U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended June 30, 2006

[ ] 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

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

Delaware	94-2875566
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

123 Saginaw Drive, Redwood City, CA 94063
(Address of principal executive offices)

(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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.
Large accelerated filer [ ] Accelerated filer [ ]
Non-accelerated filer [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, 2006, the number of outstanding shares of the Company's common stock, par value $.01, was 25,371,281.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements:

A.P. PHARMA, INC.

CONDENSED BALANCE SHEETS
(in thousands)

	June 30, 2006 (Unaudited)	December 31, 2005 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,943	$ 790
Marketable securities	15,729	5,019
Accounts receivable, net	75	1,519
Prepaid expenses and other	607	320
Total current assets	22,354	7,648
Property and equipment, net	1,020	1,164
Other long-term assets	122	157
Total assets	$ 23,496	$ 8,969
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 147	$ 614
Accrued clinical trial expenses	1,119	892
Accrued disposition costs	195	248
Other accrued expenses	840	1,012
Total current liabilities	2,301	2,766
Stockholders' equity:		
Common stock	99,533	99,248
Accumulated deficit	(78,280)	(93,029)
Accumulated other comprehensive loss	(58)	(16)
Total stockholders' equity	21,195	6,203
Total liabilities and stockholders' equity	$ 23,496	$ 8,969

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,	
	2006	2005	2006	2005
Royalties	$ --	$ 1,187	$ --	$ 2,469
Contract revenues	--	63	--	142
Total revenues	--	1,250	--	2,611
Operating expenses:				
Research & development	3,856	3,078	7,325	4,900
General & administrative	933	823	1,865	1,672
Total operating expenses	4,789	3,901	9,190	6,572
Operating loss	(4,789)	(2,651)	(9,190)	(3,961)
Interest income, net	280	74	542	146
Gain on sale of interest in royalties	8	--	23,429	--
Other income (expense), net	(15)	13	(5)	1
Income (Loss) from continuing operations	(4,516)	(2,564)	14,776	(3,814)
Loss from discontinued operations	(34)	(44)	(27)	(50)
Net income (loss)	$(4,550)	$(2,608)	$14,749	$(3,864)
Basic earnings (loss) per share:				
Income (Loss) from continuing operations	$ (0.18)	$ (0.10)	$ 0.59	$ (0.15)
Net income (loss)	$ (0.18)	$ (0.10)	$ 0.58	$ (0.15)
Diluted earnings (loss) per share:				
Income (Loss) from continuing operations	$ (0.18)	$ (0.10)	$ 0.58	$ (0.15)
Net income (loss)	$ (0.18)	$ (0.10)	$ 0.58	$ (0.15)
Weighted average common shares outstanding-basic	25,254	25,107	25,230	25,073
Weighted average common shares outstanding-diluted	25,254	25,107	25,379	25,073

See accompanying notes to condensed financial statements.

A.P. PHARMA, INC.

CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	Six months ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net income (loss)	$ 14,749	$(3,864)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Loss from discontinued operations	27	50
Loss (Gain) on sale of marketable securities	1	(2)
Depreciation and amortization	200	190
SFAS123R stock compensation expense	167	--
Stock and stock option compensation awards to non-employees	60	64
Restricted stock awards	19	8
Amortization of premium/discount and accretion of marketable securities	(10)	42
Changes in operating assets and liabilities:		
Accounts receivable	1,407	68
Prepaid expenses and other current assets	(287)	(45)
Other long-term assets	37	108
Accounts payable	(467)	(71)
Accrued clinical trial expenses	227	(412)
Other accrued expenses	(172)	(8)
Net cash provided by (used in) continuing operating activities	15,958	(3,872)
Net cash provided by (used in) discontinued operations	(45)	54
Cash flows from investing activities:		
Purchases of property and equipment	(55)	(69)
Purchases of marketable securities	(14,701)	(6,814)
Maturities of marketable securities	1,800	7,793
Sales of marketable securities	2,158	1,695
Net cash provided by (used in) investing activities	(10,798)	2,605
Cash flows from financing activities:		
Proceeds from the exercise of stock options	4	21
Proceeds from issuance of shares under Employee Stock Purchase Plan	34	53
Proceeds from issuance of restricted stock	--	1
Net cash provided by financing activities	38	75
Net increase (decrease) in cash and cash equivalents	5,153	(1,138)
Cash and cash equivalents, beginning of the period	790	3,110
Cash and cash equivalents, end of the period	$ 5,943	$ 1,972

See accompanying notes to condensed financial statements.

A.P. PHARMA, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

JUNE 30, 2006 and 2005 (UNAUDITED)

(1) Basis of Presentation

A.P. Pharma, Inc. (the "Company", "we", "our", or "us") is developing patented polymer-based delivery systems to enhance the safety and effectiveness of pharmaceutical compounds. New products and technologies under development include bioerodible polymers for injectable and implantable drug delivery. Projects have also been conducted under feasibility and development arrangements with pharmaceutical and biotechnology companies.

In the opinion of management, the accompanying unaudited condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles 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. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments 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, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006 or any other period. The condensed balance sheet as of December 31, 2005 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. generally accepted accounting principles for complete financial statements. These condensed financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Summary of Critical Accounting Policies

Except for the adoption of FAS 123(R) (see Stock-Based Compensation) we believe there have been no significant changes in our critical accounting policies during the six months ended June 30, 2006 compared to those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the U.S. Securities and Exchange Commission (SEC) on March 31, 2006.

Use of Estimates

The preparation of our financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. Estimates were made relating to useful lives of fixed assets, valuation allowances, impairment of assets, accrued clinical and preclinical expenses, valuation of stock-based compensation and contingencies. Actual results could differ materially from those estimates.

Revenue Recognition

Our revenue arrangements with multiple deliverables are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered elements. 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.

* Royalties

Royalties from licensees are based on third-party sales of licensed products or technologies and recorded as earned in accordance with contract terms when third-party results can be reliably determined and collectibility is reasonably assured.

Generally, 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 our licensees based on information provided to us by our licensees.

* License Fees

Licensing agreements generally provide for periodic minimum payments, royalties, and/or non-refundable license fees. These licensing agreements typically require a non-refundable license fee and allow partners to sell our proprietary products in a defined field or territory for a defined period. License agreements provide for the Company to earn future revenue through royalty payments. These non-refundable license fees are initially reported as deferred revenues and recognized as revenues over the estimated life of the product to which they relate as we have continuing involvement with licensees until the related product is discontinued or the related patents expire, whichever is earlier. License fees received in connection with arrangements where we have no continuing involvement are recognized as license fees when the amounts are received or when collectibility is assured, whichever is earlier. No such fees were recorded during the six months ended June 30, 2006.

A milestone payment is a payment made by a third party or corporate partner to us upon the achievement of a predetermined milestone as defined in a legally binding contract. Milestone payments are recognized as license fees when the milestone event has occurred and we have completed all milestone related services such that the milestone payment is currently due and is non-refundable. No such fees were recorded during the six months ended June 30, 2006.

* Contract Revenues

Contract revenues relate to research and development arrangements that generally provide for the Company to invoice research and development fees based on full-time equivalent hours for each project. Revenues from these arrangements are recognized as the related development costs are incurred. These revenues approximate the costs incurred. No such revenues were recorded during the six months ended June 30, 2006.

Sale of Royalty Revenues

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro(R) and Carac(R) for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and we are entitled to receive an additional $5 million based on the satisfaction of certain predetermined milestones. The royalty interest agreement was entered into by the parties in January 2006, but the effective date of the sale of the royalty interest was October 1, 2005. The royalties recognized by the Company from October 1, 2005 through December 31, 2005 were accounted for as an offset against the $25 million gain.

Cash Equivalents and Short-term Investments

We consider all short-term investments in debt securities which have original maturities of less than three months at date of purchase to be cash equivalents. Investments which have original 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. Unrealized losses recorded as of June 30, 2006 were $58,000.

Accrued Disposition Costs

Costs relating to disposal of discontinued operations are reported as accrued disposition costs in the accompanying condensed balance sheets. Accrued disposition costs include severance costs and gross profit guarantees.

Concentrations of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash equivalents, short-term investments and trade accounts receivable. We invest excess cash in a variety of high grade short-term, interest-bearing securities. This diversification of risk is consistent with our policy to ensure safety of principal and to maintain liquidity.

Segment and Geographic Information

Our operations are confined to a single business segment, the design and commercialization of polymer technologies for pharmaceutical and other applications. Substantially all of our revenues have been derived from domestic customers.

Stock-Based Compensation

Refer to Note 2 "Stock-Based Compensation" and Note 8 Stockholders' Equity in our 2005 Annual Report for further information regarding our adoption of SFAS 123(R) and our stock-based compensation arrangements, including related disclosures required upon the adoption of SFAS 123(R). On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board Statement No. 123R, "Share-Based Payment" (SFAS 123R). SFAS 123R revised SFAS 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires companies to measure and recognize compensation expense for all employee share-based payments at fair value over the service period underlying the arrangement. Therefore, we are required to record the grant-date or purchase-date fair value of stock options issued to employees and employee stock purchases. We have recorded the compensation expense for stock options issued to non-employees and restricted stock awards to employees and directors. Compensation related to options granted to non-employees is periodically remeasured as earned. We adopted SFAS 123R using the "modified prospective" method, whereby fair value of all previously-granted employee share-based arrangements that remained unvested at January 1, 2006, based on the grant-date value estimated in accordance with the pro forma provisions of SFAS 123, and all grants made on or after January 1, 2006, based on fair value estimated in accordance with SFAS 123(R), have been included in our determination of share-based compensation expense for the three and six months ended June 30, 2006. We have not restated our operating results for the three and six months ended June 30, 2005 to reflect charges for the fair value of share-based arrangements.

The fair value of each employee and director grant of options to purchase common stock is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants for the quarter ended June 30, 2006: 1) risk-free interest rate of 5.05% for stock options and 4.95% for employee stock purchase plan; 2) expected dividend yield of 0% for both stock options and employee stock purchase plan; 3) expected holding period of 6.25 years based on the simplified method provided in Staff Accounting Bulletin No. 107 for "plain vanilla options" and expected term of 1.25 years for employee stock purchase plan based on weighted-average purchase period of the plan; 4) expected volatility of 240% for stock options and 71% for employee stock purchase plan based on the Company's historical stock prices; and 5) an estimated forfeiture rate of 3.3% of the options granted based on historical data.

The SFAS 123R share-based compensation expenses recorded for awards granted under the stock option plans and employee stock purchase plan were approximately $53,000 and $167,000, net of estimated forfeitures, for the three and six months ended June 30, 2006. The share-based compensation expense of $71,000 and $96,000 was recorded in research and development expense and general and administrative expense for the six months ended June 30, 2006, respectively. No tax benefit was recognized related to share-based compensation expense since we have incurred operating losses and we have established a full valuation allowance to offset all the potential tax benefits associated with our deferred tax assets.

During the quarter ended June 30, 2006 we granted 25,000 shares of restricted stock awards to directors. The weighted average grant-date fair value of shares of restricted stock awards granted during the three months ended June 30, 2006 was $1.73. As of June 30, 2006, we had a total of 235,000 shares of restricted stock awards granted to employees and directors, of which 135,000 shares have been vested. The compensation costs charged as operating expenses for restricted stock awards were $11,000 and $19,000 for the three and six months ended June 30, 2006, respectively, and $8,000 for the three and six months ended June 30, 2005.

During the quarter ended June 30, 2006 we granted 50,000 options to directors to purchase common stock. The following table summarizes option activity for the six months ended June 30, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2006	2,165,966	$3.40		
Granted	214,940	$1.62		
Exercised	(1,797)	$1.55		
Expired and forfeited	(11,335)	$1.66		
Outstanding at March 31, 2006	2,367,774	$3.25	5.5	$429,453
Granted	50,000	$1.74		
Exercised	(1,090)	$1.05		
Expired and forfeited	(69,421)	$9.10		
Outstanding at June 30, 2006	2,347,263	$3.04	5.5	$239,426
Options exercisable at June 30, 2006	1,903,025	$3.37	4.71	$155,429

As of June 30, 2006 there was approximately $555,521 of total unrecognized compensation expense related to nonvested stock options. This expense is expected to be recognized over a weighted-average period of 1.33 years.

Prior to January 1, 2006, we accounted for employee stock-based grants in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure". We have provided below the pro forma disclosures of the effect on net loss and net loss per share as if SFAS No. 123 had been applied in measuring compensation expense for the three and six months ended June 30, 2005.

	Three Months Ended June 30,	Six Months Ended June 30,

	2005	2005
Net loss, as reported	$(2,608)	$(3,864)
Deduct:		
Stock-based employee compensation expense determined under FAS 123	(75)	(159)
Pro forma net loss	$(2,683)	$(4,023)
Basic and diluted loss per share, as reported	$ (0.10)	$ (0.15)
Basic and diluted pro forma loss per share	$ (0.11)	$ (0.16)

Fair values of awards granted under the stock option plans and employee stock purchase plan were estimated at grant date using the Black-Scholes option pricing model. For pro forma disclosure, the estimated fair value of the options is amortized to expense over the vesting period of the options using the straight line method. Forfeitures have been accounted for in the period in which they occurred. The multiple option approach is used to value the purchase rights granted under the employee stock purchase plan. We used the following assumptions for the three and six months ended June 30, 2005:

	Three Months Ended June 30,	Six Months Ended June 30,
	2005	2005
Expected life in years (from grant date):		
Stock options	5	5
Employee stock purchase plan	1.5 - 2	1.5 - 2
Interest rate:		
Stock options	3.7%	4%
Employee stock purchase plan	1.47 - 3.63%	1.47 - 3.63%
Volatility:		
Stock options	78%	78%
Employee stock purchase plan	65 - 111%	65 - 111%
Expected dividend yield:	0%	0%

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

Certain amounts in the prior quarter condensed financial statements have been reclassified to conform with the current presentation of the financial statements. Amortization of premium/discount and accretion of marketable securities in the prior quarter have been reclassified from investing activities to operating activities on the Condensed Statements of Cash Flows.

(2) Income (Loss) Per Share Information

Basic income (loss) per share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding. Because the Company is in a net loss position for the three months ended June 30, 2006 and 2005 and six months ended June 30, 2005, diluted earnings per share is also calculated using the weighted average number of common shares outstanding and excludes the effects of options which are antidilutive. For the six months ended June 30, 2006, diluted earnings per share is calculated using the weighted average number of common shares outstanding and other dilutive securities.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share

computations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Numerator:				
Net income (loss)	$(4,550)	$(2,608)	$14,749	$(3,864)
Denominator:				
Weighted-average shares outstanding used to compute basic earnings per share	25,254	25,107	25,230	25,073
Effect of dilutive stock options, employee stock purchase and restricted stock awards	--	--	149	--
Weighted-average shares outstanding and dilutive securities used to compute diluted earnings per share	25,254	25,107	25,379	25,073

(3) Comprehensive Income (Loss)

Comprehensive income (loss) for the three and six months ended June 30, 2006 and 2005 consists of the following (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	$(4,550)	$(2,608)	$14,749	$(3,864)
Unrealized gains (losses) on available-for-sale securities	(13)	--	(42)	3
Comprehensive income (loss)	$(4,563)	$(2,608)	$14,707	$(3,861)

(4) Stockholders' Equity

During the six months ended June 30, 2006, 91,311 shares of common stock were issued primarily through the exercise of stock options, employee stock purchase, issuance of restricted stock awards and for the payment of directors' fees.

(5) 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 the income (loss) attributable to our Analytical Standards division that was sold to GFS Chemicals on February 13, 2003, and changes in estimates for our cosmeceutical and toiletry business that was sold to RP Scherer on July 25, 2000, as follows (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Analytical Standards Division				
Royalties earned in excess of minimum amount recorded	$ 16	$ 1	$ 23	$ 13
Cosmeceutical and Toiletry Business				
Change in estimates for gross profit guarantees	(50)	(45)	(50)	(63)
Total income (loss) from discontinued operations	$ (34)	$ (44)	$ (27)	$ (50)

Basic and diluted income (loss) per common share from discontinued operations were less than $0.01 per share for the six months ended June 30, 2006 and 2005, respectively.

Liabilities related to the discontinued operations at June 30, 2006 in the amount of $195,000 include severance costs and accruals for gross profit guarantees. These liabilities are reported as accrued disposition costs in the accompanying condensed balance sheets.

Under the terms of the agreement with RP Scherer, 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. We expect the annual Gross Profit Guaranty payments to range from approximately $100,000 to $150,000 for the remainder of the guaranty period. As the minimum amount of Gross Profit Guaranty due is based on sales by RP Scherer and can not be estimated, no accrual has been recorded relating to sales in future periods.

Cash provided by (used in) discontinued operations primarily relates to royalty payments received from GFS Chemicals for the sale of certain products offset by a payment of $100,000 relating to the gross profit guaranty.

Below is a summary of activity for liabilities related to the discontinued operations for the six months ended June 30, 2006 (in thousands):

Accrual at December 31, 2005	$248
Additional accrual for gross profit guaranty	

Payment for gross profit guaranty	(100)
Payment under severance agreement	(3)
Accrual at June 30, 2006	$195

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (all dollar amounts rounded to the nearest thousand)

FORWARD-LOOKING STATEMENTS

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 development, approval, launch and acceptance of new products, establishment of new corporate alliances, progress in research and development programs, and other risks described below or identified from time to time in our Securities and Exchange Commission filings. Except as may be required by law, we do not intend to update any forward-looking statement to reflect events after the date of this report.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of our financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates including those related to the useful lives of fixed assets, valuation allowances, impairment of assets, accrued clinical and preclinical expenses, valuation of stock-based compensation and contingencies. Actual results could differ materially from those estimates.

Except for the adoption of SFAS 123(R) we believe there have been no significant changes in our critical accounting policies and estimates during the six months ended June 30, 2006 compared to those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005 filed with the SEC on March 31, 2006. For a description of our critical accounting policies and estimates, please refer to our Annual Report on Form 10-K for the year ended December 31, 2005.

On January 1, 2006, we adopted the provisions of Financial Accounting Standards Board Statement No. 123R, "Share-Based Payment" (SFAS 123R). SFAS 123R revised SFAS 123, "Accounting for Stock-Based Compensation" and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." SFAS 123R requires companies to measure and recognize compensation expense for all employee share-based payments at fair value over the service period underlying the arrangement. Therefore, we are required to record the grant-date or purchase-date fair value of stock options issued to employees and employee stock purchases. We have recorded the compensation expenses for stock options issued to non-employees and restricted stock awards to employees and directors. Compensation related to options granted to non-employees is periodically remeasured as earned. We adopted SFAS 123R using the "modified prospective" method, whereby fair value of all previously-granted employee share-based arrangements that remained unvested at January 1, 2006 and all grants made on or after January 1, 2006 have been included in our determination of share-based compensation expense for the three and six months ended June 30, 2006. We have not restated our operating results for the three and six months ended June 30, 2005 to reflect charges for the fair value of share-based arrangements.

Results of Operations for the Three and Six Months Ended June 30, 2006 and 2005

Our revenues have been derived principally from royalties and contract revenues. Under strategic alliance arrangements entered into with certain companies, we received non-refundable upfront fees, milestone payments and royalties based on third party product sales.

In January 2006, we completed the sale of our rights to royalties on sales of Retin-A Micro(R) and Carac(R) for up to $30 million. We received proceeds of $25 million upon the closing of the transaction and we are entitled to receive an additional $5 million based on the

satisfaction of certain predetermined milestones. The royalty interest agreement was entered into by the parties in January 2006, but the effective date of the sale of the royalty interest was October 1, 2005. The royalties recognized by the Company from October 1, 2005 through December 31, 2005 were accounted for as an offset against the $25 million gain. As a result of this transaction, royalties for the second quarter of 2006 decreased to $0 from $1,187,000 in the corresponding quarter of the prior year and decreased in the first six months of 2006 to $0 from $2,469,000 in the first six months of 2005. We will not record additional royalty revenue on sales of Retin-A Micro and Carac in future periods.

Contract revenues, which are derived from work performed under collaborative research and development arrangements, decreased from $63,000 to $0 in the second quarter of 2006 and decreased from $142,000 to $0 in the first six months of 2006. The amount of contract revenues varies from period to period depending on the level of activity requested of us by our collaborators. Therefore we can not predict the amount of contract revenues in future periods.

Research and development expense for the second quarter of 2006 increased by $778,000 from $3,078,000 to $3,856,000 due mainly to expenditures in the second quarter on initiation of our Phase 3 trial program for APF530, our product candidate for the prevention of chemotherapy-induced nausea and vomiting. Research and development expense for the first six months of 2006 increased by $2,425,000 from $4,900,000 to $7,325,000 due mainly to the preparations and initiation of our Phase 3 trial program for APF530. We expect research and development expense to increase in the second half of 2006 as we conduct our Phase 3 trial program for APF530.

General and administrative expense increased for the second quarter of 2006 by $110,000 from $823,000 to $933,000 and for the first six months of 2006 by $193,000 from $1,672,000 to $1,865,000 due primarily to increased outside consultant fees and share-based compensation expense. We expect general and administrative expense for the second half of 2006 to remain relatively constant with the first half of the year.

With the adoption of SFAS 123R, we expect our non-cash operating expenses for employee share-based compensation for the second half of 2006 to remain relatively constant with the first half of the year.

Interest income, net, increased for the second quarter of 2006 by $206,000 to $280,000 from $74,000 and for the first six months of 2006 by $396,000 from $146,000 to $542,000 due to higher interest rates earned on higher average cash and marketable securities balances.

Loss from discontinued operations represents the net 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 $34,000 for the three months ended June 30, 2006, compared with a net loss of $44,000 in the three months ended June 30, 2005. For the six months ended June 30, 2006, net loss from discontinued operations decreased by $23,000 to $27,000 from $50,000 in the year-ago period.

Capital Resources and Liquidity
- ------------------------------

Cash, cash equivalents and marketable securities increased by $15,863,000 to $21,672,000 at June 30, 2006 from $5,809,000 at December 31, 2005 due to the sale of our interest in royalties on sales of Retin-A Micro and Carac in January 2006, partially offset by cash used in operating activities.

Net cash provided by continuing operating activities for the six months ended June 30, 2006 was $15,958,000, compared to net cash of $3,872,000 used in continuing operating activities for the six months ended June 30, 2005. The increase in net cash provided by operating activities from 2005 to 2006 was mainly due to proceeds from the sale of our interest in royalties in January 2006.

Net cash used in investing activities for the six months ended June 30, 2006 was $10,798,000 compared to net cash of $2,605,000 provided by investing activities for the six months ended June 30, 2005. The

increase in the cash used in investing activities was primarily due to the purchases of $14,701,000 of marketable securities.

Our future capital requirements 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; 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.

To date, we have financed our operations including technology and product research and development, primarily through royalties received on sales of Retin-A Micro and Carac, income from collaborative research and development fees, the proceeds received from the sale of our Analytical Standards division, the sale of our cosmeceutical and toiletry business and the sale of our interest in royalties on sales of Retin-A Micro(R) and Carac(R), the sale of common stock in June 2004, and interest earned on short-term investments. Our existing cash, cash equivalents and marketable securities, together with interest income and other revenue-producing activities including license and option fees and research and development fees, are expected to be sufficient to meet our cash needs at least through the first quarter of 2007. We are actively seeking partners in the U.S. and abroad to take over the funding of the Phase 3 clinical trial of APF530, and to commercialize the product upon approval by the FDA. If we are unable to reach terms with a partner, we will have to raise additional funds. We may be unable to raise sufficient additional capital when we need it or to raise capital on favorable terms. The sale of 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, 2006.

	Total	Less than 1 year	2 to 3 years	4 to 5 years	More than 5 years
Operating Leases	$2,260	$479	$950	$831	$ --

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Since December 31, 2005, there have been no material changes in the Company's market risk exposure.

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 Chief Financial Officer, of the effectiveness of the design and operations of our disclosure controls and procedures pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2006, 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 months ended June 30, 2006, there have been no significant changes in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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, 2005.

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

The Company's annual shareholder's meeting was held on May 31, 2006, at which the following proposal was approved.

Proposal I: Election of the following directors:

	Votes For	Votes Withheld
Paul Goddard Chairman of the Board	23,430,675	786,542
Michael O'Connell	23,392,675	824,542
Peter Riepenhausen	23,124,154	1,093,063
Toby Rosenblatt	20,146,647	4,070,570
Gregory Turnbull	23,165,414	1,051,803
Dennis Winger	23,423,305	793,912
Robert Zerbe	23,422,705	794,512

Proposal II: To amend the Company's 1997 Employee Stock Purchase Plan to increase by 150,000 the number of shares of common stock reserved for issuance under the Plan.

Votes For	Votes Against	Abstain	Votes Withheld
9,167,295	1,087,990	109,837	13,852,095

Proposal III: To amend the Company's 2002 Equity Incentive Plan to increase by 400,000 the number of shares of common stock reserved for issuance under the Plan.

Votes For	Votes Against	Abstain	Votes Withheld
8,789,814	1,438,733	136,575	13,852,095

Proposal IV: To ratify the appointment of Odenberg, Ullakko, Muranishi & Co., LLP as A.P. Pharma'a independent registered public accounting firm.

Votes For	Votes Against	Abstain
23,462,980	144,026	610,211

ITEM 6. Exhibits

Exhibit 31.1 Certification of Chief Executive Officer pursuant to Rules 13A-14(a) Promulgated under the Securities Exchange Act of 1934 as amended.

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rules 13A-14(a) Promulgated under the Securities Exchange Act of 1934 as amended.

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

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 11, 2006

By: /S/ Michael O'Connell
Michael O'Connell
President and Chief Executive Officer

Date: August 11, 2006

By: /S/ Gordon Sangster
Gordon Sangster
Chief Financial Officer

Exhibit 31.1

SECTION 302 CERTIFICATIONS

Certifications:

I, Michael O'Connell, 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 officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) 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 within those entities, particularly during the period in which this report is being prepared;

b) 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

c) 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 officers 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 11, 2006

/s/ Michael O'Connell
- ---------------------
Michael O'Connell
President and Chief Executive Officer

Exhibit 31.2

SECTION 302 CERTIFICATIONS

Certifications:

I, Gordon Sangster, 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 officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) 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 within those entities, particularly during the period in which this report is being prepared;

b) 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

c) 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 officers 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 11, 2006

/s/ Gordon Sangster
- ------------------
Gordon Sangster
Chief Financial Officer

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, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael O'Connell, 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.

/s/ Michael O'Connell
Michael O'Connell,
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, 2006 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gordon Sangster, 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.

/s/ Gordon Sangster
Gordon Sangster,
Chief Financial Officer