**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

# FORM 10-Q

**[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended June 30, 2008**

**OR**

**[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the transition period from to**

**Commission File Number 001-33221**

**A.P. PHARMA, INC.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **94-2875566** |
| (State or other jurisdiction of incorporation) | (I.R.S. Employer Identification No.) |
| **123 Saginaw Drive Redwood City CA** | **94063** |
| (Address of principal executive offices) | (Zip Code) |

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

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

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ] Small Reporting Company [X]

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

Yes [ ] No [X]

At July 31, 2008, the number of outstanding shares of the Company's common stock, par value $.01, was 30,891,465.

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**PART I. Financial Information**

**Item 1: Financial Statements**:

**A.P. Pharma, Inc.**
**Condensed Balance Sheets**
**(in thousands)**

| | June 30, 2008 (unaudited) | December 31, 2007 (Note 1) |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 20,356 | $ 33,510 |
| Marketable securities | 1,164 | 1,552 |
| Accounts receivable | 152 | 152 |
| Prepaid expenses and other current assets | 489 | 582 |
| Total current assets | 22,161 | 35,796 |
| Property and equipment, net | 1,163 | 1,079 |
| Other long-term assets | 103 | 75 |
| Total assets | $ 23,427 | $ 36,950 |
| **Liabilities and Stockholders' Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,285 | $ 1,437 |
| Accrued expenses | 3,329 | 4,347 |
| Accrued disposition costs | 501 | 423 |
| Total current liabilities | 5,115 | 6,207 |
| Deferred revenue | 1,000 | 1,000 |
| Other long-term liabilities | 131 | 269 |
| Total liabilities | 6,246 | 7,476 |
| Stockholders' equity: | | |
| Common stock | 138,135 | 137,438 |
| Accumulated deficit | (120,900) | (107,926) |
| Accumulated other comprehensive loss | (54) | (38) |
| Total stockholders' equity | 17,181 | 29,474 |
| Total liabilities and stockholders' equity | $ 23,427 | $ 36,950 |

See accompanying notes to condensed financial statements.

**A.P. Pharma, Inc.**
**Condensed Statements of Operations (unaudited)**
**(in thousands, except per share amounts)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Contract revenue | $ 152 | $ 160 | $ 284 | $ 160 |
| Operating expenses: | | | | |
| Research and development | 5,538 | 3,763 | 11,678 | 8,749 |
| General and administrative | 863 | 872 | 1,943 | 1,991 |
| Total operating expenses | 6,401 | 4,635 | 13,621 | 10,740 |
| Operating loss | (6,249) | (4,475) | (13,337) | (10,580) |
| Interest income, net | 155 | 156 | 436 | 304 |
| Gain on sale of interest in royalties | — | 2,500 | — | 2,500 |
| Other income, net, | 4 | 3 | 7 | 3 |
| Loss from continuing operations | (6,090) | (1,816) | (12,894) | (7,773) |
| Income (loss) from discontinued operations | (40) | 40 | (80) | 32 |
| Loss before income taxes | (6,130) | (1,776) | (12,974) | (7,741) |
| Provision for income taxes | — | — | — | (36) |
| Net loss | $ (6,130) | $ (1,776) | $ (12,974) | $ (7,777) |
| Basic and diluted net loss per share: | | | | |
| Loss from continuing operations | $ (0.20) | $ (0.19) | $ (0.42) | $ (0.98) |
| Net loss | $ (0.20) | $ (0.19) | $ (0.42) | $ (0.98) |
| Shares used to compute basic and diluted net loss per share | 30,800 | 9,591 | 30,786 | 7,961 |

See accompanying notes to condensed financial statements.

**A.P. Pharma, Inc.**
**Condensed Statements of Cash Flows (unaudited)**
**(in thousands)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2008 | 2007 |
| Cash flows from operating activities: | | |
| Net loss | $ (12,974) | $ (7,777) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Loss (gain) from discontinued operations | 80 | (32) |
| Depreciation and amortization | 204 | 189 |
| Stock-based compensation expense | 578 | 276 |
| Amortization of discount and accretion of premium on marketable securities | — | 334 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (20) | (99) |
| Prepaid expenses and other current assets | 93 | (15) |
| Other long-term assets | (28) | 15 |
| Accounts payable | (152) | (55) |
| Accrued expenses | (1,067) | (515) |
| Net cash used in continuing operating activities | (13,286) | (7,679) |
| Net cash provided by (used in) discontinued operations | 19 | (4) |
| Net cash used in operating activities | (13,267) | (7,683) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (288) | (31) |
| Maturities of marketable securities | 372 | 2,825 |
| Sales of marketable securities | — | 5,678 |
| Net cash provided by investing activities | 84 | 8,472 |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock, net of issuance cost | — | 37,550 |
| Proceeds from the exercise of stock options | 2 | — |
| Proceeds from issuance of shares under the Employee Stock Purchase Plan | 27 | 38 |
| Net cash provided by financing activities | 29 | 37,588 |
| Net increase (decrease) in cash and cash equivalents | (13,154) | 38,377 |
| Cash and cash equivalents, beginning of the period | 33,510 | 2,333 |
| Cash and cash equivalents, end of the period | $ 20,356 | $ 40,710 |

See accompanying notes to condensed financial statements.

**A.P. Pharma, Inc.**
**Notes to Condensed Financial Statements**
**June 30, 2008 and 2007 (unaudited)**

## (1) BUSINESS AND BASIS OF PRESENTATION

A.P. Pharma, Inc. (the "Company", "we", "our", or "us") is a specialty pharmaceutical company focused on developing pharmaceutical products using our proprietary Biochronomer polymer-based drug delivery technology. Our product development philosophy is based on incorporating approved therapeutics into our proprietary bioerodible drug delivery technology to create controlled release pharmaceuticals to improve treatments for diseases or conditions. Our lead product candidate, APF530, is currently in a pivotal Phase III clinical trial for the prevention of acute and delayed onset chemotherapy-induced nausea and vomiting, or CINV. We completed enrollment of our pivotal Phase III clinical trial in the second quarter of 2008 and to expect to announce results of that trial in the third quarter of 2008. We expect to submit our new drug application, or NDA, for approval of APF530 in the fourth quarter of 2008.

Our primary focus is to advance our proprietary Biochronomer technology, consisting of bioerodible polymers designed to release drugs over a defined period. The Biochronomer technology can effectively deliver drugs over periods varying from days to several months. We have completed comprehensive animal and human toxicology studies that have established that our Biochronomer polymers are safe and well tolerated. We have completed over 100 *in vivo* and *in vitro* studies demonstrating that our Biochronomer technology is potentially applicable to a range of therapeutic areas, including prevention of nausea and vomiting, pain management, control of inflammation and treatment of ophthalmic diseases. Our lead product candidate, which utilizes our proprietary Biochronomer technology, is APF530. APF530 is designed to prevent CINV for at least five days and contains granisetron, a drug approved for this indication. In September 2005, we completed a Phase II clinical trial of APF530 that achieved all of its primary and secondary endpoints. In May 2006, we initiated our pivotal Phase III clinical trial with AFP530. We believe that this clinical trial will lead to regulatory approval of APF530 for the prevention of acute and delayed onset CINV for patients undergoing both moderately and highly emetogenic, or vomit-inducing, chemotherapy.

In addition to our lead drug candidate, we have a pipeline of other product candidates. One of these, APF112, incorporates the well-known local anesthetic, mepivacaine. It is designed to provide up to 36 hours of post-surgical pain relief and to minimize the use of morphine-like drugs, or opiates, which are used extensively in post-surgical pain management. Post-surgical pain can be treated with local anesthetics, but the usefulness of these drugs is currently limited by the short duration of their effectiveness. A longer acting local anesthetic would be expected to result in better pain management and a reduced need for opiates. Our plan was to initiate a Phase IIb clinical trial for APF112 in the first half of 2008. However, in late April 2008, we determined that some recently manufactured batches of our polymer, AP135, intended for use in our APF112 trial, contained trace amounts of an extraneous material not present in previous lots of APF135. Investigation indicated that this extraneous substance was introduced into the production process at our contract manufacturer via the use of a solvent. Based upon the results of additional testing we believe that the presence of the material affects only the cosmetic properties of the polymer and there are no related toxicology or drug release issues. We are working closely with our manufacturer to establish permanent and rigorous inspection procedures to prevent the occurrence of any future contamination.

Corrective actions have been taken and production of APF112 trial materials was resumed late in the second quarter of 2008. This has, however, resulted in a delay in the planned initiation of the APF112 Phase IIb trial into the fourth quarter of 2008. This manufacturing issue will have no impact on the APF530 development timelines.

We have several additional product candidates using our Biochronomer technology in early stages of development. This includes APF580, which incorporates an opiate into our Biochronomer technology, and is designed to provide analgesia lasting up to seven days by a single injection. It is targeted for situations where the intensity and duration of pain require use of an opiate rather than a local anesthetic.

Animal studies with APF580 are currently being conducted, and data from those studies are being supplemented with additional preclinical data from an ongoing research and development agreement with a major animal health company, which is evaluating APF580 for use in cats and dogs. We are currently completing our preparation of the Investigational New Drug Application (IND) for APF580.

The submission of the IND, which was originally planned for late in the second quarter of 2008, is now expected in the third quarter of 2008. The delay versus previous expectations was largely due to an extended period of time for the collection of certain preclinical information and not a result of the above-mentioned manufacturing issue involving AP135.

The accompanying unaudited condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. All adjustments (all of which are of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2008 are not indicative of the results that may be expected for the year ending December 31, 2008 or for any other period. The condensed balance sheet as of December 31, 2007 has been derived from the audited financial statements as of that date but it does not include all of the information and notes required by U.S. GAAP. These condensed financial statements and the notes thereto should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission (the "SEC") on March 30, 2008 (our "2007 10-K").

**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires our management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ significantly from those estimates. We believe the following policies to be critical to understanding our financial condition, results of operations, and expectations for 2008, because these policies require management to make significant estimates, assumptions and judgments about matters that are inherently uncertain.

- ***Revenue Recognition***

Our revenue arrangements with multiple deliverables are divided into separate units of accounting if certain criteria are met, including whether the delivered item has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered items. The consideration we receive is allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria are considered separately for each of the separate units. Advance payments received in excess of amounts earned are classified as deferred revenue until earned.

- ***Sale of Royalty Revenue***

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro® and Carac® for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and received a $2.5 million milestone payment in June 2007. We may receive an additional $2.5 million based on the satisfaction of certain other predetermined milestones.

- ***Cash Equivalents and Short-term Investments***

We invest excess cash in a variety of high grade primarily short–term interest-bearing securities. We consider all short-term investments in debt securities which have original maturities of less than three months at the date of purchase to be cash equivalents. Investments with maturities of three months or longer are classified as marketable securities in the accompanying condensed balance sheets. Marketable securities are classified as available for sale at the time of purchase and carried at fair value. Unrealized gains or losses, if any, are recorded as other comprehensive income or loss in stockholders' equity. If the estimated fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery in market value and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. If the impairment is considered to be other-than–temporary, the security is written down to its estimated fair value. Other-than-temporary declines in estimated fair value of all marketable securities are charged to "other income (loss), net". The cost of all securities sold is based on the specific identification method.

- ***Contract Revenue***

Contract revenue relates to research and development arrangements that generally provide for us to invoice research and development fees based on full-time equivalent hours for each project. Revenue from these arrangements are recognized as the related development services are rendered. This revenue approximates the costs incurred.

- ***Clinical Trial Accruals***

Our expenses related to clinical trials are based on estimates of the services received and efforts expended pursuant to contracts with multiple research institutions and clinical research organizations that conduct and manage clinical trials on our behalf. Since the invoicing related to these services does not always coincide with our financial statement close process, we must estimate the level of services performed and fees incurred in determining the accrued clinical trial costs. The financial terms of these agreements are subject to negotiation and variation from contract to contract and may result in uneven payment flows. Payments under the contracts depend on factors such as the successful enrollment of patients or achievement of certain events or the completion of portions of the clinical trial or similar conditions. The Phase III clinical trial of APF530 has a significant effect on the Company's research and development expenses. Expenses related to clinical trials generally are accrued based on the level of patient enrollment and services performed by the clinical research organization or related service provider according to the protocol. We monitor patient enrollment levels and related activity to the extent possible and adjust our estimates accordingly. Historically these estimates have been accurate and no material adjustments have had to be made.

- ***Income Taxes***

We make certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments occur in the calculation of certain tax assets and liabilities, which arise from differences in the timing of recognition of revenue and expense for tax and financial statement purposes. As part of the process of preparing our financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our current tax exposure under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes.

We assess the likelihood that we will be able to recover our deferred tax assets. We consider all available evidence, both positive and negative, including our historical levels of income and losses, expectations and risks associated with estimates of future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance. If we do not consider it more likely than not that we will recover our deferred tax assets, we will record a valuation allowance against the deferred tax assets that we estimate will not ultimately be recoverable. At June 30, 2008, we believed that the amount of our deferred income taxes would not be ultimately recovered. Accordingly, we recorded a full valuation allowance for deferred tax assets. However, should there be a change in our ability to recover our deferred tax assets, we would recognize a benefit to our tax provision in the period in which we determine that it is more likely than not that we will recover our deferred tax assets.

- ***Stock-Based Compensation***

We measure stock-based compensation at the grant date based on the award's fair value and recognize the expense ratably over the requisite vesting period, net of estimated forfeitures, for all stock-based awards granted after January 1, 2006 and all stock-based awards granted prior to, but not vested as of January 1, 2006.

We have elected to calculate an award's fair value based on the Black-Scholes option-pricing model. The Black-Scholes model requires various assumptions, including expected option life and volatility. If any of the assumptions used in the Black-Scholes model or the estimated forfeiture rate changes significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period. Prior to January 1, 2008, we calculated the expected term of an option using the simplified method provided in Staff Accounting Bulletin No. 107 and starting January 1, 2008, we are using historical data to calculate the expected option term.

**Recent Accounting Pronouncements**

Effective January 1, 2008 we adopted SFAS 157, *Fair Value Measurements* (“SFAS157”). In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No 157*, which provides a one year deferral (effective for years beginning after November 15, 2008) of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, we have adopted the provisions of SFAS 157 with respect to our financial assets and liabilities only. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.

- Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The adoption of this statement did not have a material impact on our results of operations, financial condition or cash flow.

Effective January 1, 2008 we adopted SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*- including an amendment of FASB Statement No. 115 (“SFAS 159”). SFAS 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for specified financial assets and liabilities on a contract-by-contract basis. We did not elect to apply the fair value option under SFAS 159.

Effective January 1, 2008, we adopted EITF 07-3, *Accounting for Advance Payments for Goods and Services to be Received for Use in Future Research and Development Activities* (“EITF 07-03). EITF 07-03 requires that non-refundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed, subject to an assessment of recoverability. The adoption did not have a material impact on our results of operations or financial condition.

In November 2007, the EITF issued EITF Issue No. 07-1 ("EITF 07-1"), *Accounting for Collaborative Arrangements Related to the Development and Commercialization of Intellectual Property*. Companies may enter into arrangements with other companies to jointly develop, manufacture, distribute, and market a product. Often the activities associated with these arrangements are conducted by the collaborators without the creation of a separate legal entity (that is, the arrangement is operated as a "virtual joint venture"). The arrangements generally provide that the collaborators will share, based on contractually defined calculations, the profits or losses from the associated activities. Periodically, the collaborators share financial information related to product revenues generated (if any) and costs incurred that may trigger a sharing payment for the combined profits or losses. The consensus requires collaborators in such an arrangement to present the result of activities for which they act as the principal on a gross basis and report any payments received from (made to) other collaborators based on other applicable GAAP or, in the absence of other applicable GAAP, based on analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election. EITF 07-1 is effective for collaborative arrangements in place at the beginning of the annual period beginning after December 15, 2008. Management does not expect that the adoption EITF 07-1 will have a material impact on our financial position and results of operations.

In December 2007, the FASB issued SFAS 141 (revised 2007), *Business Combinations* (“SFAS141R”). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest of the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. This statement is effective for us beginning January 1, 2009. We will assess the potential impact of the adoption of SFAS 141R if and when a future acquisition occurs.

In December 2007, the FASB approved the issuance of SFAS No. 160. *Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* ("SFAS 160"). SFAS 160 will change the accounting and reporting for minority interests, which will now be termed *non-controlling interests.* SFAS 160 requires non-controlling interest to be presented as a separate component of equity and requires the amount of net income attributable to the parent and to the non-controlling interest to be separately identified on the consolidated statement of operations. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. At this time, we do not expect adoption of SFAS 160 to have any impact on our financial position, results of operations or cash flows.

In March 2008, the FASB issued FAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133* ( "SFAS 161"). SFAS 161 requires enhanced disclosure related to derivatives and hedging activities and thereby seeks to improve the transparency of financial reporting. Under SFAS 161, entities are required to provide enhanced disclosures relating to: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedge items are accounted for under SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* ("SFAS 133') and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance and cash flows. SFAS 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS 133 for all financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We do not expect adoption of SFAS 161 to have any impact on our financial position, results of operations or cash flows.

In April 2008, the FASB issued FASB Staff Position No. FAS 142-3 *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No 142 *Goodwill and Other Intangible Assets* and requires enhanced disclosures relating to: (a) the entity's accounting policy on the treatment costs incurred to renew or extend the term of a recognized intangible asset; (b) in the period of acquisition or renewal, the weighted-average period prior to the next renewal or extension (both explicit and implicit), by major intangible asset class and (c) for an entity that capitalizes renewal or extension costs, the total amount of costs incurred in the period to renew or extend the term of a recognized intangible asset for each period for which a statement of financial position is presented by major intangible asset class. FSP 142-3, must be applied prospectively to all intangible assets acquired as of and subsequent to fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. We do not expect adoption of FSP142-3 to have any impact on our financial position, results of operations or cash flows.

**(2) FAIR VALUE**

In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and investments) measured at fair value on a recurring basis as of June 30, 2008 (in thousands):

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Money market funds | $ 20,033 | $ — | $ — | $ 20,033 |
| Asset backed securities | — | 1,164 | — | 1,164 |
| Total | $ 20,033 | $ 1,164 | $ — | $ 21,197 |

**(3) NET LOSS PER SHARE INFORMATION**

Basic and diluted net loss per share is computed by dividing net loss by the weighted average number of common shares outstanding. Diluted net loss per share excludes the effect of potentially dilutive securities because they are anti-dilutive. Such potentially dilutive securities at June 30, 2008 include outstanding stock options for 1,586,480 common shares and unearned restricted stock awards for 72,750 common shares.

**(4) STOCK-BASED COMPENSATION**

The following table shows the stock-based compensation expense for all awards (in thousands except per share amount):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Operating expenses: | | | | |
| Research and development | $ 220 | $ 48 | $ 285 | $ 104 |
| General and administrative | 63 | 65 | 293 | 172 |
| Total stock-based compensation expense | $ 283 | $ 113 | $ 578 | 276 |
| | | | | |
| Impact on basic and diluted net loss per common share | $ .01 | $ .01 | $ .02 | $ .03 |

The following table summarizes option activity for the six months ended June 30, 2008:

| | Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at January 1, 2008 | 550,383 | $ 8.57 |
| Granted | 1,099,300 | $ 1.42 |
| Expired and Forfeited | (61,495) | $ 8.74 |
| Exercised | (1,708) | $ 1.37 |
| Outstanding at June 30, 2008 | 1,586,480 | $ 3.62 |

*Employee Stock Purchase Plan*. We adopted an Employee Stock Purchase Plan (the "Purchase Plan") in 1997. Qualified employees may elect to have a certain percentage of their salary withheld to purchase shares of our common stock under the Purchase Plan. The purchase price per share is equal to 85% of the fair market value of the stock on specified dates. Sales under the purchase plan in the six months periods ending June 30, 2008 and 2007 were 26,103 and 11,254 shares at an average price of $1.03 and $3.40 per share respectively. Shares available for future purchase under the Purchase Plan are 107,057 at June 30, 2008.

We modified our ESPP such that the length of all offering periods, beginning May 1, 2008 is six months. Consequently, there is no reset feature associated with any new offering period. Our closing stock price on the April 30, 2008 ESPP purchase date was lower than the closing price on the November 1, 2007 offering date. As a result, participants were re-enrolled into a new six-month offering period, beginning May 1, 2008 and ending October 31, 2008. As a result of the amendment, $41 of compensation cost was accelerated or generated of which $33 was recognized during the quarter ended June 30, 2008.

**(5) COMPREHENSIVE LOSS**

Comprehensive loss for the three and six months ended June 30, 2008 and 2007 consists of the following (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Net loss | $ (6,130) | $ (1,776) | $ (12,974) | $ (7,777) |
| Unrealized gains (losses) on available-for-sale marketable securities | (4) | 5 | (16) | 12 |
| Comprehensive loss | $ (6,134) | $ (1,771) | $ (12,990) | $ (7,765) |

**(6) INCOME TAXES**

There is no provision for income taxes for the three or six months ended June 30, 2008 because we incurred net operating losses. In the first quarter of 2007 we recorded a catch up provision of $36 for California State Alternative Minimum Tax.

**(7) STOCKHOLDERS' EQUITY**

In June, 2007, we sold 24,393,939 shares of common stock in a public offering at a price of $1.65 per share, for net proceeds of approximately $37.2 million after deducting underwriting fees and costs associated with the offering. The shares were offered under our registration statement on Form S-1, as amended (Registration No. 333-141918).

On May 23, 2007, we filed a Certificate of Amendment to our Certificate of Incorporation with the Secretary of State of the State of Delaware affecting a 1-for-4 reverse stock split of our common stock. All share and per share amounts for all periods presented have been retroactively restated to reflect the reverse stock split.

**(8) DISCONTINUED OPERATIONS**

We completed the sale of certain assets of our Analytical Standards division as well as certain technology rights for our topical pharmaceutical and cosmeceutical product lines and other assets ("cosmeceutical and toiletry business") in February 2003 and July 2000, respectively.

The Analytical Standards division and cosmeceutical and toiletry business are reported as discontinued operations for all periods presented in the accompanying Condensed Statements of Operations.

Income (loss) from discontinued operations represents primarily the loss attributable to changes in estimates of our cosmeceutical and toiletry business that was sold to RP Scherer on July 25, 2000, as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Analytical Standards Division | | | | |
| Royalties earned in excess of minimum amount recorded | $ — | $ 1 | $ — | $ 17 |
| | | | | |
| Cosmeceutical and Toiletry Business | | | | |
| Change in estimates for gross profit guarantees | (40) | 39 | (80) | 15 |
| Total income (loss) from discontinued operations | $ (40) | $ 40 | $ (80) | $ 32 |

Basic and diluted income (loss) per common share from discontinued operations was less than $0.01 per share for the three and six months ended June 30, 2008 and 2007.

As of June 30, 2008, liabilities related to the discontinued operations in the amount of $501 represent accruals for gross profit guarantees. These liabilities are reported as accrued disposition costs in the accompanying balance sheets.

The cash provided by discontinued operations of $19 in 2008 relates to royalties received from GFS Chemicals, Inc. (“GFS”), a privately held company based in Columbus, Ohio, from sales of Analytical Standards products. The cash used in discontinued operations of $4 in 2007 relates to a payment of $52 in conjunction with the Gross Profit Guaranty offset by royalties received from GFS from sales of Analytical Standards products.

On February 13, 2003, we completed the sale of our Analytical Standards division to GFS. In this transaction, we received $2.1 million on closing and were entitled to receive royalties on sales of Analytical Standards products for a period of five years following the sale at rates ranging from 5% to 15%. As of June 30, 2008, all royalties due from GFS have been received.

In conjunction with the terms of an agreement with RP Scherer, a subsidiary of Cardinal Health, where we sold certain technology rights associated with our cosmeceutical and toiletry business, we guaranteed a minimum gross profit percentage on RP Scherer’s combined sales of products to Ortho Neutrogena and Dermik (“Gross Profit Guaranty”). The guaranty period commenced on July 1, 2000 and ends on the earlier of July 1, 2010 or the end of two consecutive guaranty periods where the combined gross profit on sales to Ortho and Dermik equals or exceeds the guaranteed gross profit (the “two period test”). The Gross Profit Guaranty expense totaled $944 for the first seven guaranty years and in those years profits did not meet the two period test. Effective March 2007, in conjunction with a sale of assets by RP Scherer’s successor company to an Amcol International subsidiary (“Amcol”), a new agreement was signed between us and Amcol to provide continuity of product supply to Ortho and Dermik. This new agreement potentially extends the gross profit guaranty period an additional three years to July 1, 2013 unless it is terminated earlier with the two period test. Therefore, we expect the annual Gross Profit Guaranty payment to range from $100 to $200 per annum. Amcol has indicated that its costs differ from those it charged historically to the RP Scherer successor company to produce the product; we have requested documentation of actual costs and have accrued for 2008 at the historical rate. As there is no minimum amount of Gross Profit Guaranty due, no accrual for the guaranty is estimable for future years. A liability of $501 and $420 related to the amount due under the gross profit guaranty is included in accrued disposition costs as of June 30, 2008 and December 31, 2007, respectively.

**(9) SUBSEQUENT EVENTS**

On July 3, 2008, our Board of Directors approved an increase to the number of shares available for grant under our Non-Qualified Stock Option Plan by one million shares. The Non-Qualified Stock Option Plan is used for inducement grants.

On July 7, 2008 we announced the appointment of Ronald Prentki as our President and Chief Executive Officer (CEO). In conjunction with Ron’s appointment, he was granted a stock option for 1.4 million shares. The options vest over a four year period with 25% of the shares vesting one year from July 7, 2008 and have an exercise price of $1.19, the fair market value on the date of the grant.

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

**Forward-looking Statements**

This Form 10-Q contains "forward-looking statements" as defined by the Private Securities Reform Act of 1995. These forward-looking statements involve risks and uncertainties including uncertainties associated with timely development, approval, launch and acceptance of new products, satisfactory completion of clinical studies, establishment of new corporate alliances, progress in research and development programs, reliance on third parties, including contract manufacturers and other risks and uncertainties identified in the Company's filings with the Securities and Exchange Commission. We caution investors that forward-looking statements reflect our analysis only on their stated date. We do not intend to update them except as required by law.

**Results of Operations for the Three and Six Months Ended June 30, 2008 and 2007 (in thousands unless otherwise indicated)**

Contract revenue, which is derived from work performed under collaborative research and development arrangements, was $152, $160, $284 and $160 for the three months ended June 30, 2008 and 2007 and the six months ended June 30, 2008 and 2007, respectively. The amount of contract revenue varies from period to period depending on the level of activity requested of us by our collaborators. Therefore, we cannot predict the amount of contract revenue in future periods.

Research and development expense for the three months ended June 30, 2008 increased by $1,775 from $3,763 for the three months ended June 30, 2007 to $5,538. The increase was primarily as a result of an increase in our APF530 Phase 3 clinical trial and related costs. Additionally, there were increases in costs associated with our post-operative pain product and our undisclosed opiate pain product. Salaries and related costs, including stock based compensation, increased to support the increased activities and outside costs also increased. Research and development expense for the six months ended June 30, 2008 increased by $2,929 from $8,749 for the six months ended June 30, 2007 to $11,678. The increase was primarily due to increased expenses for our undisclosed opiate pain product, increased clinical trial and related expenses for APF530 and increased expenses for our post-operative pain product. Salaries and related costs, including stock based compensation, also increased to support the increased clinical activities, as did outside costs. We expect research and development expense to decrease in the second half of 2008, reflecting the completion of our Phase 3 study for APF530.

General and administrative expense decreased for the three months ended June 30, 2008 by $9 from $872 for the three months ended June 30, 2007, to $863. General and administrative expense decreased by $48 for the six months ended June 30, 2008 from $1991 for the six months ended June 30, 2007, to $1943. Stock-based compensation expense was higher for the six months offset by lower outside services and salaries. We expect general and administrative expense in the second half of 2008 to increase due to the appointment of our new Chief Executive Officer and costs associated with other executive recruitment activities.

Interest income, net, increased for the six months ended June 30, 2008 by $132 to $436 from $304 for the six months ended June 30, 2007 primarily due to higher average balance of cash, cash equivalents and marketable securities.

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro® and Carac® for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and received a $2.5 million milestone payment in June 2007, which was recorded as gain on sale of interest in royalties. We may receive up to an additional $2.5 million based on the satisfaction of certain other predetermined milestones.

Loss from discontinued operations represents the net income/loss attributable to the Analytical Standards division which was sold to GFS Chemicals, Inc. in February 2003 and the cosmeceutical and toiletries business which was sold to RP Scherer Corporation in July 2000. Net loss from discontinued operations totaled $40 for the three months ended June 30, 2008, compared to net income of $40 in the three months ended June 30, 2007. Net loss from discontinued operations totaled $80 for the six months June 30, 2008 compared to net income of $32 for the six months ended June 30, 2007. The loss for the three and six months ended June 30, 2008 reflects our expectation that the Gross Profit Guaranty payment for 2008 will be in the range of $100 to $200 for 2008. The company that now owns rights to the cosmeceutical and toiletries business has indicated that its costs differ from those it charged historically to the RP Scherer successor company to produce the product; we have requested documentation of actual costs.

**Capital Resources and Liquidity**

Cash and cash equivalents decreased by $13.1 million to $20.4 million at June 30, 2008 from $ 33.5 million at December 31, 2007 due primarily to our net loss for the six months ended June 30, 2008.

Net cash used in continuing operating activities for the six months ended June 30, 2008 was $13.3 million, compared to net cash used of $7.7 million for the six months ended June 30, 2007. The increase in net cash used by continuing operating activities from 2008 to 2007 was mainly due to the increased loss in 2008, as compared to the same period in 2007.

Net cash provided by investing activities for the six months ended June 30, 2008 was $84, compared to net cash provided of $8.5 million from investing activities for the six months ended June 30, 2007. The decrease in cash provided by investing activities was primarily due to lower sales and maturities of marketable securities in the six months ended June 30, 2008, as compared to the same period in 2007.

In the six months ended June 30, 2007 $37.6 million cash was provided by proceeds from issuance of common stock, net of estimated issuance costs.

To date, we have financed our operations including technology and product research and development through the sale of common stock, royalties received on sales of Retin-A Micro® and Carac®, income from collaborative research and development fees, the proceeds received from the sales of our Analytical Standards division and our cosmeceutical and toiletry business, interest earned on short-term investments and the sale of our interest in the royalty income from Retin-A Micro® and Carac®. We believe our existing cash, cash equivalents and marketable securities, together with interest income will be sufficient to meet our cash needs for at least one year. We anticipate expenditures to decrease as activities associated with our Phase III APF530 trial are winding down.

Our capital requirements going forward from 2008 will depend on numerous factors including, among others, our ability to enter into collaborative research and development and licensing agreements; progress of product candidates in preclinical and clinical trials; investment in new research and development programs; time required to gain regulatory approvals; resources that we devote to self-funded products; resources required for gross margin guarantees, potential acquisitions of technology, product candidates or businesses; and the costs of defending or prosecuting any patent opposition or litigation necessary to protect our proprietary technology.

We may not be able to raise sufficient additional capital when we need it or to raise capital on favorable terms. The sale of additional equity or convertible debt securities in the future may be dilutive to our stockholders, and debt financing arrangements may require us to pledge certain assets and enter into covenants that could restrict certain business activities or our ability to incur further indebtedness and may contain other terms that are not favorable to us or our stockholders. If we are unable to obtain adequate funds on reasonable terms, we may be required to curtail operations significantly or to obtain funds by entering into financing, supply or collaboration agreements on unattractive terms.

Below is a summary of fixed payments related to certain contractual obligations (in thousands). This table excludes amounts already recorded on our condensed balance sheet as current liabilities at June 30, 2008.

| | Total | Less than 1 year | 2 to 3 years | 4 to 5 Years | More than 5 years |
|---|---|---|---|---|---|
| Other Operating Leases | $ 1,534 | $ 544 | $ 956 | $ 34 | $ — |

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**Item 3. Quantitative and Qualitative Disclosure about Market Risk**

Our exposure to interest rate risk relates primarily to our investment portfolio. We do not use derivative financial instruments. We manage our interest rate risk by maintaining an investment portfolio primarily consisting of debt instruments of high credit quality and relatively short average maturities. At June 30, 2008, 93% of our cash, cash equivalents and marketable securities was held in money market funds.

**Item 4. Controls and Procedures**

Evaluation of disclosure controls and procedures: We carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and the Interim Chief Financial Officer, of the effectiveness of the design and operations of our disclosure controls and procedures pursuant to Rule 13a-15(e) and 15(d)-15(e) of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Interim Chief Financial Officer concluded that as of June 30, 2008, the end of period covered by this report, our disclosure controls and procedures were effective at the reasonable assurance level to alert them in a timely manner to material information relating to the Company required to be included in our Exchange Act filings.

Changes in internal controls: During the three and six months ended June 30, 2008, there have been no changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II. OTHER INFORMATION

### Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in the "RISK FACTORS" section of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

### ITEM 4. Submission of Matters to a Vote of Security Holders

Our annual shareholders' meeting was held on May 28, 2008, at which the following proposals were approved.

Proposal I: Election of the following directors:

| | Votes For | Votes Withheld |
|---|---|---|
| Paul Goddard | 21,560,039 | 3,093,472 |
| Peter Riepenhausen | 21,580,967 | 3,072,544 |
| Toby Rosenblatt | 21,451,544 | 3,201,967 |
| Arthur Taylor | 21,579,015 | 3,074,496 |
| Gregory Turnbull | 21,565,165 | 3,088,346 |
| Robert Zerbe | 21,579,539 | 3,073,972 |

Proposal II: To ratify the appointment of Odenberg, Ullakko, Muranishi & Co. LLP as the Company's independent registered public accounting firm for the year ending December 31, 2008.

| Votes For | Votes Against | Abstain |
|---|---|---|
| 24,524,835 | 104,681 | 23,995 |

### Item 5. Other Events

On July 3, 2008, our Board of Directors approved an increase to the number of shares available for grant under our Non-Qualified Stock Option Plan by one million shares. The Non-Qualified Stock Option Plan is used for inducement grants.

### Item 6. Exhibits

Exhibit 10-U Employment Letter Agreement with Ronald Prentki, President and Chief Executive Officer

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rules 13A-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Exhibit 31.2 Certification of Interim Chief Financial Officer pursuant to Rules 13A- 15(f) promulgated under the Securities exchange Act of 1934, as amended.

Exhibit 32 Certifications of Chief Executive Officer and Interim Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

A.P. PHARMA, INC.

Date: August 14, 2008
/s/ Ronald J. Prentki
Ronald J. Prentki
President and Chief Executive Officer

Date: August 14, 2008
/s/ Gregory Turnbull
Gregory Turnbull
Interim Chief Financial Officer

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Exhibit 31.1

**SECTION 302 CERTIFICATIONS**

I, Ronald J. Prentki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which could be reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2008

/s/ Ronald J. Prentki
Ronald J. Prentki
President and Chief Executive Officer

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Exhibit 31.2

**SECTION 302 CERTIFICATIONS**

I, Gregory H. Turnbull, certify that:

1. I have reviewed this quarterly report on Form 10-Q of A.P. Pharma, Inc.

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant is made known to us by others, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which could be reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 14, 2008

/s/ Gregory H. Turnbull
Gregory H. Turnbull
Interim Chief Financial Officer

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Exhibit 32

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Ronald J. Prentki, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

August 14, 2008

/s/ Ronald J. Prentki
Ronald J. Prentki,
President and Chief Executive Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending June 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gregory H. Turnbull, Interim Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

August 14, 2008

/s/ Gregory H. Turnbull
Gregory H. Turnbull,
Interim Chief Financial Officer

July 2, 2008

Mr. Ronald J. Prentki
[redacted]

Dear Ron:

A. P. Pharma, Inc. (the "Company") is pleased to offer you the position of President and Chief Executive Officer of the Company. The terms of your employment with the Company are as set forth below:

**1. Position**.

**a. Title**. You will become the President and Chief Executive Officer of the Company, working out of the Company's headquarters office in Redwood City, California. As such, you will report to the Company's Board of Directors (the "Board"). Upon commencement of employment, you will also be appointed to serve as a member of the Board, and as long as you are a Company employee you agree to serve in such capacity without additional compensation.

**b. Duties**. As President and Chief Executive Officer, you will have the duties, responsibilities and authority customarily associated with such position as the Company's most senior executive officer, including responsibility for the overall management of the Company. You agree to the best of your ability and experience that you will loyally and conscientiously perform all of your duties and obligations to the Company. During your employment, you further agree that you: (i) will devote substantially all of your business time and attention to the business of the Company; (ii) will not render commercial or professional services of any nature to any other person or organization, whether or not for compensation, without the prior written consent of the Board which will not be unreasonably withheld; and (iii) will not directly or indirectly engage or participate in any business or activity that is competitive in any manner with the business of the Company. Nothing in this letter agreement will prevent you from serving on advisory boards or boards of charitable organizations, so long as such service does not unduly interfere with the performance of your duties to the Company. The Company also requests that you not accept nor seriously discuss joining the board of any public or private for-profit company without first seeking the permission of the Nominating and Governance Committee of the Company. While you are an executive officer and director of the Company, the Company will assist you in satisfying your reporting obligations under Section 16 of the Securities Exchange Act of 1934 (the "Exchange Act").

**2. Start Date**. Subject to fulfillment of any pre-conditions imposed by this letter agreement, you will commence full-time employment with the Company on a mutually agreed upon start date (the "Start Date").

**3. Compensation and Benefits**.

**a. Base Salary**. For all services rendered to the Company, you will receive a bi-weekly base salary of not less than $16,346.15 (which on an annualized basis equals $425,000), which will be paid in accordance with the Company's regular bi-weekly payroll practice. For purposes of this letter agreement, the term "Base Salary" means the annual base salary set forth in this Section 3.a. or, to the extent the amount of such Base Salary is adjusted upward from time to time in the future pursuant to the Company's annual review process, your annualized base salary as applicable on the relevant date. The Board's Compensation and Stock Option Committee (the "Committee") will periodically review your Base Salary followed by a recommendation to the board for possible increase, the first such review will take place in not more than 12 months from the Start Date.

**b. Incentive Bonuses**. Except as set forth below with respect to the period ending on December 31, 2008, you will be eligible to earn an annual incentive bonus with an annual target amount equivalent to 50% of your Base Salary ("Target Bonus"). Your right to be paid an annual incentive bonus under this Section 3.b. will be based on your continued employment throughout each applicable performance period (subject to Section 7) and the satisfaction of operating performance metrics and other milestones established by the Committee in its sole discretion (but with input from you) with respect to such period, all subject to final approval by the board. Such performance metrics and milestones will be established no later than 60 days after the start of the applicable performance period; *provided* that with respect to 2008, such metrics and milestones will be established on or before September 30, 2008. The actual amount of bonus paid, assuming certification by the Committee and subsequently the board that the objectives have been achieved and the level of such achievement, may be more or less than the Target Bonus amount. Any bonus payable under this Section 3.b. will be payable within 60 days following the end of the applicable performance period (provided that you remain employed on the last day of the applicable performance period). With respect to 2008, any bonus amount earned and that becomes payable will be pro-rated from your Start Date through December 31, 2008.

**c. Benefits**. The Company will provide you with the opportunity to participate in benefits plans and programs of the Company, if any, to the extent your position, tenure and other qualifications make you eligible to participate, subject to any eligibility requirements imposed by such plans. You will be entitled to reasonable vacation time each year based on your reasonable judgment as to an appropriate and beneficial amount of vacation time relative to the responsibilities of your position. You will be expected to use all vacation time in the year earned. You will not accrue any days of vacation time based upon your days of service. You will also be entitled to paid time off for holidays based on the Company's written policies as then in effect. The Company reserves the right to cancel or change the benefit plans and programs it offers to its employees at any time.

**d. Indemnification**. Commencing as of the Start Date, you will be covered under the Company's insurance policies (the "Policies") for directors' and officers' liability coverage and will be provided indemnification to the maximum extent permitted by the Company's Bylaws and Certificate of Incorporation, including becoming a party to the Company's standard indemnification agreement (the "Indemnification Agreement"). Such coverage and indemnification will be on terms no less favorable than provided to any other Company senior executive or director. The indemnification and liability insurance shall cover events occurring at any time during the period in which you are rendering services in any capacity to the Company, even if such claims are brought after the end of such service period in accordance with the terms of the Policies and the Indemnification Agreement. In the event of any claims covered by them, you will be entitled to have your costs paid and fees advanced by the Company in accordance with the terms of the Policies and the Indemnification Agreement. Provided it can do so on commercially reasonable terms (as determined in the sole discretion of the Board), the Company agrees during your tenure as Chief Executive Officer and, to the extent applicable to you, thereafter to maintain at least the level of insurance coverage as is provided for under the Policies as of the date of this letter agreement.

**4. Equity Awards**.

**a. Initial Stock Option Grant**. Subject to your acceptance of this letter and effective upon your Start Date, the Compensation Committee, under authorization from the board, will grant you on the Start Date stock options (the "Options") to purchase 1,400,000 shares of the Company's Common Stock with a per share exercise price equal to the closing price of a share of the Company's common stock as reported on the Nasdaq Global Market on your Start Date. The Option shares in each Option will vest and become exercisable at the rate of 25% of the total number of Option shares on the first anniversary of your Start Date and l/48th of the total number of Option shares on that same date of each month thereafter until you are completely vested. Vesting will, of course, depend on your continued and continuous service relationship with the Company. The Options may at your election be incentive stock options equal to the maximum number of shares permissible under the Internal Revenue Code of 1986 and the applicable Treasury Regulations (currently $100,000 of exercise price vesting in each calendar year) which will be granted under the Company's 2007 Equity Incentive Plan, and will be nonstatutory options for the balance of the shares which will be granted under either or both of the Company's 2007 Equity Incentive Plan and Non-Qualified Stock Plan. Each Option will have a ten-year term (subject to earlier termination in accordance with its terms), and will be subject to the terms of the Stock Option Agreement between you and the Company (which will incorporate the terms of Section 7.c.(ii) and Section 7.c.(iii) below). Except in the event of a termination of your employment for Cause, you will be able to exercise those Option shares that were vested on your last day of your service to the Company for, in the case of incentive stock options, three months following such last day, and in the case of nonstatutory options, one year following such last day. In the event of a termination for Cause for other than an act cited in Section 7.b.(i)(g), you will be able to exercise any vested Options within three months following such Termination Date; however, if a termination for Cause results from your Inability to Perform Services or your death, any vested Options as of the Termination Date may be exercised within one year following such Termination Date.

**b.** **Subsequent Equity Awards**. Subject to the discretion of the Company's Board of Directors and the Committee, you may be eligible to receive additional grants of stock options or other equity awards from time to time in the future, on such terms and subject to such conditions as the Board shall determine as of the date of any such award.

**5.** **Pre-employment Conditions**.

**a.** **Confidentiality Agreement**. Your acceptance of this offer and commencement of employment with the Company is contingent upon the execution, and delivery to an officer of the Company, of the Company's Employee Confidential Information and Inventions Agreement a copy of which is attached as Exhibit I for your review and execution (the "Confidentiality Agreement"), prior to or on your Start Date.

**b.** **Right to Work**. For purposes of federal immigration law, you will be required to provide to the Company documentary evidence of your identity and eligibility for employment in the United States. Such documentation must be provided to us on your Start Date or our employment relationship will not become effective.

**6.** **No Conflicting Obligations**. You understand and agree that by accepting this offer of employment, you represent to the Company that your performance will not breach any other agreement to which you are a party and that you have not, and will not during the term of your employment with the Company, enter into any oral or written agreement in conflict with any of the material provisions of this letter or the Company's policies. You are not to bring with you to the Company, or use or disclose to any person associated with the Company, any confidential or proprietary information belonging to any former employer or other person or entity with respect to which you owe an obligation of confidentiality under any agreement or otherwise. The Company does not need and will not use such information and we will assist you in any way possible to preserve and protect the confidentiality of proprietary information belonging to third parties. Also, we expect you to abide by any obligations to refrain from soliciting any person employed by or otherwise associated with any former employer and suggest that you refrain from having any contact with such persons until such time as any non-solicitation obligation expires.

**7.** **Termination of Employment.**

**a.** **At-Will Employment**. Subject only to the Company's obligations described in Sections 3.d., 7, 8, and 9, your employment with the Company will be on an "at will" basis, meaning that either you or the Company may terminate your employment at any time for any reason or no reason without further obligation.

**b.** **Termination for Cause**. If the Company terminates your employment at any time for Cause, your salary shall cease on the date of termination, and you will not be entitled to any of the severance benefits detailed below other than payment of items listed in clauses (i) through (iii) of the second paragraph of Section 7.c. and such other benefits as expressly required in such event by applicable law or the terms of any applicable Company benefit plans

**(i) Definition of Cause**. For purposes of this letter agreement, "Cause" shall refer to any of the following that are materially injurious to the Company and shall mean your: (a) willful material or persistently repeated failure to substantially perform your duties and responsibilities hereunder, resulting in a timely written warning from the Board citing such failure/s (other than a failure resulting from your complete or partial incapacity due to physical or mental illness or impairment or disability); (b) willful act that constitutes gross misconduct; (c) willful breach of a material provision of this letter (including the Confidentiality Agreement); (d) material or willful violation of a federal or state law or regulation applicable to the business of the Company; (f) your indictment for a felony; or (g) your commission of a fraud against the Company or any willful misconduct that brings the reputation of the Company into material disrepute. No act or omission by you will be considered "willful", unless it is determined that it was committed without good faith or without a reasonable belief that the act or omission was in the best interests of the Company. Executive's death or Inability to Perform Services (as defined below) shall also constitute Cause for termination. The foregoing is an exclusive list of the acts or omissions that shall be considered "Cause". To effect a termination for Cause, preceded by a written warning if effected under (a) above, the Board will provide you with a written notice of its intent to effect such a termination and the reason therefor and will give you 30 days from your receipt of such notice in which to cure any act or omission giving rise to Cause

**(ii) Definition of Inability to Perform Services**. For purposes of this Agreement, Cause to terminate your employment based on the your inability to perform services shall exist if any illness or other incapacity renders the you physically or mentally unable to perform the essential functions of your position, with or without reasonable accommodation, for a period in excess of 12 workweeks in any consecutive 12 month period ("Inability to Perform Services"). A physician selected in good faith by the Board shall make a determination of whether you are physically or mentally unable to perform the essential functions of your position, with or without reasonable accommodation, subject to its review and consideration of all relevant information..

**c. Termination Without Cause - Severance Benefits**. In no way limiting the Company's policy of employment at-will, if your employment terminates in a manner that constitutes an Involuntary Termination (as defined below in Section 7.(iv)), the Company will offer certain severance benefits to you. As a condition to your receipt of such benefits, you are required to comply with your continuing obligations to the Company (including the return of any Company property), resign from all positions you hold with the Company including membership on the Board (unless otherwise requested by the Board), and execute the Company's standard form of release agreement, as attached hereto as Exhibit II, releasing any claims you may have against the Company, its agents and successors.

Upon termination of your employment for any reason (the last day of your employment is referred to as your "Termination Date"), you will receive the following payments as of the Termination Date: (i) all unpaid salary, if any, accrued through the Termination Date; (ii) any bonuses earned prior to but unpaid as of the Termination Date (including any such bonuses covered by Section 3.b.); and (iii) any unreimbursed business expenses and any unreimbursed relocation expenses as specified in Section 9, both substantiated in accordance with Company policy. The amounts under clauses (i) through (iii) in the preceding sentence shall be paid to you without the condition of your providing the Company with any release of claims.

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**(i) Payment Upon Involuntary Termination**. In the event that you experience an Involuntary Termination, you will also be entitled to receive (i) cash severance equal to an amount equal to 24 months of your then-current Base Salary and (ii) continuance of payment by the Company of its portion of the health insurance benefits provided to you immediately prior to your Involuntary Termination pursuant to the terms of the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended ("COBRA") or other applicable law for a maximum of either 12 months following your Termination Date or until you become eligible for health insurance coverage from another source, whichever occurs sooner (provided that you must promptly inform the Company, in writing, if you become eligible for health insurance coverage from another source within 12 months after the termination).. Subject to any delay required under Section 9 below, the cash severance amount set forth in this Section 7.c.(i) shall be paid within 30 days after an Involuntary Termination, subject to the Company's receipt of your effective release of claims referred to above.

**(ii) Vesting Acceleration on Involuntary Termination occurring absent a Change of Control**. In addition to the benefits provided in Section 7.c.(i) above, but only with respect to an Involuntary Termination not covered by Section 7.c.(iii) below, you will be entitled to additional vesting of equity incentives effective as of your Termination Date such that as of the effective date of your Involuntary Termination you will be treated as vested in a number of equity incentive shares equal to the total number of equity incentive shares that would have vested in accordance with their terms in the 12 month period following the date of your Involuntary Termination in addition to the number of equity incentive shares in which you would otherwise be vested in on the date of your Involuntary Termination.

**(iii) Change of Control Acceleration**. In the event: (i) you experience an Involuntary Termination in connection with a Change of Control (the Involuntary Termination shall be deemed to be in connection with a Change of Control if the Involuntary Termination occurs within 30 days prior to the Change of Control or is required by the merger agreement or other instrument relating to such Change of Control or is made at the express request of the other party to the transaction constituting such Change of Control or within one year following a Change of Control of the Company), you will 100% vest in all of the shares subject to your outstanding and unvested equity incentives upon the effective date of your Involuntary Termination; or (ii) if any of your equity incentives are terminating in a Change of Control because the successor entity has not agreed to assume or substitute for such equity incentives in connection with the transaction, you will immediately vest in all such equity incentives for 100% of the shares subject to such equity incentives effective on the date on which any such equity incentive is terminating in connection with the transaction, as applicable.

As used herein, a “Change of Control” means the occurrence of any of the following events:

(a) the consummation of a merger or consolidation of the Company with any other corporation, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or its parent) at least 50% of the total voting power represented by the voting securities of the Company or such surviving entity or its parent outstanding immediately after such merger or consolidation;

(b) the consummation of the sale or disposition of all or substantially all of the Company’s assets to any other person or entity (other than to a wholly-owned subsidiary); or

(c) any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) becomes the “beneficial owner”(as defined in Rule 13d-3 of the Exchange Act), directly or indirectly, of securities representing 50% or more of the total voting power represented by the Company’s then outstanding voting securities

**(iv) Definition of Involuntary Termination**. For purposes of this letter agreement, an Involuntary Termination is any termination of your employment with the Company or its acquirer or successor, as the case may be, which is either: (i) by the Company (or its acquirer or successor) without Cause; (ii) by you for Good Reason; or (iii) the liquidation or dissolution of the Company or its ceasing operations other than temporary cessation resulting from Acts of God.

**(v) Definition of Good Reason**. For purposes of this letter agreement, you will have “Good Reason” to terminate your employment upon the occurrence of any of the following without your express written consent: (i) a change in your responsibilities, titles or offices (including your position as a member of the Board), or any removal of you from, or any failure to re-elect you to, any of such positions, or causing you or requiring you to report to anyone other than the Board, which has the effect of materially diminishing your responsibility or authority, including without limitation that you are no longer the sole chief executive officer of the Company; (ii) a reduction of your Base Salary or Target Bonus; (iii) a material reduction in the level or kind of employee benefits to which you were entitled immediately prior to such reduction with the result that your overall benefits package is significantly reduced; (iv) a substantial reduction, without good business reasons, of the facilities and perquisites (including office space and location) available to you immediately prior to such reduction; (v) relocation of your primary place of business for the performance of your duties to the Company to a location that is more than 50 miles from the location specified in Section l.a.; (vi) any material breach of a material provision of this letter agreement by the Company (including without limitation the failure to timely provide you the cash compensation, equity compensation and/or employee benefits owed you under this letter agreement); or (vii) any failure or refusal of a successor company to the Company’s business to expressly agree in writing to assume the Company’s obligations hereunder.

**(vi) No Obligation of You to Mitigate**. No payment or benefit made to you or to be made to you pursuant to this letter agreement shall be subject to offset, as the amount of any payment provided for in this Section 7 shall not be reduced, offset or subject to recovery by the Company by reason of any compensation earned by you as the result of employment by another employer after your Termination Date, or by reason of your failure to seek other employment, or otherwise, except for the possible early termination of health insurance benefits as provided in Section 7.c.(i).

**8. Section 409A Tax Matters**. In the event that the Company determines that any of your severance benefits payments fails to satisfy the distribution requirement of Section 409A(a)(2)(A) of the Internal Revenue Code (the "Code") as a result of Section 409A(a)(2)(B)(i) of the Code, the payment of such benefit shall be accelerated to the minimum extent necessary so that the benefit is not subject to the provisions of Section 409A(a)(1) of the Code; for these purposes, each severance payment is hereby designated as a separate payment and will not collectively be treated as a single payment. (The payment schedule as revised after the application of the preceding sentence shall be referred to as the "Revised Payment Schedule.") However, in the event the payment of benefits pursuant to the Revised Payment Schedule would be subject to Section 409A(a)(1) of the Code, the payment of such benefits shall not be paid pursuant to the Revised Payment Schedule and instead the payment of such benefits shall be delayed to the minimum extent necessary so that such benefits are not subject to the provisions of Section 409A(a)(1) of the Code. The Board shall attach conditions to and/or adjust the amounts paid pursuant to this Section 8 to preserve, as closely as possible, the economic consequences that would have applied in the absence of this Section 8; provided, however, that no such condition and/or adjustment shall result in the payments being subject to Section 409A(a)(1) of the Code.

**9. Relocation Reimbursement.** In addition to other benefits provided to you herein by the Company, the Company will reimburse you for the following costs and expenses:

a. up to $150,000 to cover expenses incurred by you in the sale of your home (documented); covered expenses include realtor commissions, transfer taxes, legal fees, title insurance charges, escrow fees and other similar expenses directly related to the sale of your home;

b. costs of moving usual household and personal goods;

c. costs of moving automobiles (if sold instead of moved, comparable credit extended towards costs of additional house-hunting relocation trips);

d. up to three months of temporary housing;

e. up to three months storage of moved goods;

f. costs of a total of four house-hunting/relocation trips for you or your spouse; and

g. costs of final move for you and your spouse.

**10. Miscellaneous.**

**a. Notice**. Notices and all other communications contemplated by this letter agreement shall be in writing and shall be deemed to have been duly given when personally delivered or when mailed by overnight courier, U.S. registered or certified mail, return receipt requested and postage prepaid. In the case of yourself, mailed notices shall be addressed to you at the home address that you most recently communicated to the Company in writing. In the case of the Company, mailed notices shall be addressed to its corporate headquarters, and all notices shall be directed to the attention of its Chairman of the Board.

**b. Priority**. Terms and definitions specified in this letter agreement shall supersede those contained within other supportive agreements, such as stock option plans and their standard agreements.

**c. Assignment**. This letter agreement shall not be assignable by either party and shall be binding upon, and shall inure to the benefit of, the heirs, executors, administrators, legal representatives, successors and assigns of the parties. In the event that all or substantially all of the business, assets and/or stock of the Company is sold or transferred, then this letter agreement shall be binding on the transferee of the business, assets and/or stock.

We are all delighted to be able to extend you this offer and look forward to working with you. To indicate your acceptance of the Company's offer, please sign and date this letter in the space provided below and return it to me on or before July 3, 2008, along with a signed and dated original copy of the Employee Confidential Information and Inventions Agreement. This letter, together with the Employee Confidential Information and Inventions Agreement and the agreements expressly referenced herein, set forth the terms of your employment with the Company and supersede any prior representations or agreements, whether written or oral. This letter will be governed by the laws of California, without regard to its conflict of laws provisions. In the event of any conflict in terms between this letter agreement and any other agreement between you and the Company (including without limitation the two Attachments and the other agreements referenced herein), the terms of this letter agreement shall prevail. This letter agreement may not be modified or amended, except by a written agreement, signed by the Chairman of the Board and yourself. No waiver by either party of any breach of, or of compliance with, any condition or provision of this letter agreement by the other party shall be considered a waiver of any other condition or provision or of the same condition or provision at another time.

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Very truly yours,

**A.P. PHARMA, INC.**

By: /s/ Paul Goddard
Paul Goddard, Chairman of the Board

**ACCEPTED AND AGREED:**

Ronald J. Prentki

/s/ Ronald J. Prentki Date July 3, 2008
Signature

Exhibit I: Employee Confidential Information and Inventions Agreement
Exhibit II: Form of Release of Claims