SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K/A
(Amendment No. 2)

(Mark One)

[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 1998 or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from ---------- to ----------

Commission File Number 0-16109

ADVANCED POLYMER SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

| Delaware | 94-2875566 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |

| 123 Saginaw Drive, Redwood City, California | 94063 |
|---|---|
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code: (650) 366-2626

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12 (g) of the Act:
Common Stock ($.01 par value)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (ss.229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

The aggregate market value of the voting stock of the registrant held by non-affiliates of the registrant as of February 28, 1999, was $64,091,712. (1)

As of February 28, 1999, 19,993,311 shares of registrant's Common Stock, $.01 par value, were outstanding.

---

(1)Excludes 6,500,319 shares held by directors, officers and shareholders whose ownership exceeds 5% of the outstanding shares at February 28, 1999. Exclusion of such shares should not be construed as indicating that the holders thereof possess the power, directly or indirectly, to direct the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

| Document | Form 10-K Part |
| --- | --- |
| Definitive Proxy Statement to be used in connection with the Annual Meeting of Stockholders. | III |

TABLE OF CONTENTS

PART II



PART IV



The accompanying information in Items 6, 7 and 8 has been restated to reflect a change in accounting for license fees. See footnote 17 to Item 8, financial statements.

Item 6. SELECTED FINANCIAL DATA
(in thousands, except per share data)

| For the Years Ended and as of December 31 | 1998 | 1997 | 1996 | 1995 | 1994 |
|---|---|---|---|---|---|
| | (As Restated (1)) | | | | |
| **Statements of Operations Data** | | | | | |
| Product revenues | $13,637 | 12,442 | 6,138 | 5,803 | 5,093 |
| Royalties, license fees and R&D fees | 6,984 | 3,266 | 1,056 | 451 | 508 |
| Consumer products | -- | -- | 10,468 | 9,104 | 9,389 |
| Milestone payments | -- | 1,500 | -- | 750 | -- |
| Cost of sales | 7,127 | 7,164 | 10,772 | 11,047 | 10,149 |
| Research and development, net | 4,382 | 3,740 | 3,506 | 4,139 | 6,334 |
| Selling, marketing and advertising | 2,999 | 3,806 | 8,455 | 6,560 | 5,669 |
| General and administrative | 3,009 | 3,552 | 2,984 | 3,082 | 2,844 |
| Loss on purchase commitment, including related inventory | -- | -- | 1,400 | 600 | 685 |
| Net income (loss) | 2,525 | (1,808) | (10,381) | (9,359) | (10,653) |
| Basic earnings (loss) per common share | 0.13 | (0.10) | (0.58) | (0.57) | (0.71) |
| Diluted earnings (loss) per common share | 0.12 | (0.10) | (0.58) | (0.57) | (0.71) |
| Weighted average common shares outstanding - basic | 19,854 | 18,779 | 17,987 | 16,459 | 15,018 |
| Weighted average common shares outstanding - diluted | 20,381 | 19,815 | 19,494 | 16,953 | 15,401 |
| **Balance Sheet Data** | | | | | |
| Working capital | $ 4,760 | 5,151 | 3,860 | 5,725 | 5,641 |
| Total assets | 23,081 | 24,180 | 18,444 | 23,082 | 23,508 |
| Long-term debt, excluding current portion | -- | 3,055 | 5,579 | 6,355 | 979 |
| Shareholders' equity | 9,036 | 4,113 | 7 | 1,233 | 7,786 |

(1) See footnote 17 to Item 8, Financial Statements. The above five-year summary reflects the cumulative effect of the restatement as of January 1, 1992.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations(Dollar amounts are rounded to nearest thousand)

The following tables summarize highlights from the statements of operations expressed as a percentage change from the prior year and as a percentage of product revenues.

STATEMENTS OF OPERATIONS HIGHLIGHTS (in thousands)

| | For the Years Ended December 31, | | | Annual % Change | |
|---|---|---|---|---|---|
| | 1998 | 1997 | 1996 | 98/97 | 97/96 |
| | (As Restated (1)) | | | | |
| Product revenues | $13,637 | 12,442 | 6,138 | 10% | 103% |
| Royalties, license fees and R&D fees | 6,984 | 3,266 | 1,056 | 114% | 209% |
| Consumer products | -- | -- | 10,468 | --% | (100%) |
| Milestone payment | -- | 1,500 | -- | (100%) | --% |
| Total revenues | 20,621 | 17,208 | 17,662 | 20% | (3%) |
| Cost of sales | 7,127 | 7,164 | 10,772 | (1%) | (33%) |
| Research and development, net | 4,382 | 3,740 | 3,506 | 17% | 7% |
| Selling and marketing | 2,999 | 3,806 | 5,405 | (21%) | (30%) |
| Advertising and promotion | -- | -- | 3,050 | --% | (100%) |

| | | | | | |
|---|---|---|---|---|---|
| General and administrative | 3,009 | 3,552 | 2,984 | (15%) | 19% |
| Loss on purchase commitments, Including related inventory | -- | -- | 1,400 | --% | (100%) |

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| Expenses expressed as a percentage of total revenues: | | | |
| Cost of sales | 35% | 42% | 61% |
| Research and development, net | 21% | 22% | 20% |
| Selling and marketing | 15% | 22% | 31% |
| Advertising and promotion | -- | -- | 17% |
| General and administrative | 15% | 21% | 17% |
| Loss on purchase commitments, including related inventory | -- | -- | 8% |

(1) See footnote 17 to Item 8, Financial Statements. Subsequent to the issuance of the Company's 1998 financial statements and the filing of its 1998 Form 10-K with the Securities and Exchange Commission (SEC), and following discussions with the staff of the SEC concerning its review of the Company's financial statements, APS decided to restate its financial statements for fiscal years ended December 31, 1992 through 1998. The statements of operations highlights reflect the cumulative effect of the restatement as of December 31, 1995. The accompanying consolidated financial statements for the years ended December 31, 1998, 1997 and 1996 included in Item 8 present restated results to reflect a change in accounting such that license fees are amortized over the estimated life of the product to which they relate. In prior presentations, the Company recognized as earned license fees which were non-refundable and not subject to material contingencies or commitments. The change results in a difference in the timing of revenue recognition of license fees and has no effect on the Company's cash flows.

## Results of Operations for the years ended December 31, 1998 and 1997

Except for statements of historical fact, the statements herein are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval, launch and acceptance of new products, development of new products, establishment of new corporate alliances, progress in research and development programs, risks of consummation of contemplated action to maximize shareholder value (as to which there is no assurance) and other risks described below or identified from time to time in the Company's Securities and Exchange Commission filings.

The Company's revenues are derived principally from product sales, license fees and royalties and R&D fees. Under strategic alliance arrangements entered into with certain corporations, APS can receive an access/license fee, milestone payments, commitments for future minimum purchases, royalties based on third party product sales or a share of partners' revenues, and revenues from the supply of Microsponge and Polytrap systems. The Company is currently manufacturing and selling Microsponge(R) delivery systems for use by customers in approximately 100 different skin care products.

These strategic alliances are intended to provide the Company with the marketing expertise and/or financial strength of other companies. In this respect, the Company's periodic financial results are dependent upon the degree of success of current collaborations and the Company's ability to negotiate acceptable collaborative agreements in the future.

Product revenues for 1998 totaled $13,637,000, an increase of $1,195,000 or 10% from the prior year. This increase resulted from the launches of a variety of new cosmeceutical products incorporating the Microsponge system technology.

Royalties, license fees and R&D fees increased by $3,718,000 or 114% from the prior year to a total of $6,984,000. Approximately 31% of the increase is attributable to higher R&D fees. Increased royalties accounted for approximately 20% of the increase. The remaining 49% of the increase is due to license fees from corporate partners for access to new products and termination of exclusive supply agreements that resulted in recognition of the unamortized portion of the related license fees. License fees totaled $2,555,000 in 1998, an increase of $1,830,000 or 152% from the prior year. Approximately $1,500,000 of the increase relates to license fees for terminated or renegotiated supply agreements.

Total revenues for 1997 included a milestone payment of $1,500,000 from Ortho upon receipt of marketing clearance from the FDA for Retin-A Micro in February 1997.

Gross profit on product revenues for 1998 was $6,511,000, an increase of $1,233,000 or 23% over the prior year. The gross profit improvement was mainly due to increased sales of higher margin proprietary cosmeceutical products.

Research and development expenses increased by $642,000 or 17% to $4,382,000 due mainly to increased headcount, increased expenditure on new technology and expenses resulting from the move to new facilities in the first quarter of 1998.

Selling and marketing expense decreased by $807,000 or 21% from the prior year to $2,999,000 primarily as a result of reduced headcount, reduced outside services and one-time expenses related to the relocation of a senior executive in the prior year.

General and administrative expenses decreased by $543,000 or 15% to $3,009,000. This decrease was primarily attributable to a favorable settlement of the lawsuit from Biosource and a reduction in a variety of outside services.

Interest income decreased by $124,000 or 34% from the prior year due to lower average cash balances. Interest expense decreased by $247,000 or 23% due mainly to scheduled principal repayments during the year.

Net income for 1998 was $2,525,000, an improvement of $4,333,000 over the prior year's net loss of $1,808,000.

## Results of Operations for the years ended December 31, 1997 and 1996

Product revenues excluding revenues from consumer products for 1997 totaled $12,442,000, an increase of $6,305,000 or 103% over the prior year. This increase resulted primarily from the launches of a variety of new products incorporating the Microsponge(R) system technology by the Company's marketing partners. These product launches included Anew Retinol Recovery Complex PM Treatment which is marketed by Avon, and

TxSystems(TM) AFIRM retinol formulation and Beta Lift peel kits which are marketed by Medicis Pharmaceutical.

Royalties, license fees and R&D fees increased by $2,210,000 or 209% to $3,266,000 due mainly to royalties received from Ortho on sales of Retin-A(R) Micro(TM) and from Lander on sales of certain consumer products. License fees received from new corporate partners for access to new products also contributed to the increase.

Total revenues for 1997 of $17,208,000 also included recognition of $1,500,000 as a portion of a milestone payment received from J&J upon receipt of marketing clearance from the Food and Drug Administration ("FDA") for Retin-A Micro in February 1997.

Total revenues of $17,662,000 for 1996 included $10,468,000 from sales of consumer products most of which were licensed out to Lander Company effective January 1, 1997.

Gross profit as a percentage of total product revenues including consumer products (in 1996), increased from 35% in 1996 to 42% in 1997. The increase was primarily attributable to increased sales of higher margin proprietary cosmeceutical products, the absence of consumer products and increased manufacturing volume.

Operating expenses for 1997 of $11,098,000 represented a decrease of $5,247,000 or 32% from the prior year total of $16,345,000. Operating expenses for the prior year included a loss on purchase commitment for the purchase of melanin for $1,400,000.

Selling and marketing expense decreased by $1,599,000 or 30% from the year-ago period to $3,806,000 in 1997. This substantial decrease was due primarily to the execution of the Company's strategic plan whereby it is no longer responsible for the direct selling, advertising and distribution of consumer products. Effective January 1, 1997, the Company out-licensed most of its consumer products to Lander Company in return for a royalty stream. This also resulted in the elimination of spending on advertising and promotion of products which had been $3,050,000 in the prior year.

Research and development expenses increased by $234,000 or 7% to $3,740,000 in 1997 as the Company continued to invest in the expansion of its technology base.

General and administrative expense increased by $568,000 or 19% to $3,552,000 in 1997 due mainly to increased spending on a variety of outside services.

Interest income increased by $47,000 or 15% to $370,000 due to higher average cash balances. Interest expense decreased by $171,000 or 14% to $1,053,000 due mainly to scheduled principal repayments during the year.

The net loss for the year of $1,808,000 represented a decrease of 83% or $8,573,000 from the year-ago loss of $10,381,000.

## Capital Resources and Liquidity

Total assets as of December 31, 1998 were $23,081,000 compared with $24,180,000 at December 31, 1997. Working capital decreased to $4,760,000 at December 31, 1998 from $5,151,000 at December 31, 1997 and cash and cash equivalents decreased to $4,088,000 from $8,672,000. For the year ended December 31, 1998, the Company's operating activities used $1,548,000 of cash compared to $30,000 in the prior year. The Company invested approximately $4,382,000 in product research and development and $2,999,000 in selling and marketing the Company's products and technologies.

Accounts receivable, net increased to $2,533,000 at December 31, 1998 from $2,288,000 at December 31, 1997. Days sales outstanding increased to 68 days in 1998 from 67 days in 1997. Receivables from royalties, license fees and R&D fees increased to $2,297,000 in 1998 from $1,100,000 in 1997 due mainly to an increase in related revenues and deferred revenues in the fourth quarter of 1998. Royalty payments are not typically due from customers until 45 days after the end of each quarter. Research and development fees are typically billed at the end of each quarter.

Capital expenditures for the year ended December 31, 1998 totaled $2,710,000 compared to $2,800,000 in the prior year. Capital expenditures were incurred for plant expansion projects at the Company's manufacturing facility in Lafayette, Louisiana which are necessary to meet anticipated higher volume requirements. This stage of the plant expansion has been completed. Capital expenditures were also incurred for leasehold improvements to the newly-leased corporate offices and research and development facility in Redwood City and for replacement of non-Year 2000 compliant systems.

The Company has financed its operations, including technology and product research and development, from amounts raised in debt and equity financings, the sale of Microsponge and Polytrap delivery systems and analytical standard products; payments received under licensing agreements; and interest earned on short-term investments.

During 1998, the company received approximately $1,651,000 from the exercise of approximately 310,000 warrants to purchase common stock which had been issued in conjunction with a 1994 private placement.

In March 1999, the Company received a $4,000,000 term loan with a fixed interest rate of 13.87%. The loan is secured by the assets of the Company's manufacturing facility in Louisiana and a portion of the Company's accounts receivable. Principal and interest payments are due in equal monthly installments over a period of forty-eight months commencing March 1999.

The term loan was obtained mainly to refinance the scheduled debt repayments made in the first quarter of 1999.

The Company's existing cash and cash equivalents, collections of trade accounts receivable, together with interest income and other revenue producing activities including licensing fees, royalties and research and development fees are expected to be sufficient to meet the Company's working capital requirements for the foreseeable future, assuming no changes to existing business plans.

## Year 2000

The Company is conducting a comprehensive review of its internal computer systems to ensure these systems are adequate to address the issues expected to arise in connection with the Year 2000. These issues include the possibility that software which uses only the last two digits to refer to the year will no longer function properly for years that begin with 20 rather than 19. In addition, the Company is reviewing the status of its customers and suppliers with regard to this issue and assessing the potential impact of non-compliance by such parties on the Company's operations.

The Company has developed a phased program to address Year 2000 issues. The first phase consists of identifying necessary changes to application software used by the Company. The Company utilizes an integrated ERP system for the majority of its manufacturing and financial systems and has received the Year 2000 compliant version of the software from the vendor. Implementation of the upgraded software was completed on September 30, 1998.

The second phase consists of determining whether Company systems not addressed in Phase One (including non-IT systems) are Year 2000 compliant. Identification of systems that are not Year 2000 compliant has been completed. The Company is now in the process of upgrading or replacing these systems. The Company expects to upgrade or replace these non-compliant systems by the third quarter of 1999.

The third phase consists of determining the extent to which the Company may be impacted by third parties' systems, which may not be Year 2000-compliant. The Year 2000 computer issue creates risk for the Company from third parties with whom the Company deals on financial transactions worldwide. While the Company expects to complete efforts in the second quarter of 1999, there can be no assurance that the systems of other companies with which the Company deals or on which the Company's systems rely will be converted on a timely basis, or that any such failure to convert by another company could not have an adverse effect on the Company.

Based on current estimates, management expects the total cost to remediate non-compliant systems will be less than $650,000 (approximately $580,000 of which was incurred in 1998). Most of the costs incurred were for purchases of new systems and related equipment. The estimate may change materially as the Company continues to review and audit the result of its work. The Company expects to fund all costs to upgrade or replace systems that are not Year 2000-compliant through operating cash flows.

The Company has not yet determined its most likely worst case Year 2000 scenario. Potential Year 2000 scenarios are going to be considered in the Company's contingency plans.

The Company is currently in the process of developing formal contingency plans for addressing any problems which may result if the work performed in phase two and three do not successfully resolve all issues by the Year 2000. The Company expects to complete its contingency plans in the second quarter of 1999.

Failure to complete any necessary remediation by the Year 2000 may have a material adverse impact on the operations of the Company. Failure of third parties, such as customers and suppliers, to remediate Year 2000 problems in their IT and non-IT systems would also have a material adverse impact on the operations of the Company.

## New Accounting Standards

- ------------------------

In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 131 "Disclosures about Segments of A Business Enterprise" (SFAS 131) which is effective for financial statements beginning after December 15, 1997, and establishes standards for disclosures about segments of an enterprise. Currently the Company operates in a single segment.

In June 1998, the FASB issued SFAS No. 133 "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133) which will be effective for all fiscal quarters of fiscal years beginning after June 15, 1999. SFAS 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. SFAS 133 generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributed to the hedged risk or (b) the earnings effect of hedged forecasted transactions. Earlier application of all provisions of this statement is encouraged but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this statement. The Company anticipates that adoption of this statement will not have a material effect on the consolidated financial statements.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

## Consolidated Balance Sheets

| | December 31, 1998 | December 31, 1997 |
|---|---|---|
| | (As Restated - See Note 17) | |
| **Assets** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 4,088,173 | 8,672,021 |
| Accounts receivable less allowance for doubtful accounts of $96,284 and $57,453 at December 31, 1998 and 1997, respectively | 2,532,527 | 2,288,297 |
| Receivables for royalties, license fees and R&D fees | 2,296,852 | 1,100,368 |
| Accrued interest receivable | 3,801 | 13,606 |
| Inventory | 2,959,443 | 2,639,129 |
| Advances to officers and employees | 338,947 | 96,706 |
| Prepaid expenses and other | 592,599 | 430,839 |
| Total current assets | 12,812,342 | 15,240,966 |
| Property and equipment, net | 8,643,856 | 6,771,173 |
| Deferred loan costs, net | 90,428 | 353,693 |
| Prepaid license fees, net | -- | 82,880 |
| Goodwill and other intangibles, net of accumulated amortization of $1,286,873 and $1,102,480 at December 31, 1998 and 1997, respectively | 1,351,813 | 1,477,542 |
| Other long-term assets | 182,892 | 254,180 |
| Total Assets | $ 23,081,331 | 24,180,434 |
| **Liabilities and Shareholders' Equity** | | |
| Current Liabilities: | | |
| Accounts payable | $ 1,347,737 | 1,636,189 |
| Accrued expenses | 1,057,287 | 2,832,299 |
| Accrued settlement liability | 1,300,000 | 1,800,000 |
| Current portion - long-term debt | 3,055,460 | 2,523,389 |
| Deferred revenue | 1,291,540 | 1,297,970 |
| Total current liabilities | 8,052,024 | 10,089,847 |
| Deferred revenue - long-term | 5,993,245 | 6,922,345 |
| Long-term debt | -- | 3,055,460 |
| Total Liabilities | 14,045,269 | 20,067,652 |
| Commitments and Contingencies | | |
| Shareholders' Equity: | | |
| Preferred stock, authorized 2,500,000 shares; none issued or outstanding at December 31, 1998 and 1997 | -- | -- |
| Common stock, $.01 par value, authorized 50,000,000 shares; issued and outstanding 19,993,311 and 19,464,821 at December 31, 1998 and 1997, respectively | 199,933 | 194,648 |
| Warrants, issued and outstanding: 196,538 at December 31, 1998 and 506,816 at December 31, 1997 | 497,192 | 983,192 |
| Additional paid-in capital | 84,206,508 | 81,327,554 |
| Accumulated deficit | (75,867,571) | (78,392,612) |
| Total Shareholders' Equity | 9,036,062 | 4,112,782 |
| Total Liabilities and Shareholders' Equity | $ 23,081,331 | 24,180,434 |

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

| | For the Years Ended December 31, | | |
|---|---|---|---|
| | 1998 | 1997 | 1996 |
| | (As Restated - See Note 17) | | |
| Revenues | | | |
| Product revenues | $13,637,093 | 12,441,484 | 6,138,094 |
| Royalties, license fees and R&D fees | 6,983,702 | 3,266,095 | 1,055,935 |
| Consumer products | -- | -- | 10,467,512 |
| Milestone payments | -- | 1,500,000 | -- |
| Total revenues | 20,620,795 | 17,207,579 | 17,661,541 |
| Expenses | | | |
| Cost of sales | 7,126,573 | 7,164,120 | 10,771,766 |
| Research and development, net | 4,381,913 | 3,740,337 | 3,506,161 |
| Selling and marketing | 2,999,424 | 3,806,030 | 5,404,774 |
| Advertising and promotion | -- | -- | 3,050,180 |
| General and administrative | 3,009,488 | 3,551,977 | 2,984,213 |
| Loss on purchase commitment, including related inventory | -- | -- | 1,400,000 |
| Operating income (loss) | 3,103,397 | (1,054,885) | (9,455,553) |
| Interest expense | (805,364) | (1,052,715) | (1,223,303) |
| Interest income | 246,260 | 370,478 | 322,986 |
| Other expense, net | (19,252) | (71,119) | (25,595) |
| Income (loss) | $ 2,525,041 | (1,808,241) | (10,381,465) |
| Basic earnings (loss) per common Share | $ 0.13 | (0.10) | (0.58) |
| Diluted earnings (loss) per common share | $ 0.12 | (0.10) | (0.58) |
| Weighted average common shares outstanding - basic | 19,854,103 | 18,778,921 | 17,987,153 |
| Weighted average common shares Outstanding - diluted | 20,380,832 | 19,814,833 | 19,494,412 |

See accompanying notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

For the Years Ended December 31, 1998, 1997 and 1996
(As Restated - See Note 17)

| | Common Stock | | Common Stock Warrants | | Additional | Accumulated Other | | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Paid-In Capital | Comprehensive Income | Accumulated Deficit | Shareholders' Equity |
| Balance, December 31, 1995 | 17,026,666 | $170,267 | 1,628,611 | $2,653,076 | $64,600,516 | $12,348 | $(66,202,906) | $1,233,301 |
| Options exercised | 416,219 | 4,162 | -- | -- | 1,993,017 | -- | -- | 1,997,179 |
| Shares retired | (12,836) | (128) | -- | -- | (97,747) | -- | -- | (97,875) |
| Private placement, net of $62,149 in offering costs | 201,922 | 2,019 | 86,538 | 295,751 | 1,640,081 | -- | -- | 1,937,851 |
| Common stock to be issued in connection with the agreement with Johnson & Johnson | (432,101) | (4,321) | -- | -- | 4,321 | -- | -- | -- |
| Common stock issued in connection with the agreement with Johnson & Johnson | 432,101 | 4,321 | -- | -- | (4,321) | -- | -- | -- |
| Common stock issued in | | | | | | | | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| connection with the agreement with Lander Company, net of $39,547 in offering costs | 356,761 | 3,567 | -- | -- | 2,956,976 | -- | -- | 2,960,543 |
| Common stock issued to Dow Corning, net of $4,000 in offering costs | 200,000 | 2,000 | -- | -- | 1,194,000 | -- | -- | 1,196,000 |
| Common stock issued to Biosource | 94,000 | 940 | -- | -- | 599,060 | -- | -- | 600,000 |
| Securities issued in debt financing arrangements | 10,675 | 107 | 4,325 | (50,935) | 78,353 | -- | -- | 27,525 |
| Fair value of stock options issued to non-employees | -- | -- | -- | -- | 161,299 | -- | -- | 161,299 |
| Warrants exercised | 66,337 | 663 | (87,500) | (155,200) | 539,537 | -- | -- | 385,000 |
| Warrants expired | -- | -- | (200,000) | (285,000) | 285,000 | -- | -- | -- |
| Reclassification adjustment for unrealized holding gains included in net income | -- | -- | -- | -- | -- | (12,348) | -- | (12,348) |
| Net loss | -- | -- | -- | -- | -- | -- | (10,381,465) | (10,381,465) |
| Balance December 31, 1996 | 18,359,744 | $183,597 | 1,431,974 | $2,457,692 | $73,950,092 | $ -- | $(76,584,371) | $ 7,010 |
| Options exercised | 165,374 | 1,654 | -- | -- | 777,452 | -- | -- | 779,106 |
| Fair value of stock options issued to non-employees | -- | -- | -- | -- | 96,757 | -- | -- | 96,757 |
| Common stock issued to employees under the Employee Stock Purchase Plan | 14,545 | 145 | -- | -- | 87,125 | -- | -- | 87,270 |
| Warrants exercised | 925,158 | 9,252 | (925,158) | (1,474,500) | 6,416,128 | -- | -- | 4,950,880 |
| Net loss | -- | -- | -- | -- | -- | -- | (1,808,241) | (1,808,241) |
| Balance, December 31, 1997 | 19,464,821 | $194,648 | 506,816 | $ 983,192 | $81,327,554 | $ -- | $(78,392,612) | $ 4,112,782 |
| Options exercised | 79,598 | 796 | -- | -- | 413,072 | -- | -- | 413,868 |
| Fair value of stock options issued to non-employees | -- | -- | -- | -- | 42,200 | -- | -- | 42,200 |
| Restricted stock awards | 100,000 | 1,000 | -- | -- | 99,857 | -- | -- | 100,857 |
| Common stock issued to employees under the Employee Stock Purchase Plan | 38,614 | 386 | -- | -- | 190,249 | -- | -- | 190,635 |
| Warrants exercised | 310,278 | 3,103 | (310,278) | (486,000) | 2,133,576 | -- | -- | 1,650,679 |
| Net income | -- | -- | -- | -- | -- | -- | 2,525,041 | 2,525,041 |
| Balance, December 31, 1998 | 19,993,311 | $199,933 | 196,538 | $ 497,192 | $84,206,508 | $ -- | $(75,867,571) | $ 9,036,062 |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

| | For the Years Ended December 31, | | |
|---|---|---|---|
| | 1998 | 1997 | 1996 |
| | (As Restated - See Note 17) | | |
| Cash flows from operating activities: | | | |
| Net income (loss) | $ 2,525,041 | (1,808,241) | (10,381,465) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | | |
| Depreciation and amortization | 1,104,337 | 980,933 | 1,393,805 |
| Provision for loss on purchase commitments, including inventory | -- | -- | 1,400,000 |
| Allowance for doubtful accounts | 38,830 | 22,967 | 9,331 |
| Stock compensation awards to non-employees | 42,200 | 96,757 | 161,299 |
| Restricted stock awards | 100,857 | -- | -- |
| Amortization of deferred loan costs | 263,265 | 263,265 | 215,366 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (283,060) | (1,286,817) | 958,682 |
| Receivables for royalties, license fees and R&D fees | (1,196,484) | (458,667) | (197,346) |
| Accrued interest receivable | 9,805 | (9,643) | 12,510 |
| Inventory | (320,314) | (554,056) | 5,573,511 |
| Advances to officers and employees | (242,241) | (3,727) | (23,058) |
| Prepaid expenses and other | (161,760) | (199,753) | 684,192 |
| Assets held for sale | -- | -- | (2,181,004) |
| Other long-term assets | 71,288 | (194,577) | 129,425 |
| Accounts payable and accrued expenses | (2,063,464) | 654,324 | (6,075,821) |
| Accrued settlement liability | (500,000) | -- | 1,200,000 |
| Deferred revenue | (935,530) | 2,466,949 | 1,003,366 |
| Net cash used in operating activities | (1,547,230) | (30,286) | (6,117,207) |
| Cash flows from investing activities: | | | |
| Purchases of property and equipment | (2,709,747) | (2,799,683) | (719,640) |
| Purchases of intangible assets | (58,664) | (400,000) | -- |
| Proceeds from sale of equipment and assets held for sale | -- | 2,181,004 | -- |
| Purchases of marketable securities | -- | -- | (512,513) |
| Maturities and sales of marketable securities | -- | -- | 500,165 |
| Net cash used in investing activities | (2,768,411) | (1,018,679) | (731,988) |
| Cash flows from financing activities: | | | |
| Repayment of long-term debt | (2,523,389) | (1,490,779) | (870,598) |
| Proceeds from long-term debt and warrants | -- | -- | 758,795 |
| Proceeds from private placements, net of offering costs | -- | -- | 1,937,851 |
| Proceeds from stock issued to Lander Company, net of offering costs | -- | -- | 2,960,543 |
| Proceeds from the exercise of common stock options and warrants, net of common stock retired | 2,064,547 | 5,729,986 | 2,284,304 |
| Proceeds from issuance of shares under the employee Stock Purchase Plan | 190,635 | 87,270 | -- |
| Net cash (used in) provided by financing activities | (268,207) | 4,326,477 | 7,070,895 |
| Net (decrease) increase in cash and cash equivalents | (4,583,848) | 3,277,512 | 221,700 |
| Cash and cash equivalents at the beginning of the year | 8,672,021 | 5,394,509 | 5,172,809 |
| Cash and cash equivalents at the end of the year | $ 4,088,173 | 8,672,021 | 5,394,509 |
| Cash paid in interest | $ 559,664 | 790,379 | 893,239 |

Supplemental disclosure of non-cash financing transactions:
During the first quarter of 1996, the Company acquired all rights to the Polytrap technology from Dow Corning Corporation ("DCC") in exchange for 200,000 shares of common stock valued at $1,200,000.
During the first quarter of 1996, the Company paid Biosource for the 1995 purchase commitment totaling $600,000 by issuing 94,000 shares of common stock.
In 1996, the Company offset a deposit of approximately $188,000 with a creditor against a loan from the same creditor (Note 8).

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 1998, 1997 AND 1996

Note 1   Business

Advanced Polymer Systems, Inc. ("APS" or the "Company") develops, manufactures and sells patented delivery systems that allow for the controlled release of active ingredients which have benefits in the ethical dermatology, cosmetic and personal care areas.  Certain projects are conducted under development and licensing arrangements with large companies and a number of projects are exclusive to APS.  Prior to 1997, APS also marketed and distributed a range of consumer products for personal care through its subsidiary, Premier, Inc. ("Premier"). Effective January 1, 1997, APS licensed the consumer products to a third party.

Note 2   Summary of Significant Accounting Policies

Principles of Consolidation:  The consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries, Premier, Advanced Consumer Products, Inc. ("ACP") and APS Analytical Standards.  All significant intercompany balances and transactions have been eliminated in consolidation.

Subsequent to the issuance of the Company's 1998 financial statements and the filing of its 1998 10-K with the Securities and Exchange Commission ("SEC"), and following discussions with the staff of the SEC concerning its review of the Company's financial statements, APS decided to restate its financial statements for all periods presented (Note 17).

Cash Equivalents and Marketable Securities

For purposes of the Consolidated Statements of Cash Flows and Consolidated Balance Sheets, the Company considers all short-term investments that have original maturities of less than three months to be cash equivalents.  Short-term investments consist primarily of commercial paper, master notes and repurchase agreements.  All investments were classified as cash equivalents in the accompanying original financial statements since there were no investments with original maturities longer than three months.  The Company has classified its investments in certain debt and equity securities as "available-for-sale".

Financial Instruments

The Company's investments are recorded at fair value with unrealized holding gains and losses reported as a separate component of shareholders' equity.  The carrying amounts reported in the balance sheets for cash, receivables, accounts payable, accrued liabilites and short-term and long-term debt approximate fair values due to the short-term maturities.

Inventory

Inventory is stated at the lower of cost or market value, utilizing the average cost method (Note 6).

Property and Equipment

Property and equipment are carried at cost.  Depreciation is computed using the straight-line method over the estimated useful lives of the assets, not exceeding twenty years (Note 7).

Prepaid License Fees

A fee paid to Biosource in 1992 was amortized over a seven-year period consistent with the term of the agreement (Note 3). Amortization of prepaid license fees totalled $82,880, $82,872 and $137,880 in 1998, 1997 and 1996, respectively.  As of December 31, 1998, the prepaid license fee has been fully amortized.

Deferred Loan Costs

Deferred charges relate to costs incurred in obtaining certain loans. These charges are being amortized over the life of the loans using the effective interest method (Note 8).

Long-Lived Assets, Including Goodwill and Other Intangibles

In accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" as circumstances dictate, the Company evaluates whether changes have occurred that would require revision of the remaining estimated lives of recorded long-lived assets, including goodwill, or render those assets not recoverable. If such circumstances arise, recoverability is determined by comparing the undiscounted net cash flows of long-lived assets to their respective carrying values. The amount of impairment, if any, is measured based on the projected discounted cash flows using an appropriate discount rate. At this time, the Company believes that no significant impairment of long-lived assets, including goodwill and other intangibles, has occurred and that no reduction of the estimated useful lives of such assets is warranted.

In 1997, APS acquired all the rights to Exact(R) acne medication from Johnson & Johnson Consumer Products, Inc. for $350,000. Effective January 1, 1997, APS licensed Exact and other consumer products to Lander Company. The rights are being amortized on a straight-line basis over the length of the licensing agreement with Lander.

In the first quarter of 1996, APS acquired all patents and rights to the Polytrap technology from Dow Corning Corporation in exchange for 200,000 shares of its common stock. APS recorded intangible assets totalling $1,200,000 relating to this transaction. The intangible assets are being amortized on a straight-line basis over a period of approximately 10 years, which is the remaining life of the main patent acquired.

In 1992, APS acquired for 157,894 shares of its common stock, the outstanding 25% interest in ACP, APS' over-the-counter consumer products subsidiary. The acquisition was accounted for as a purchase. Excess of cost over net assets acquired arising from the purchase was amortized over five years on a straight-line basis.

Amortization of intangible assets totalled $184,392, $188,259 and $279,756, in 1998, 1997 and 1996, respectively.

## Stock-Based Compensation

The Company has chosen to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for "Stock Issued to Employees" and related interpretations. Accordingly, except for stock options issued to non-employees and restricted stock awards to employees, no compensation cost has been recognized for the Company's fixed stock option plans and stock purchase plan (Note 10).

## Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and related notes to financial statements. Changes in such estimates may affect amounts in future periods.

## Revenue Recognition

Product revenues are recorded upon shipment of products.

The Company has several licensing agreements that generally provide for the Company to receive periodic minimum payments, royalties, and/or non-refundable license fees. These licensing agreements typically require a non-refundable license fee and allow customers to sell the Company's proprietary products in a specific field or territory. The license agreements provide for APS to earn future revenue through product sales and/or, in some cases, royalty payments. The license fees are non-refundable even if the agreements are terminated before their term or APS fails to supply product to the licensee. These license fees are amortized on a straight-line basis over the estimated life of the product to which they relate. When the customer fails to meet applicable contract terms and product supply is no longer required, any unamortized license fees are recognized as revenue.

Contractually required minimum royalties are recorded ratably throughout the contractual period. Royalties in excess of minimum royalties are recognized as earned when the related product is shipped to the end customer by the Company's licensees based on information received by the Company from its licensees.

A milestone payment is a payment made by a third party or corporate partner to the Company upon the achievement of a predetermined milestone as defined in a legally binding contract. Milestone payments are recognized as revenue when the milestone event has occurred and the Company has completed all milestone related services such that the milestone payment is currently due and is non-refundable. In 1997, the Company achieved a milestone payment with the receipt of marketing clearance from the FDA for Retin-A(R) Micro(TM) (Note 15).

Fees from research and development activities are recognized as revenues when earned and contract provisions are met. Such fees (revenues) represent amounts paid to APS as reimbursement of costs incurred in product development and clinical evaluation, including a portion of overhead and administrative expenses. As a general policy, revenues are not recognized if amounts received are refundable or the Company has related future performance obligations.

Advertising and Promotion Costs
- -------------------------------

Advertising and promotion costs are expensed as incurred.

Earnings (Loss) Per Share
- -------------------------

The Company has adopted and retroactively applied the provisions of Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("FAS 128") for all periods presented. FAS 128 requires the Company to report both basic earnings per share, which is computed by dividing net income by the weighted-average number of common shares outstanding, and diluted earnings per share, which is computed by dividing net income by the total of weighted-average number of common shares outstanding and dilutive potential common shares outstanding (Note 11).

Deferred Revenue
- ----------------

Non-refundable license fees received by the Company are reported as deferred revenues and amortized over the estimated life of the product to which they relate (Note 17).

Prepaid royalties paid to APS by Ortho-McNeil Pharmaceutical Corporation ("Ortho"), a subsidiary of Johnson & Johnson Inc. ("J&J"), as part of the retinoid licensing agreement are also reported as deferred revenues (Note 15). In accordance with the licensing agreement, 25% of the royalties earned by APS are applied against the deferred revenues after certain annual minimum royalty payments are met.

Concentrations of Credit Risk
- -----------------------------

Financial instruments which potentially expose the Company to concentrations of credit risk, as defined by Statement of Financial Accounting Standards No. 105, consist primarily of trade accounts receivable. Approximately 65% and 51% of the recorded trade receivables were concentrated with five and five customers in the cosmetic and personal care industries as of December 31, 1998 and 1997, respectively. To reduce credit risk, the Company performs ongoing credit evaluations of its customers' financial conditions. The Company does not generally require collateral.

Reclassifications
- -----------------

Certain reclassifications have been made to the prior year financial statements to conform with the presentation in 1998.

Note 3 Related Party Transactions

The Company has entered into agreements with Biosource Technologies, Inc. ("Biosource") of which Toby Rosenblatt, a member of the Company's Board of Directors, is a stockholder and a former director. All agreements between APS and Biosource have been, and will continue to be, considered and approved by a vote of the disinterested directors. The agreements provided APS worldwide rights to use and sell Biosource's biologically-synthesized melanin in Microsponge systems for all sun protection, cosmetic, ethical dermatology and over-the-counter skin care purposes. In return, APS was required to make annual minimum purchases of melanin, pay royalties on sales of APS melanin-Microsponge products and was required to prepay $500,000 of royalties. For estimated losses on purchase commitments and related inventory, the Company accrued $0,$0 and $1,400,000 in 1998, 1997 and 1996, respectively. All minimum financial commitments under the current agreements have been expensed by APS.

In 1996, APS paid Biosource the 1995 minimum purchase commitment by issuing Biosource 94,000 shares of APS common stock.

In November, 1997 Biosource filed a complaint against the Company in the San Mateo Superior Court. In December 1998, the Company reached a settlement agreement with Biosource for a net amount of $1,300,000, which consists of a $1,500,000 settlement of Biosource's claims and a $200,000 settlement of the Company's cross claims (Note 4). The Company's consolidated financial statemements for the period ended December 31, 1998 include a favorable decrease in accrued settlement liability of $500,000 resulting from the settlement agreement.

As of December 31, 1998, the Company has an outstanding secured loan receivable of $253,000 from an officer of the Company. The loan bears an interest rate of approximately 5% and is secured by the shares of Company stock owned by the officer. The loan was approved by the Compensation Committee of the Company's Board of Directors. Repayment of the loan is due by December 31, 1999.

Note 4 Legal Proceeding

In November, 1997 Biosource filed a complaint against the Company in the San Mateo Superior Court. Biosource claimed damages from the Company on the grounds that the Company had failed to pay certain minimum amounts allegedly due under a contract for the supply of melanin.

In December 1998, the Company reached a settlement agreement with Biosource for a net amount of $1,300,000, which consists of a $1,500,000 settlement of Biosource's claims and a $200,000 settlement of the Company's cross claims. Pursuant to the agreement, the Company paid Biosource $300,000 in January, 1999. The remaining $1,000,000 is payable by any combination of cash and/or the issuance of shares of the Company's Common Stock. The settlement agreement also provides for the termination of the license and supply agreement between the parties.

Note 5 Cash Equivalents

All investments in debt securities have been classified as cash equivalents in the accompanying balance sheets as they had original maturities of 90 days or less.

At December 31, 1998 and 1997, the amortized cost and estimated market value of investments in debt securities are set forth in the tables below:

| | December 31, 1998 | |
|---|---|---|
| | Cost | Estimated Marked Value |
| Available-for-Sale: | | |
| Corporate debt securities | $1,984,204 | 1,984,204 |
| Other debt securities | 152,119 | 152,119 |
| Totals | $2,136,323 | 2,136,323 |

| | December 31, 1997 | |
|---|---|---|
| | Cost | Estimated Market Value |
| Available-for-Sale: | | |
| Corporate debt securities | $6,726,919 | 6,726,919 |
| Other debt securities | 869,634 | 869,634 |
| Totals | $7,596,553 | 7,596,553 |

Note 6 Inventory

The major components of inventory are as follows:

| | December 31, | |
|---|---|---|
| | 1998 | 1997 |
| Raw materials and work-in-process | $ 743,383 | 834,496 |
| Finished goods | 2,216,060 | 1,804,633 |
| Total inventory | $2,959,443 | 2,639,129 |

Note 7 Property and Equipment

Property and equipment consist of the following:

| | December 31, | |
|---|---|---|
| | 1998 | 1997 |
| Building | $ 1,831,392 | 1,823,625 |
| Land and improvements | 163,519 | 163,519 |
| Leasehold improvements | 1,423,584 | 1,233,074 |
| Furniture and equipment | 14,504,305 | 13,001,437 |

| | | |
|---|---|---|
| Total property and equipment | 17,922,800 | 16,221,655 |
| Accumulated depreciation and amortization | (9,278,944) | (9,450,482) |
| Property and equipment, net | $ 8,643,856 | 6,771,173 |

Depreciation expense amounted to $837,064, $709,802 and $976,163 for the years ended December 31, 1998, 1997, and 1996, respectively.

Note 8 Long-Term Debt

Long-term debt consists of the following:

| | December 31, 1998 | 1997 |
|---|---|---|
| Bank loan, interest payable monthly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flow of a subsidiary of the Company and guaranteed by the Company | $1,550,000 | 2,550,000 |
| Term loan, subordinated to bank loan, interest payable quarterly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company | 852,500 | 1,402,500 |
| Term loan, principal and interest due in equal monthly installments commencing October 1996 through December 1999, secured by certain real and personal property | 652,960 | 1,626,349 |
| Total | 3,055,460 | 5,578,849 |
| Less current portion | 3,055,460 | 2,523,389 |
| Long-term debt | $ -- | 3,055,460 |

In 1995, the Company received an aggregate amount of $8,122,334 from three financing arrangements.

The first financing arrangement was a $3,000,000 bank loan with an interest rate equal to two percentage points above the Prime Rate (7.75% as of December 31, 1998). The loan is secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company.

The second financing arrangement was a $1,650,000 term loan with a syndicate of lenders and a fixed interest rate of 14%. The loan is also secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company. The security interest of the debt holders is subordinated to the bank loan's security interest.

In the third quarter of 1995, the Company consummated a transaction whereby certain assets were sold to a third party and subsequently leased back for a fixed rental stream over a period of forty-eight months. The Company has the option either to purchase all the properties at the expiration of the term of the lease or extend the term of the lease. The Company reported this transaction as a financing transaction since the requirements for consummation of a sale were not met. A deposit of $188,000 with the lender was offset against the loan balance as of December 31, 1998 and 1997. This transaction has been reflected in the table above as a term loan.

The terms of certain financing agreements contain, among other provisions, requirements for a subsidiary of the Company to maintain defined levels of earnings, net worth and various financial ratios, including debt to net worth. In conjunction with the debt financing agreements, APS issued a total of 197,500 warrants with an original exercise price of $7.00 per share of common stock. In accordance with the original terms of the warrant agreements, the exercise price on 110,000 of the warrants outstanding at December 31, 1997 was reduced to $3.00 per share on December 31, 1997 as a result of the Company reporting a net loss for the 1997 fiscal year.

All costs incurred in obtaining the financing arrangements have been capitalized as deferred charges, and are being amortized over the life of the loans using the effective interest method. Interest paid in 1998, 1997 and 1996 approximated interest expense reflected in the Consolidated Statements of Operations.

Note 9 Commitments

Lease Commitments: Total rental expense for property and equipment was $1,019,534, $770,187 and $655,283 for 1998, 1997 and 1996, respectively.

The Company's future minimum lease payments under noncancellable operating leases for facilities as of December 31, 1998, are as follows:

| Years Ending December 31, | Minimum Payments |
|---|---|
| 1999 | $ 768,279 |
| 2000 | 770,849 |
| 2001 | 747,455 |
| 2002 | 737,333 |
| 2003 | 675,135 |
| Thereafter | 573,474 |
| | $4,272,525 |

Note 10 Shareholders' Equity

Private Placements and Common Stock Warrants: In January 1996, in accordance with a 1994 private placement agreement, APS issued J&J 432,101 shares of common stock as a result of the APS stock price not achieving certain predetermined levels. The 200,000 warrants issued to J&J in conjunction with this private placement expired in 1996 (Note 15).

During 1997, 925,158 warrants issued in connection with a 1994 private placement were exercised. In March 1998, the remaining 310,278 warrants from the 1994 private placement were exercised.

In conjunction with certain debt financing agreements made in 1995 (Note 8), APS issued a total of 197,500 warrants with an original exercise price of $7.00 per share of common stock. In accordance with the warrant agreements, the exercise price was reduced to $3.00 on December 31, 1997 as a result of the Company reporting a net loss for the 1997 fiscal year. These warrants expire on March 27, 2000.

In the first quarter of 1996, the Company formed a collaborative agreement with Lander Company under which the Company received approximately $2,961,000 in net proceeds from the sale of 356,761 shares of common stock. The agreement also provided for licensing fees, research and development funding and royalties on product sales.

In 1996, APS acquired all patents and rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS common stock (Note 2).

During the second quarter of 1996, APS received $1,937,851 net of offering costs, through a private placement and sale of 201,922 shares of common stock and 86,538 warrants exercisable over a three-year period. The warrants are exercisable at the following prices:

| Number of Shares | Exercise Price |
|---|---|
| 28,846 | $ 7.43 |
| 28,846 | 9.90 |
| 28,846 | 12.38 |

Shareholders Rights Plan: On August 19, 1996, the Board of Directors approved a Shareholders Rights Plan under which shareholders of record on September 3, 1996 received a dividend of one Preferred Stock purchase right ("Rights") for each share of common stock outstanding. The Rights were not exercisable until 10 business days after a person or group acquired 20% or more of the outstanding shares of common stock or announced a tender offer which could have resulted in a person or group beneficially owning 20% or more of the outstanding shares of common stock (an "Acquisition") of the Company. The Board of Directors approved an increase in threshold to 30% in December 1997. Each Right, should it become exercisable, will entitle the holder (other than acquirer) to purchase company stock at a discount. The Board of Directors may terminate the Rights plan or, under certain circumstances, redeem the rights.

In the event of an Acquisition without the approval of the Board, each Right will entitle the registered holder, other than an acquirer and certain related parties, to buy at the Right's then current exercise price a number of shares of common stock with a market value equal to twice the exercise price.

In addition, if at the time when there was a 30% shareholder, the Company were to be acquired by merger, shareholders with unexercised Rights could purchase common stock of the acquirer with a value of twice the exercise price of the Rights.

The Board may redeem the Rights for $0.01 per Right at any time prior to Acquisition. Unless earlier redeemed, the Rights will expire on August 19, 2006.

Stock-Based Compensation Plans: The Company has two types of stock-based compensation plans, a stock purchase plan and stock option plans.

In 1997, the stockholders approved the Company's 1997 Employee Stock Purchase Plan (the "Plan"). Under the 1997 Employee Stock Purchase Plan, the Company is authorized to issue up to 400,000 shares of common stock to its employees, nearly all of whom are eligible to participate. Under the terms of the Plan, employees can elect to have up to a maximum of 10 percent of their base earnings withheld to purchase the Company's common stock. The purchase price of the stock is 85 percent of the lower of the closing prices for the Company's common stock on: (i) the first trading day in the enrollment period, as defined in the Plan, in which the purchase is made, or (ii) the purchase date. The length of the enrollment period may not exceed a maximum of 24 months. Enrollment dates are the first business day of May and November provided that the first enrollment date was April 30, 1997. Approximately 50 percent of eligible employees participated in the Plan in 1998. Under the Plan, the Company issued 38,614 shares in 1998, 14,545 shares in 1997 and no shares in 1996. The weighted average fair value of purchase rights granted during 1998 and 1997 were $1.65 and $2.77, respectively. The weighted average exercise price of the purchase rights exercised during 1998 and 1997 were $3.83 and $6.00, respectively. As of December 31, 1998, the Company had 346,841 shares reserved for issuance under the stock purchase plan.

The Company has various stock option plans for employees, officers, directors and consultants. The options are granted at fair market value and expire no later than ten years from the date of grant. The options are exercisable in accordance with vesting schedules that generally provide for them to be fully exercisable four years after the date of grant.

The following table summarizes option activity for 1998, 1997 and 1996:

| | 1998 | | 1997 | | 1996 | |
|---|---|---|---|---|---|---|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 2,947,755 | $6.63 | 2,901,440 | $6.46 | 2,972,324 | $5.98 |
| Granted | 777,000 | 5.18 | 313,500 | 7.50 | 502,500 | 7.89 |
| Exercised | (79,598) | 5.20 | (165,374) | 4.71 | (416,219) | 4.80 |
| Expired or Cancelled | (77,974) | 7.83 | (101,811) | 8.36 | (157,165) | 6.25 |
| Outstanding at end of year | 3,567,183 | 6.32 | 2,947,755 | 6.63 | 2,901,440 | 6.46 |
| Options exercisable at year-end | 2,698,960 | | 2,259,683 | | 1,945,056 | |
| Shares available for future grant at year end | 293,269 | | 358,295 | | 569,984 | |
| Weighted-average fair value of options granted during the year | | $2.45 | | $4.25 | | $5.12 |

The following table summarizes information about fixed stock options outstanding at December 31, 1998:

| | OPTIONS OUTSTANDING | | | OPTIONS EXERCISABLE | |
|---|---|---|---|---|---|
| Range of Exercise Prices | Number Outstanding 12/31/98 | Weighted Average Remaining Contractual Life | Weighted Average Remaining Exercise Price | Number Exercisable at 12/31/98 | Weighted Average Remaining Exercise Price |
| $3.44-$5.25 | 1,205,490 | 6.8 years | $ 4.55 | 875,285 | $ 4.64 |
| $5.38-$6.25 | 939,620 | 5.9 | 5.66 | 796,079 | 5.59 |
| $6.38-$8.13 | 933,073 | 7.3 | 7.28 | 538,596 | 7.28 |
| $9.25-$15.00 | 489,000 | 4.0 | 10.12 | 489,000 | 10.12 |

| | | | | | |
|---|---|---|---|---|---|
| $3.44-$15.00 | 3,567,183 | 6.3 | 6.32 | 2,698,960 | 6.44 |
| | ========= | | | ========= | |

The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards No. 123, ("SFAS No. 123") "Accounting for Stock-Based Compensation." Accordingly, except for stock options issued to non-employees and restricted stock awards to employees, no compensation cost has been recognized for the various fixed stock option plans and stock purchase plan. The compensation cost that has been charged against income for the stock options issued to non-employees and restricted stock awards to employees was $142,057, $96,800 and $161,300 for 1998, 1997 and 1996, respectively. Had compensation cost for the Company's stock-based compensation plans been determined consistent with the fair value method provisions of SFAS No. 123, the Company's net loss and loss per common share would have increased to the pro-forma amounts indicated below:

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| | | (As Restated - See Note 17) | |
| Net income (loss) - as reported | $ 2,525,041 | (1,808,241) | (10,381,465) |
| Net income (loss) - pro-forma | 795,086 | (3,135,399) | (11,466,237) |
| Basic earnings (loss) per common share | 0.13 | (0.10) | (0.58) |
| Diluted earnings (loss) per common share | 0.12 | (0.10) | (0.58) |
| Basic earnings (loss) per common share - pro-forma | 0.04 | (0.17) | (0.64) |
| Diluted earnings (loss) per common share - pro-forma | 0.04 | (0.17) | (0.64) |

For stock options, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1998, 1997 and 1996, respectively: dividend yield of 0 for all years; expected volatility of 48 percent, 60 percent and 85 percent; risk-free interest rates of 4.7 percent, 5.7 percent and 6.1 percent; and expected life of five years, five years and four years for all the stock option plans.

For the stock purchase plan, the fair value of each award is also estimated using the Black-Scholes option pricing model. For purchase rights granted in 1998, the multiple option approach with the following assumptions were used for expected terms of six, twelve, eighteen and twenty-four months: risk-free interest rate of 5.1%; volatility of 54%; and dividend yield of zero. The purchase rights granted in 1997 were valued using the following assumptions for expected terms of six, twelve, eighteen and twenty-four months, respectively: risk-free interest rates of 5.7 percent, 5.8 percent, 6.0 percent and 6.0 percent; volatility of 40 percent for all four terms; and dividend yield of zero for all terms. There were no grants under the stock purchase plan in 1996.

The amounts disclosed above under the fair value method of SFAS No. 123 include compensation costs and fair values for options and purchase rights granted since January 1, 1995 and may not be representative of the effects in future years.

Note 11 Earnings Per Share

In the fourth quarter of 1997, the Company adopted and retroactively applied the requirements of Statement of Financial Accounting Standards No. 128, "Earnings Per Share", to all periods presented. The following table sets forth the computation of the Company's basic and diluted earnings (loss) per share:

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| | | (As Restated - See Note 17) | |
| Net income (loss) (numerator) | $ 2,525,041 | (1,808,241) | (10,381,465) |
| | ========== | ========== | ========== |
| Shares calculation (denominator): | | | |
| Weighted average shares outstanding - basic | 19,854,103 | 18,778,921 | 17,987,153 |
| Effect of dilutive securities: | | | |
| Stock options and employee stock purchase plan | 381,518 | 634,655 | 859,767 |
| Warrants | 145,211 | 401,257 | 647,492 |
| | ---------- | ---------- | ---------- |
| Weighted average shares outstanding - diluted | 20,380,832 | 19,814,833 | 19,494,412 |

| | | | |
|---|---|---|---|
| Earnings (loss) per share - basic | 0.13 | (0.10) | (0.58) |
| Earnings (loss) per share - diluted | 0.12 | (0.10) | (0.58) |

The following options with expiration dates ranging from December 18, 2001 to June 10, 2008 were outstanding during the periods presented, but were not included in the computation of diluted earnings per share since the exercise prices of the options were greater than the average market price of the common shares:

| | 1998 | 1997 | 1996 |
|---|---|---|---|
| Number outstanding | 1,362,432 | 757,417 | 522,000 |
| Range of exercise prices | $6.81 - $15.00 | $7.88 - $15.00 | $9.25 - $11.13 |

Note 12   Comprehensive Income

During the first quarter of 1998, the Company adopted Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income" which establishes standards for reporting and display of comprehensive income and its components in a full set of general purpose financial statements. For the years ended December 31, 1998 and 1997, comprehensive income (loss) was the same as net income (loss). For the year ended December 31, 1996, a reclassification adjustment for gains included in net income is reported in the Statement of Shareholders' Equity.

Note 13   Defined Contribution Plan

The Company sponsors a defined contribution plan covering substantially all of its employees. In the past three calendar years, the Company made matching contributions equal to 50% of each participant's contribution during the plan year up to a maximum amount equal to the lesser of 3% of each participant's annual compensation or $4,800, $4,750 and $4,750 for the 1998, 1997 and 1996 calendar years, respectively. The Company may also contribute additional discretionary amounts as it may determine. For the years ended December 31, 1998, 1997 and 1996, the Company contributed to the plan approximately $124,000, $110,000 and $110,000, respectively. No discretionary contributions have been made to the plan since its inception.

Note 14   Income Taxes

A reconciliation of the federal statutory rate of 34% to the Company's effective tax rate is as follows:

| | December 31 | | |
|---|---|---|---|
| | 1998 | 1997 | 1996 |
| U.S. Federal statutory rate (benefit) | 34.00% | (34.00)% | (34.00)% |
| State taxes, net of federal income tax benefit | -- | -- | -- |
| Net losses without benefits | -- | 31.40 | 33.75 |
| Utilization of temporary differences for which no benefit was previously recognized | (34.76) | -- | -- |
| Nondeductible expenses | 0.76 | 2.60 | 0.25 |
| Total tax expense (benefit) | -- | -- | -- |

At December 31, 1998, the Company had net federal operating loss carryforwards of approximately $73,400,000 for income tax reporting purposes and California operating loss carryforwards of approximately $3,460,000. The federal net operating losses expire beginning in 1999 through the year 2018. The California net operating loss carryforwards expire beginning in 1999 through the year 2003. A federal net operating loss carryforward from 1983 in the approximate amount of $147,000 expired December 31, 1998. A California net operating loss carryforward from 1993 in the approximate amount of $370,000 expired on December 31, 1998.

The Company also has investment tax credits and research and experimental tax credits aggregating approximately $1,692,000 and $909,000 for federal and California purposes, respectively. The federal credit carryforwards expire beginning in 1999 through the year 2018. The California credits carry over indefinitely until utilized.

In addition, there are California credit carryforwards for qualified manufacturing and research and development equipment of approximately

$20,000; these credits expire beginning in 2003 through the year 2006.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities as of December 31, 1998 and 1997 are presented below:

| | 1998 | 1997 |
|---|---|---|
| Deferred tax assets: | | |
| Deferred research expenditures | $ 1,544,000 | 1,367,000 |
| Accruals and reserves not currently deductible for tax purposes | 977,000 | 1,934,000 |
| Net operating loss carryforwards | 25,260,000 | 25,680,000 |
| Credit carryforwards | 2,621,000 | 2,445,000 |
| Other | 286,000 | 246,000 |
| Gross deferred tax assets | 30,688,000 | 31,672,000 |
| Less valuation allowance | (29,927,000) | (31,522,000) |
| Total deferred tax assets | 761,000 | 150,000 |
| Deferred tax liabilities: | | |
| Property and equipment | (761,000) | (150,000) |
| Total deferred tax liabilities | (761,000) | (150,000) |
| Net deferred taxes | $ -- | -- |

The net change in the valuation allowance for the year ended December 31, 1998 was a decrease of approximately $1,595,000. The net change in the valuation allowance for the years ended December 31, 1997 and 1996 was an increase of approximately $340,000 and $3,756,000, respectively. Management believes that sufficient uncertainty exists regarding the realizability of its deferred asset and, accordingly, a valuation allowance is required.

Gross deferred tax assets as of December 31, 1998 include approximately $2,800,000 relating to the exercise of stock options, for which any related tax benefits will be credited to equity when realized.

Note 15 Ortho-McNeil Pharmaceutical Corporation

In May 1992, APS entered into development, and licensing and investment agreements with Ortho-McNeil Pharmaceutical Corporation ("Ortho") for the development of retinoid products. The first product is a Microsponge system entrapment of tretinoin (trans-retinoic acid or "t-RA"), a prescription acne drug for which FDA approval was received in February 1997. A second product licensed to Ortho is a Microsponge entrapment of a retinoid to be used for the treatment of photodamaged skin.

The terms of the agreements included an $8,000,000 investment in APS for 723,006 newly issued shares of APS common stock and the payment to APS of $6,000,000 in R&D fees by J&J.

J&J made a second equity investment in the Company in May 1994. Under this agreement, J&J purchased 1,000,000 shares of newly issued common stock in consideration for $5,000,000. In January 1996, APS issued J&J 432,101 shares of common stock as a result of the APS stock price not achieving certain predetermined levels. The 200,000 warrants issued in 1994 to J&J in conjunction with this equity investment expired in 1996. As of December 31, 1998, J&J owned approximately 7% of the APS common shares outstanding.

In February 1995, APS received $750,000 in prepaid royalties and an additional $750,000 as a milestone payment on the submission to the FDA of its New Drug Application for the tretinoin prescription acne treatment. The milestone payment was recognized as revenue upon receipt. The prepaid royalties of $750,000 were recorded as deferred revenues. In February 1997, upon receipt of approval from the FDA to market Retin-A(R) Micro (tretinoin gel) microsphere for the treatment of acne, APS received $3,000,000 from Ortho of which one half is a milestone payment which was recognized as revenue in 1997 and half is prepaid royalties which was recorded as deferred revenues. APS earns a mark-up on Microsponge systems supplied to Ortho and Ortho pays APS a royalty on product sales, subject to certain minimums. Should these minimums not be achieved, Ortho would lose its exclusivity and APS would regain marketing rights to the retinoid products.

Note 16 Subsequent Event (Unaudited)

In March 1999, the Company received a $4,000,000 term loan with a fixed interest rate of 13.87%. The loan is secured by the assets of the Company's manufacturing facility in Louisiana. Principal and interest payments are due in equal monthly installments over a period of forty-eight months commencing March 1999.

The term loan was obtained mainly to refinance the scheduled debt repayments made in the first quarter of 1999.

Note 17 Restatement

Subsequent to the issuance of the Company's 1998 financial statements and the filing of its 1998 Form 10-K with the Securities and Exchange Commission (SEC), and following discussions with the staff of the SEC concerning its review of the Company's financial statements, APS decided to restate its financial statements for fiscal years ended December 31, 1992 through 1998. The accompanying consolidated financial statements reflect the cumulative effect of the restatement as of December 31, 1995. The cumulative effect of the change as of December 31, 1995 is to increase total deferred revenue by $4,000,000 from $750,000 to $4,750,000, increase accumulated deficit by $4,000,000 from $62,202,906 to $66,202,906 and decrease total shareholders' equity by $4,000,000 from $5,233,301 to $1,233,301. The accompanying consolidated financial statements for the years ended December 31, 1998, 1997 and 1996 present restated results to reflect a change in accounting such that license fees are amortized over the estimated life of the product to which they relate. In prior presentations, the Company recognized as earned license fees which were non-refundable and not subject to material contingencies or obligations. The change results in a difference in the timing of revenue recognition of license fees and has no effect on the Company's cash flows.

A comparison of the restated and previously reported statements of operations for the years ended December 31, 1998, 1997 and 1996 and balance sheets as of December 31, 1998 and December 31, 1997 follows:

CONSOLIDATED STATEMENTS OF OPERATIONS

For the Years Ended December 31,

| | 1998 (As Restated) | 1998 (As Previously Reported) | 1997 (As Restated) | 1997 (As Previously Reported) | 1996 (As Restated) | 1996 (As Previously Reported) |
|---|---|---|---|---|---|---|
| Product revenues | $13,637,093 | $13,637,093 | $12,441,484 | $12,441,484 | $ 6,138,094 | $ 6,138,094 |
| Royalties, license and option fees and R&D fees | 6,983,702 | 6,354,186 | 3,266,095 | 4,391,175 | 1,055,935 | 2,059,301 |
| Consumer products | -- | -- | -- | -- | 10,467,512 | 10,467,512 |
| Milestone payments | -- | -- | 1,500,000 | 1,500,000 | -- | -- |
| Total revenues | 20,620,795 | 19,991,279 | 17,207,579 | 18,332,659 | 17,661,541 | 18,664,907 |
| Cost of sales | 7,126,573 | 7,126,573 | 7,164,120 | 7,164,120 | 10,771,766 | 10,771,766 |
| Operating expenses: | | | | | | |
| Research & development, net | 4,381,913 | 4,381,913 | 3,740,337 | 3,740,337 | 3,506,161 | 3,506,161 |
| Selling & marketing | 2,999,424 | 2,999,424 | 3,806,030 | 3,806,030 | 5,404,774 | 5,404,774 |
| Advertising & promotion | -- | -- | -- | -- | 3,050,180 | 3,050,180 |
| General & administration | 3,009,488 | 3,009,488 | 3,551,977 | 3,551,977 | 2,984,213 | 2,984,213 |
| Loss on purchase commitments | -- | -- | -- | -- | 1,400,000 | 1,400,000 |
| Total operating expenses | 10,390,825 | 10,390,825 | 11,098,344 | 11,098,344 | 16,345,328 | 16,345,328 |
| Operating income (loss) | 3,103,397 | 2,473,881 | (1,054,885) | 70,195 | (9,455,553) | (8,452,187) |
| Interest income | 246,260 | 246,260 | 370,478 | 370,478 | 322,986 | 322,986 |
| Interest expense | (805,364) | (805,364) | (1,052,715) | (1,052,715) | (1,223,303) | (1,223,303) |
| Other expense, net | (19,252) | (19,252) | (71,119) | (71,119) | (25,595) | (25,595) |
| Net income (loss) | $ 2,525,041 | $ 1,895,525 | $(1,808,241) | $ (683,161) | $(10,381,465) | $ (9,378,099) |
| Basic earnings (loss) per common share | $ 0.13 | $ 0.10 | $ (0.10) | $ (0.04) | $ (0.58) | $ (0.52) |
| Diluted earnings (loss) per common share | $ 0.12 | $ 0.09 | $ (0.10) | $ (0.04) | $ (0.58) | $ (0.52) |
| Weighted average common shares outstanding - basic | 19,854,103 | 19,854,103 | 18,778,921 | 18,778,921 | 17,987,153 | 17,987,153 |
| Weighted average common shares outstanding - diluted | 20,380,832 | 20,380,832 | 19,814,833 | 19,814,833 | 19,494,412 | 19,494,412 |

CONSOLIDATED BALANCE SHEETS

| | As of December 31, 1998 | | As of December 31, 1997 | |
|---|---|---|---|---|
| | (As Restated) | (As Previously Reported) | (As Restated) | (As Previously) Reported) |
| ASSETS | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ 4,088,173 | $ 4,088,173 | $ 8,672,021 | $ 8,672,021 |
| Accounts receivable less allowance for doubtful accounts of $96,284 and $57,453 at December 31, 1998 and 1997, respectively | 2,532,527 | 2,532,527 | 2,288,297 | 2,288,297 |
| Receivables for royalties, license fees and R&D fees | 2,296,852 | 2,296,852 | 1,100,368 | 1,100,368 |
| Accrued interest receivable | 3,801 | 3,801 | 13,606 | 13,606 |
| Inventory | 2,959,443 | 2,959,443 | 2,639,129 | 2,639,129 |
| Advances to officers and employees | 338,947 | 338,947 | 96,706 | 96,706 |
| Prepaid expenses and other | 592,599 | 592,599 | 430,839 | 430,839 |
| Total current assets | 12,812,342 | 12,812,342 | 15,240,966 | 15,240,966 |
| Property and equipment, net | 8,643,856 | 8,643,856 | 6,771,173 | 6,771,173 |
| Deferred loan costs, net | 90,428 | 90,428 | 353,693 | 353,693 |
| Prepaid license fees, net | -- | -- | 82,880 | 82,880 |
| Goodwill and other intangibles, net of accumulated amortization of $1,286,873 and $1,102,480 at December 31, 1998 and 1997, respectively | 1,351,813 | 1,351,813 | 1,477,542 | 1,477,542 |
| Other long-term assets | 182,892 | 182,892 | 254,180 | 254,180 |
| Total assets | $ 23,081,331 | $ 23,081,331 | $ 24,180,434 | $ 24,180,434 |
| LIABILITIES & SHAREHOLDERS' EQUITY | | | | |
| Current liabilities: | | | | |
| Accounts payable | $ 1,347,737 | $ 1,347,737 | 1,636,189 | 1,636,189 |
| Accrued expenses | 1,057,287 | 1,057,287 | 2,832,299 | 2,832,299 |
| Accrued settlement liability | 1,300,000 | 1,300,000 | 1,800,000 | 1,800,000 |
| Current portion - long-term debt | 3,055,460 | 3,055,460 | 2,523,389 | 2,523,389 |
| Deferred revenue | 1,291,540 | 750,000 | 1,297,970 | 306,014 |
| Total current liabilities | 8,052,024 | 7,510,484 | 10,089,847 | 9,097,891 |
| Deferred revenue - long-term | 5,993,245 | 1,035,855 | 6,922,345 | 1,785,855 |
| Long-term debt | -- | -- | 3,055,460 | 3,055,460 |
| Total liabilities | 14,045,269 | 8,546,339 | 20,067,652 | 13,939,206 |
| Commitments and Contingencies | | | | |
| Shareholders' equity: | | | | |
| Preferred stock, authorized 2,500,000 shares; none issued or outstanding at December 31, 1998 and 1997 | -- | -- | -- | -- |
| Common stock, $.01 par value, authorized 50,000,000 shares; issued and outstanding 19,993,311 and 19,464,821 at December 31, 1998 and 1997, respectively | 199,933 | 199,933 | 194,648 | 194,648 |
| Warrants, issued and outstanding: 196,538 at December 31, 1998 and 506,816 at December 31, 1997 | 497,192 | 497,192 | 983,192 | 983,192 |
| Additional paid-in capital | 84,206,508 | 84,206,508 | 81,327,554 | 81,327,554 |
| Accumulated deficit | (75,867,571) | (70,368,641) | (78,392,612) | (72,264,166) |
| Total shareholders' equity | 9,036,062 | 14,534,992 | 4,112,782 | 10,241,228 |
| Total liabilities and shareholders' equity | $ 23,081,331 | $ 23,081,331 | $ 24,180,434 | $ 24,180,434 |

Independent Auditors' Report

The Board of Directors and Shareholders
Advanced Polymer Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1998. In connection with our audits of the consolidated financial statements, we also have audited the consolidated financial statement schedule as listed in Item 14(a)2. These consolidated financial statements and the consolidated financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and the financial statement schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1998, in conformity with generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in note 17 to the consolidated financial statements, the accompanying consolidated financial statements have been restated.

/s/KPMG LLP

San Francisco, California
March 12, 1999, except as to note 17, which is dated as of November, 18, 1999

Part IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a) 1. Financial Statements
The financial statements and supplementary data set forth in Part II of the 10-K/A (Amendment No. 2) Annual Report are incorporated herein by reference.
2. Financial Statement Schedules
Schedule II Valuation Accounts
All other schedules have been omitted because the information is not required or is not so material as to require submission of the schedule, or because the information is included in the financial statements or the notes thereto.
3. Exhibits
3-A-Copy of Registrant's Certificate of Incorporation. (1)
3-B-Copy of Registrant's Bylaws. (1)
10-C-Registrant's 1992 Stock Plan dated August 11, 1992. (2)*
10-D-Registrant's 1997 Employee Stock Purchase Plan dated March 5, 1997 (9)*
10-E-Lease Agreement between Registrant and Metropolitan Life Insurance Company for lease of Registrant's executive offices in Redwood City dated as of November 17, 1997. (11)
10-N-Agreement with Johnson & Johnson dated April 14, 1992. (3)
10-P-Warrant to Purchase Common Stock. (5)
10-S-Lease Agreement between Registrant and Financing for Science International dated September 1, 1995 (6)
10-T-Security and Loan Agreement between Registrant and Venture Lending dated September 27, 1995 (6)
10-U-Asset Purchase Agreement with Dow Corning Corporation dated January 23, 1996 (7)
10-V-Investment Agreement between Registrant and Lander Company. (8)
10-W-License, Assignment and Supply Agreement between Registrant and Lander Company. (10)
21-Proxy Statement for the Annual Meeting of Shareholders. (4)
23-Consent of Independent Auditors.
27-Financial Data Schedules

(b) Reports on Form 8-K
None.

(c) Exhibits
The Company hereby files as part of this Form 10-K/A (Amendment No. 2) the exhibits listed in Item 14(a)3 as set forth above.

(d) Financial Statement Schedules
See Item 14(a)2 of this Form 10-K/A (Amendment No. 2).

---

(1) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Registration Statement on Form S-1 (Registration No. 33-15429) and incorporated herein by reference.
(2) Filed as Exhibit No. 28.1 to Registrant's Registration Statement on Form S-8 (Registration No. 33- 50640), and incorporated herein by reference.
(3) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, and incorporated herein by reference.
(4) To be filed supplementally.
(5) Filed as an Exhibit with corresponding Exhibits 4.1, 4.2, 4.3 and 4.4 to Registrant's Registration Statement on Form S-3 (Registration No.33-82562) and incorporated herein by reference.
(6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995.
(7) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
(8) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1996, and incorporated herein by referenced.
(9) Filed an Exhibit No. 99.1 to Registrant's Registration Statement on Form S-8 (Registration No. 333-35151), and incorporated herein by reference.
(10) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1996 and incorporated herein by reference.
(11) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1997, and incorporated herein by reference.

* Management Contract or Compensatory plans.

For purposes of complying with the amendments to the rules governing Registration Statements on Form S-8 (effective July 13, 1990) under the Securities Act of 1933 ("the Act"), as amended, the undersigned registrant hereby undertakes as follows, which undertaking shall be incorporated by reference into Part II of the registrant's Registration Statements on Form S-8 Nos. 33-18942, 33-21829, 33-29084, 33-50640, 333-06841, 333-35151 and 333-60585 filed on April 25, 1990, May 12, 1988, September 30, 1991, August 11, 1992, June 26, 1996, September 8, 1997 and August 4, 1998, respectively.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

SIGNATURES

Pursuant to the requirement of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ADVANCED POLYMER SYSTEMS, INC.

By: /s/John J. Meakem, Jr.

John J. Meakem, Jr.
Chairman, President, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /S/ John J. Meakem, Jr.<br>John J. Meakem, Jr. | Chairman, President, Chief Executive Officer | November 18, 1999 |
| /S/ Michael O'Connell<br>Michael O'Connell | Executive Vice President, Chief Administrative Officer and Chief Financial Officer | November 18, 1999 |
| /S/ Stephen Drury<br>Stephen Drury | Director | November 18, 1999 |
| /S/ Carl Ehmann<br>Carl Ehmann | Director | November 18, 1999 |
| /S/ Jorge Heller<br>Jorge Heller | Director | November 18, 1999 |
| /S/ Peter Riepenhausen<br>Peter Riepenhausen | Director | November 18, 1999 |
| /S/ Toby Rosenblatt<br>Toby Rosenblatt | Director | November 18, 1999 |
| /S/ Richard Spizzirri<br>Richard Spizzirri | Director | November 18, 1999 |
| /S/ Gregory H. Turnbull<br>Gregory H. Turnbull | Director | November 18, 1999 |
| /S/ C. Anthony Wainwright<br>C. Anthony Wainwright | Director | November 18, 1999 |
| /S/ Dennis Winger<br>Dennis Winger | Director | November 18, 1999 |

Schedule II

Valuation Accounts

| | Beginning Balance | Additions Charged to Expense | Deductions | Ending Balance |
|---|---|---|---|---|
| December 31, 1996 | | | | |
| Accounts receivable, allowance for doubtful accounts | $68,650 | 9,331 | 30,454 | 47,527 |
| December 31, 1997 | | | | |
| Accounts receivable, allowance for doubtful accounts | 47,527 | 22,967 | 13,040 | 57,454 |
| December 31, 1998 | | | | |
| Accounts receivable, allowance for doubtful accounts | 57,454 | 38,830 | -- | 96,284 |

CONSENT OF INDEPENDENT AUDITORS

The Board of Directors and Shareholders
Advanced Polymer Systems, Inc.:

We consent to incorporation by reference in the Registration Statements (Nos. 33-18942, 33-21829, 33-29084, 33-50640, 333-06841, 333-35151 and 333-60585) on Forms S-8 of Advanced Polymer Systems, Inc. and in the Registration Statements (Nos. 33-47399, 33-51326, 33-67936, 33-82562, 33-88972, 333-00759, 333-042527 and 333-69815) on Forms S-3 of Advanced Polymer Systems, Inc. of our report dated March 12, 1999, except as to note 17, which is dated as of November 18, 1999 (which expresses an unqualified opinion and includes an explanatory paragraph relating to the restatement described in note 17), relating to the consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 1998, and the related schedule, which report appears in the December 31, 1998 annual report on Form 10-K/A (Amendment No. 2) of Advanced Polymer Systems, Inc.

/s/KPMG LLP

San Francisco, California
November 18, 1999

EXHIBIT INDEX
Form 10-K Annual Report

3-A-Copy of Registrant's Certificate of Incorporation. (1)
3-B-Copy of Registrant's Bylaws. (1)
10-C-Registrant's 1992 Stock Plan dated August 11, 1992. (2)*
10-D-Registrant's 1997 Employee Stock Purchase Plan dated March 5, 1997 (9)*
10-E-Lease Agreement between Registrant and Metropolitan Life Insurance Company for lease of Registrant's executive offices in Redwood City dated as of November 17, 1997. (11)
10-N-Agreement with Johnson & Johnson dated April 14, 1992. (3)
10-P-Warrant to Purchase Common Stock. (5)
10-S-Lease Agreement between Registrant and Financing for Science International dated September 1, 1995 (6)
10-T-Security and Loan Agreement between Registrant and Venture Lending dated September 27, 1995 (6)
10-U-Asset Purchase Agreement with Dow Corning Corporation dated January 23, 1996 (7)
10-V-Investment Agreement between Registrant and Lander Company. (8)
10-W-License, Assignment and Supply Agreement between Registrant and Lander Company. (10)
21-Proxy Statement for the Annual Meeting of Shareholders. (4)
23-Consent of Independent Auditors.
27-Financial Data Schedules

---

(1) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Registration Statement on Form S-1 (Registration No. 33-15429) and incorporated herein by reference.
(2) Filed as Exhibit No. 28.1 to Registrant's Registration Statement on Form S-8 (Registration No. 33- 50640), and incorporated herein by reference.
(3) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, and incorporated herein by reference.
(4) To be filed supplementally.
(5) Filed as an Exhibit with corresponding Exhibits 4.1, 4.2, 4.3 and 4.4 to Registrant's Registration Statement on Form S-3 (Registration No.33-82562) and incorporated herein by reference.
(6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995.
(7) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1995, and incorporated herein by reference.
(8) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1996, and incorporated herein by referenced.
(9) Filed an Exhibit No. 99.1 to Registrant's Registration Statement on Form S-8 (Registration No. 333-35151), and incorporated herein by reference.
(10) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on form 10-K for the year ended December 31, 1996, and incorporated herein by reference.
(11) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1997, and incorporated herein by reference.

* Management Contract or Compensatory plans.

5
THE SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM
THE RESTATED CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 1998, AND
RESTATED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE 12 MONTHS ENDED
DECEMBER 31, 1998, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH
FINANCIAL STATEMENTS.

1
YEAR
DEC-31-1998
DEC-31-1998
4,088,173
0
4,829,379
96,284
2,959,443
12,812,342
17,922,800
9,278,944
23,081,331
8,052,024
0
0
0
199,933
8,836,129
23,081,331
13,637,093
20,620,795
7,126,573
7,126,573
10,390,825
38,830
805,364
2,525,041
0
2,525,041
0
0
0
2,525,041
0.13
0.12

5
THE SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM
THE RESTATED CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 1997, AND
RESTATED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE 12 MONTHS ENDED
DECEMBER 31, 1997, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH
FINANCIAL STATEMENTS.

1
YEAR
DEC-31-1997
DEC-31-1997
8,672,021
0
3,388,665
57,453
2,639,129
15,240,966
16,221,655
9,450,482
24,180,434
10,089,847
3,055,460
0
0
194,648
3,918,134
24,180,434
12,441,484
17,207,579
7,164,120
7,164,120
11,098,344
22,967
1,052,715
(1,808,241)
0
(1,808,241)
0
0
0
(1,808,241)
(0.10)
(0.10)

5
THE SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE UNAUDITED RESTATED CONSOLIDATED BALANCE SHEET AS OF DECEMBER 31, 1996, AND RESTATED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE 12 MONTHS ENDED DECEMBER 31, 1996, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

1
YEAR
DEC-31-1996
DEC-31-1996
5,394,509
0
1,666,148
47,527
2,085,073
11,654,762
13,465,088
8,783,796
18,444,168
7,794,848
5,578,849
183,597
0
0
(176,587)
18,444,168
16,605,606
17,661,541
10,771,766
10,771,766
16,345,328
9,331
1,223,303
(10,381,465)
0
(10,381,465)
0
0
0
(10,381,465)
(0.58)
(0.58)