continuing involvement in transferred financial assets. Also, ASC 860 removes the concept of a qualifying special purpose entity, limits the circumstances in which a transferor derecognizes a portion or component of a financial asset, defines participating interest and enhances the information provided to financial statement users to provide greater transparency. This guidance was effective for us as of January 1, 2010. The adoption of this guidance had no impact on our consolidated financial statements.

Consolidation of Variable Interest Entities Amended
(Included in ASC 810 Consolidation)

Revisions under ASC 810, require an enterprise to perform ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity; and eliminates the quantitative approach previously required for determining the primary beneficiary of a variable interest entity. This ASC guidance also requires enhanced disclosures that will provide users of financial statements with more transparent information about an enterprise s involvement in a variable interest entity. This guidance was effective for us as of January 1, 2010. The adoption of this guidance had no impact on our consolidated financial statements.

Multiple Deliverable Revenue Arrangements
(Accounting Standards Updates 2009-13 and 2009-14)

In October 2009, the FASB issued a new accounting standard which provides guidance for arrangements with multiple deliverables. Specifically, the new standard requires an entity to allocate consideration at the inception of an arrangement to all of its deliverables based on their relative selling prices. In the absence of the vendor-specific objective evidence or third-party evidence of the selling prices, consideration must be allocated to the deliverables based on management s best estimate of the selling prices. In addition, the new standard eliminates the use of the residual method of allocation. In October 2009, the FASB also issued a new accounting standard which changes revenue recognition for tangible products containing software and hardware elements. Specifically, tangible products containing software and hardware that function together to deliver the tangible products essential functionality are scoped out of the existing software revenue recognition guidance and will be accounted for under the multiple-element arrangements revenue recognition guidance discussed above. Both standards will be effective for us in the first quarter of 2011. Early adoption is permitted. We are currently evaluating the impact that the adoption of this standard may have on our consolidated financial statements.

Critical Accounting Policies

See Item 7, Management's Discussion and Analysis of Results of Operations and Financial Condition in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2009, for a discussion of the Company's critical accounting policies.

Seasonality

Our operating results and operating cash flows historically have been subject to seasonal variations. Our revenues are usually higher in the second half of the year than in the first half of the year and the first quarter is usually the slowest quarter because fewer projects are undertaken during and around the Chinese spring festival.

Inflation

We believe our operations have not been materially adversely affected by inflation or changing prices.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Interest Rate Risk

The Company deposits surplus funds with Chinese banks earning daily interest. The Company does not invest in any instruments for trading purposes. All of the Company s outstanding debt instruments carry fixed rates of interest. The Company s operations generally are not directly sensitive to fluctuations in interest rates. The amount of long-term debt outstanding as of June 30, 2010 and December 31, 2009 was $34.38 million and $50.53 million, respectively. A hypothetical 1.0% increase in the annual interest rates for all of our credit facilities under which we had outstanding borrowings at June 30, 2010 would not have any material impact on our net income before provision for income taxes for the quarter. Management monitors the banks prime rates in conjunction with our cash requirements to determine the appropriate level of debt balances relative to other sources of funds. We have not entered into any hedging transactions in an effort to reduce our exposure to interest rate risk.

Foreign Exchange Risk

Our reporting currency is the U.S. dollar. Except for the U.S. holding company, all of our consolidated revenues, consolidated costs and expenses, and our assets are denominated in RMB. As a result, we are exposed to foreign exchange risk as our revenues and results of operations may be affected by fluctuations in the exchange rate between U.S. dollars and RMB. If the RMB depreciates against the U.S. dollar, the value of our RMB revenues, earnings and assets as expressed in our U.S. dollar financial statements will decline. Assets and liabilities are translated at exchange rates at the balance sheet dates and revenue and expenses are translated at the average exchange rates and shareholders equity is translated at historical exchange rates. Any resulting translation adjustments are not included in determining net income but are included in determining other comprehensive income, a component of shareholders equity. An average appreciation (depreciation) of the RMB against the U.S. dollar of 5% would increase our comprehensive income by $3.32 million based on our outstanding revenues, costs and expenses, assets and liabilities denominated in RMB as of June 30, 2010. As of June 30, 2010, our accumulated other comprehensive income was $30.89 million. We have not entered into any hedging transactions in an effort to reduce our exposure to foreign exchange risk.

The value of the Renminbi against the U.S. dollar and other currencies is affected by, among other things, changes in China s political and economic conditions. Since July 2005, the Renminbi has not been pegged to the U.S. dollar. Although the People s Bank of China regularly intervenes in the foreign exchange market to prevent significant short-term fluctuations in the exchange rate, the Renminbi may appreciate or depreciate significantly in value against the U.S. dollar in the medium to long term. Moreover, it is possible that in the future, PRC authorities may lift restrictions on fluctuations in the Renminbi exchange rate and lessen intervention in the foreign exchange market.

Inflation

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross margin and selling, general and administrative expenses as a percentage of net revenues if the selling prices of our products do not increase with these increased costs.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. We maintain a system of disclosure controls and procedures. The term "disclosure controls and procedures," as defined by regulations of the SEC, means controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit to the SEC under the Exchange Act, is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit to the SEC under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and our principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions to be made regarding required disclosure. Each of Guoshen Tu, our Chief Executive Officer, and Terence Yap, our Chief Financial Officer, have evaluated the design and operating effectiveness of our disclosure controls and procedures as of June 30, 2010. Based upon their evaluation, these executive officers have concluded that our disclosure controls and procedures are effective as of June 30, 2010.

Changes in Internal Control over Financial Reporting. There has been no change to our internal control over financial reporting during the quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

From time to time, we may have disputes that arise in the ordinary course of our business. Currently, there are no legal proceedings to which we are a party, or to which any of our property is subject, that we expect to have a material adverse effect on our financial condition.

ITEM 1A. RISK FACTORS

There are no material changes from the risk factors previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2009, filed with the SEC on March 2, 2010, as amended on March 10, 2010.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number	Description
31.1	Certification of Principal Executive Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Principal Executive Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Principal Financial Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

DATED: July 26, 2010
China Security & Surveillance Technology, Inc.

By: /s/ Guoshen Tu
Principal Executive Officer

By: /s/ Terence Yap
Principal Financial Officer

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