SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (Fee Required) For the fiscal year ended December 31, 1996 or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 (No Fee Required) For the transition period from _____ to _____.

Commission File Number 0-16109

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

Delaware	94-2875566
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3696 Haven Avenue, Redwood City, California	94063
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (415) 366-2626

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

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock ($.01 par value)

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

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

The aggregate market value of the voting stock of the registrant held by nonaffiliates of the registrant as of February 28, 1997, was $149,602,066. (1)

As of February 28, 1997, 18,412,562 shares of registrant's Common Stock, $.01 par value, were outstanding.

Exhibit Index at Page 35
Total Pages 35

1 Excludes 5,668,132 shares held by directors, officers and shareholders whose ownership exceeds 5% of the outstanding shares at February 28, 1997. Exclusion of such shares should not be construed as indicating that the holders thereof possess the power, direct or indirect, to direct the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

DOCUMENTS INCORPORATED BY REFERENCE

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

TABLE OF CONTENTS

PART I

Item 1. BUSINESS

INTRODUCTION-FORWARD LOOKING STATEMENTS

To the extent that this report discusses future financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval, launch and acceptance of new products, the costs associated with new product introductions, as well as other factors described below under the headings "APS Technology", "Products", "Manufacturing", "Marketing", "Government Regulation", "Patents and Trade Secrets" and "Competition". In addition, such risks and uncertainties also include the matters discussed under Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 below.

THE COMPANY

Advanced Polymer Systems, Inc. and subsidiaries ("APS" or the "Company") is using its patented Microsponge(R) delivery systems and related proprietary technologies to enhance the safety, effectiveness and aesthetic quality of topical prescription, over-the-counter ("OTC") and personal care products. The Company is currently manufacturing and selling Microsponge systems for use by corporate customers in almost 100 different cosmetic and personal care products sold worldwide. APS holds 188 issued U.S. and foreign patents on its technology and has over 68 other patent applications pending.

The Company, founded in February 1983 as a California corporation under the name AMCO Polymerics, Inc., changed its name to Advanced Polymer Systems, Inc. in 1984 and was reincorporated in Delaware in 1987.

Products under development or in the marketplace utilize the Company's Microsponge systems in three primary ways: 1) as reservoirs releasing active ingredients over an extended period of time, 2) as receptacles for absorbing undesirable substances, such as excess skin oils, or 3) as closed containers holding ingredients away from the skin for superficial action. The resulting benefits include extended efficacy, reduced skin irritation, cosmetic elegance, formulation flexibility and improved product stability.

In February 1997, the Company received FDA approval for the first ethical pharmaceutical product based on its patented Microsponge technology - Retin A(R)-Micro(TM) - which has been licensed to Ortho-McNeil Pharmaceutical Corporation, a member of the Johnson & Johnson ("J&J") family of companies. This product was launched in March 1997. In September 1994, the Company submitted a New Drug Application (NDA) for a melanin-Microsponge sunscreen. The NDA was found to be non-approvable pending additional information which the Company is continuing to provide.

APS has established several alliances with multinational corporations including J&J and Rhone-Poulenc Rorer to develop products which incorporate Microsponge systems. In general, these alliances provide for the client companies to pay the costs of product development, clinical testing, regulatory approval and commercialization. In return, the clients receive certain marketing rights to the products developed. APS typically receives an initial cash infusion in the form of license fees, future payments contingent on the achievement of certain milestones, revenues from the manufacture of Microsponge systems, and royalty payments based on third party product sales. J&J and Rhone-Poulenc Rorer also have made equity investments in the Company. APS and Dow Corning Corporation formed a joint venture alliance in 1992 to develop and commercialize Polytrap(R) and Microsponge systems for use in the manufacture of cosmetics and personal care products. In the first quarter of 1996, APS acquired all rights to the Polytrap technology from Dow Corning in exchange for 200,000 shares of APS common stock.

Effective January 1997, the Company licensed its consumer products to Lander Company in the United States and Canada in return for guaranteed minimum royalties, revenues from the sale of Microsponge systems and research and development funding for new consumer products. Lander will be responsible for all aspects of commercialization including selling, marketing, manufacturing, distribution and customer service. Also as part of its long-term strategic plan to move away from the direct marketing of consumer products, the Company plans to discontinue the marketing of its in-licensed suncare products.

To maintain quality control over manufacturing, APS has committed significant resources to its production processes and polymer systems development programs. The Company's manufacturing facility in Lafayette, Louisiana, is responsible for large-scale production of Microsponge systems and related technologies. All products are manufactured according to Current Good Manufacturing Practices guidelines ("CGMPs") established by the FDA. In addition, APS has a process development pilot plant in its Louisiana facility. APS also has established relationships with contract manufacturers, which provide second-source production capabilities to handle growing product demand. The Company's objective is to utilize these third parties selectively, so that it can maintain its flexibility and direct the bulk of APS' capital resources to other areas such as product and technology development.

APS TECHNOLOGY

The fundamental appeal of the Company's Microsponge technology stems from the difficulty experienced with conventional formulations in releasing active ingredients over an extended period of time. Cosmetics and skin care preparations are intended to work only on the outer layers of the skin. Yet, the typical active ingredient in conventional products is present in a relatively high concentration and, when applied to the skin, may be rapidly absorbed. The common result is over-medication, followed by a period of under-medication until the next application. Rashes and more serious side effects can occur when the active ingredients rapidly penetrate below the skin's surface. APS' Microsponge technology is designed to allow a prolonged rate of release of the active ingredients, thereby offering potential reduction in the side effects while maintaining the therapeutic efficacy.

Microsponge Systems. The Company's Microsponge systems are based on microscopic, polymer-based microspheres that can bind, suspend or entrap a wide variety of substances and then be incorporated into a formulated product, such as a gel, cream, liquid or powder. A single Microsponge is as tiny as a particle of talcum powder, measuring less than one-thousandth of an inch in diameter. Like a true sponge, each microsphere consists of a myriad of interconnecting voids within a non-collapsible structure that can accept a wide variety of substances. The outer surface is typically porous, allowing the controlled flow of substances into and out of the sphere. Several primary characteristics, or parameters, of the Microsponge system can be defined during the production phase to obtain spheres that are tailored to specific product applications and vehicle compatibility.

Polymeric (R) Systems. In January 1996, the Company signed a definitive agreement with Dow Corning Corporation, one of the world's largest suppliers of ingredients used in cosmetics and personal care products, to acquire full rights to Dow Corning's Polytrap(R) technology and full responsibility for the continuing commercialization of Polytrap systems in exchange for 200,000 shares of APS common stock. Polytrap systems are designed to: 1) absorb skin oils and eliminate shine, 2) provide a smooth and silky feel to product formulations, 3) entrap and deliver various ingredients in personal care products and 4) convert liquids into powders.

Microsponge and Polytrap systems are made of biologically inert polymers. Extensive safety studies have demonstrated that the polymers are non-irritating, non-mutagenic, non-allergenic, non-toxic and non-biodegradable. As a result, the human body cannot convert them into other substances or break them down. Furthermore, although they are microscopic in size, these systems are too large to pass through the stratum corneum (skin surface) when incorporated into topical products.

Colon-specific Systems. A Microsponge system offers the potential to hold active ingredients in a protected environment and provide controlled delivery of oral medication to the lower gastrointestinal (GI) tract, where it will be released upon exposure to specific enzymes in the colon. This approach if successful, should open up entirely new opportunities for APS.

Bioerodible Systems. The Company is also developing systems based on new bioerodible polymers for the delivery of small and large molecule drugs, including proteins and peptides, which, if successful, should open up new fields of opportunity in systemic drug delivery arenas.

PRODUCTS

APS is focusing its efforts primarily on the ethical dermatology, OTC skin care and personal care markets in which Microsponge systems can provide substantial advantages. Certain additional applications for the Company's technology are also under development, as noted below.

Ethical Dermatology

APS defines "ethical dermatology" products as prescription and non-prescription drugs that are promoted primarily through the medical profession for the prevention and treatment of skin problems or diseases. The Company is developing several ethical dermatology products which will require approval of the FDA before they can be sold in the United States. Although these pharmaceuticals are likely to take longer to reach the marketplace than OTC and personal care products, due to the regulatory approval process, the Company believes that the benefits offered by Microsponge delivery systems will allow valuable product differentiation in this large and potentially profitable market. Results from various human clinical studies reaffirm that this technology offers the potential to reduce the drug side effects, maintain the therapeutic efficacy and potentially increase patient compliance with the treatment regimen. The following ethical dermatology products have been developed or are under development by APS:

Tretinoin Acne Medication. In February 1997, the Company received FDA approval for Microsponge-entrapped tretinoin for improved acne treatment. This submission to the FDA represented the culmination of an intensive research and clinical development program involving approximately 1,150 patients. Tretinoin has been marketed in the U.S. by Ortho Dermatological, a Johnson & Johnson subsidiary, under the brand name RETIN-A(R) since 1971. It has proven to be a highly effective topical acne medication. However, skin irritation among sensitive individuals can limit patient compliance with the prescribed therapy. The Company believes its patented approach to drug delivery reduces the potentially irritating side effects of tretinoin. Ortho Dermatological began marketing this product in March 1997.

Melanin-Microsponge Sunscreen. Concern about the sun's harmful effects and its role in aging and skin cancer has resulted in heightened awareness of preventative measures in the sunscreen market. APS has developed a sun protectant designed to provide the highest-available protection against the sun's UVA rays as well as protection from the burning UVB rays. This unique APS product candidate incorporates the Company's melanin-Microsponge system containing genetically engineered melanin, a natural pigment found in skin.

The Company filed its NDA in September 1994 for marketing clearance. Since it involves an entirely new ethical pharmaceutical ingredient and application, the regulatory review process is lengthier and more complex. The NDA was found to be non-approvable pending additional information which the Company is continuing to provide. There can be no assurance that FDA approval will be received. If approval is received, the Company plans to market this product through a strategic partner.

5-Fluorouracil. Another ethical dermatology product candidate, Microsponge-entrapped 5-Fluorouracil (5-FU), was the subject of an Investigational New Drug ("IND") filing in early 1995. 5-FU is an effective chemotherapeutic agent for treating actinic keratosis, a pre-cancerous, hardened-skin condition caused by excessive exposure to sunlight. However,

patient compliance with the treatment regimen is poor, due to significant, adverse side effects. Through a joint agreement with Rhone-Poulenc Rorer, the Company is developing a Microsponge-enhanced topical formulation that potentially offers a less irritating solution for treating actinic keratosis. Phase II clinical studies have been completed and Phase III clinical studies are scheduled to commence in mid-1997.

Tretinoin Photodamage Treatment. Initial product development was undertaken in 1994 to develop a Microsponge system product for the treatment of photodamage, which contributes to the premature aging of skin and has been implicated in skin cancer. Should an IND be filed for this product, funding for this second tretinoin treatment indication will be provided by J&J's Ortho-McNeil Pharmaceutical subsidiary.

Cosmeceutical Products

Retinol. Retinol is a highly pure form of vitamin A which has demonstrated a remarkable ability for maintaining the skin's youthful appearance. However, it has been available only on a limited basis because it becomes unstable when mixed with other ingredients. APS has been able to stabilize retinol in a formulation which is cosmetically elegant and which has a low potential for skin irritation. The Company has executed agreements with three companies, each of which have marketing strength in a particular channel of distribution. The channels for which the Company has licensed retinol are direct marketing (Avon), dermatologists (Medicis) and salons and spas (Sothys). The Company retains full rights to alternate channels of distribution, including department stores and other mass merchandisers.

Personal Care and OTC Products

APS technologies are ideal for skin and personal care products. They can retain several times their weight in liquids, respond to a variety of release stimuli, and absorb large amounts of excess skin oil, all while retaining an elegant feel on the skin's surface. In fact, APS technologies are currently employed in almost 100 products sold by major cosmetic and toiletry companies worldwide. Among these products are skin cleansers, conditioners, oil control lotions, moisturizers, deodorants, razors, lipstick, makeup, powders, and eye shadows.

Entrapping cosmetic ingredients in APS' proprietary Microsponge delivery systems offers several advantages, including improved physical and chemical stability, greater available concentrations, controlled release of the active ingredients, reduced skin irritation and sensitization, and unique tactile qualities.

Other Product Applications

While not the principal focus of APS development efforts, other products could benefit from the value-added application of the Company's polymer technology. To date, the Company has chosen to apply its technology to the following non-skin-care field:

Analytical Standards. APS initially developed microsphere precursors to the Microsponge for use as a testing standard for gauging the purity of municipal drinking water. Marketed by APS nationwide, these microspheres are suspended in pure water to form an accurate, stable, reproducible turbidity standard for the calibration of turbidimeters used to test water purity.

APS believes its Analytical Standards technology has much broader applications than testing the turbidity of water. The Company has begun to develop standards for industrial use for the calibration of spectrophotometers and colorimeters.

MANUFACTURING

Polymer Raw Material. Raw materials for the Company's polymers are petroleum-based monomers which are widely available at low cost. The monomers have not been subject to unavailability or significant price fluctuations. Raw material costs generally account for less than a third of the total cost of the Company's products.

Process Engineering and Development. The Company employs chemical engineers and operates a pilot-plant facility for developing production processes. The equipment used for manufacturing and process development is commercially available in industrial sizes and is installed in the Company's production facility in Lafayette, Louisiana.

Microsponge Production. APS has committed significant resources to the production process and polymer systems development required to commercialize its products. The Company has to date manufactured most Microsponge systems in company-owned and operated facilities.

The Company's manufacturing facility in Lafayette, Louisiana, is responsible for large-scale production of Microsponge systems and related technologies. APS also has established relationships with contract manufacturers which provide second-source production capabilities. The Company's objective is to utilize these third parties selectively, so that it can maintain its flexibility and direct the bulk of APS' capital resources to other areas, such as product development and marketing. All products are manufactured according to CGMP. In addition, APS has a process development pilot plant in its Louisiana facility.

MARKETING

A key part of APS' business strategy is to ally the Company with major marketing partners. The Company has therefore negotiated several agreements for the development of Microsponge delivery systems, the supply of entrapped ingredients, and the marketing of formulated products. To create an incentive for APS to develop products as quickly as possible, these development and license agreements provide, in some cases, for substantial payments by the client companies during the period of product development and test marketing. Additionally, some agreements provide for non-refundable payments on the achievement of certain key milestones, royalties on sales of formulated products, and minimum annual payments to maintain exclusivity. APS has, in some product areas, retained co-marketing rights.

In general, APS grants limited marketing exclusivity in defined markets to client companies, while retaining the right to manufacture the Microsponge delivery systems it develops for these clients. However, after development is completed and a client commercializes a formulated product utilizing the Company's delivery systems, APS can exert only limited influence

over the manner and extent of the client's marketing efforts. APS' client companies may cancel their agreements without penalty.

The Company's material agreements and relationships are set forth below:

Johnson & Johnson Inc. In May 1992, APS and Ortho-McNeil Pharmaceutical Corporation ("Ortho"), a subsidiary of J&J, entered into a licensing agreement related to tretinoin-based products incorporating APS' Microsponge technology. As part of the agreement, in 1992, license fees of $6,000,000 were paid to APS. In addition, Johnson & Johnson purchased 723,006 shares of newly issued APS common stock for $8,000,000. In 1994, J&J purchased 1,000,000 additional shares of newly issued common stock for $5,000,000. J&J also received 200,000 warrants that expired in 1996. The number of shares issuable to J&J was increased by 432,101 pursuant to an agreed upon formula tied to the trading price of APS stock prior to January 1996. The license fee provides Ortho with exclusive distribution or license rights for all Ortho tretinoin products utilizing the APS Microsponge system. Ortho's exclusivity will continue as long as certain annual minimum payments are made. In addition, Ortho will pay license fees and milestone payments over time to APS. APS will also receive royalty payments on net product sales worldwide.

In February 1997, APS received FDA approval for the first product covered by this agreement, Microsponge-entrapped tretinoin. This product will be marketed by Ortho Dermatological beginning March 1997. APS received a milestone payment of $3,000,000 from Ortho upon receipt of the approval.

In December 1996, the Company purchased the Take-Off(R) trademark from Johnson & Johnson Consumer Products, Inc. for a royalty of 3% on net sales of Take-Off products with annual minimums for five years. Effective January, 1997, this product was licensed to Lander Company.

Rhone-Poulenc Rorer. In March 1992, APS and Rhone-Poulenc Rorer ("RPR") restructured their 1989 joint venture agreement to give APS more freedom in developing products. Under the new terms, APS has regained from RPR worldwide marketing rights to products in the prescription dermatology field, including the melanin-based sunscreen product in which RPR had invested approximately $4,000,000 in development costs. APS also gained ownership of a partially-completed manufacturing facility in Vacaville, California, which the Company sold in December 1995. Also under the new terms, RPR invested $2,000,000 in cash in APS and relieved APS of the obligation to repay a $1,500,000 advance. In return, RPR received 705,041 shares of APS stock and maintains a minority share in the potential net profits of the melanin-based sunscreen product. Furthermore, RPR has agreed to continue funding the exploration and development of certain dermatology applications of APS' technology in which APS shares marketing rights. Product applications include a 5-FU treatment for pre-cancerous actinic keratosis. In 1995, RPR filed an IND application to begin human clinical testing of 5-FU. Phase II clinical trials for 5-FU have been completed and Phase III clinical trials are scheduled to commence in mid 1997.

Dow Corning. In July 1991, APS and Dow Corning Corporation formed a collaborative alliance to manufacture and sell both APS' Microsponge and Dow Corning's Polytrap technologies worldwide in the cosmetics and toiletries field. Under the agreement, Dow Corning provided financial assistance in this venture, as well as worldwide sales and support services; APS contributed its technology, research and development, technical support and manufacturing capability for both the Microsponge and Polytrap products. In the first quarter of 1996, APS acquired full rights to the Polytrap technology and full responsibility for the continuing commercialization in exchange for 200,000 shares of APS common stock.

Lander Company. In March 1996, the Company formed a collaboration with Lander Company, Inc. to develop and provide premium quality, store-brand personal care products based on the Company's patented delivery system technology. Under terms of the agreement, the Company received a $3 million equity investment and license fees and will receive additional licensing fees, royalties on product sales and research and development funding for new consumer products. APS and Lander will collaborate on product formulations and marketing preparations and Lander will be responsible for sales, manufacturing and distribution to retailers.

Effective January 1997, APS established a new strategic alliance with Lander under which Lander was granted full marketing rights in the United States and Canada to Microsponge-based Exact(R) acne medications, Take-Off(R) facial

cleansers, Everystep(R) Foot Powder, as well as in-licensed consumer products. Under terms of the agreement, Lander will be responsible for all aspects of commercialization including selling, marketing, manufacturing, distribution and customer service. APS will receive guaranteed minimum royalties, revenues from the sale of Microsponge systems and research and development funding for new branded consumer products.

Avon. In August 1996, APS signed a license and supply agreement with Avon under which APS is providing Avon with a formulation incorporating Microsponge delivery systems and retinol, an ingredient developed to improve the appearance of aging skin. Under terms of the agreement, APS received upfront licensing fees and will receive manufacturing revenues on supply of product.

Medicis. In October 1996, APS entered into an agreement with Medicis Pharmaceutical Corporation for the commercialization of dermatology products. Medicis will initially be responsible for marketing two newly developed APS products in the United States. In return, APS received an upfront licensing fee, and will receive an additional licensing fee and a share of revenues, with guaranteed minimums.

Procter & Gamble. In the first quarter of 1992, after having been one of APS' original licensees in 1987, Scott Paper Company began the regional U.S. launch of Baby Fresh with Ultra Guard baby wipes. Ultra Guard is Scott's trademark for an APS Microsponge system that contains dimethicone to help protect a baby's skin from diaper rash. In early 1993, Scott achieved national distribution for Baby Fresh with Ultra Guard. In the first quarter of 1996, Kimberly-Clark completed its acquisition of Scott Paper Company. One of the conditions of the acquisition imposed by the Federal Trade Commission was that Kimberly-Clark divest the acquired baby wipe business. Procter & Gamble bought the baby wipe business in 1996 and now markets the product under the Pampers brand name.

GOVERNMENT REGULATION

Ethical Products

In order to clinically test, produce and sell products for human therapeutic use, mandatory procedures and safety evaluations established by the FDA and comparable agencies in foreign countries must be followed. The procedure for seeking and obtaining the required governmental clearances for a new therapeutic product includes pre-clinical animal testing to determine safety and efficacy, followed by human clinical testing, and can take many years and require substantial expenditures. In the case of third-party agreements, APS expects that the corporate client will fund the testing and the approval process with guidance from APS. The Company intends to seek the necessary regulatory approvals for its proprietary dermatology products as they are being developed.

APS' facilities, where the Company manufactures pharmaceutical raw materials, are subject to periodic governmental inspections. If violations of applicable regulations are noted during these inspections, significant problems may arise affecting the continued marketing of any products manufactured by the Company.

The Company's plant in Lafayette, Louisiana operates according to CGMP prescribed by the FDA. This compliance has entailed modifying certain manufacturing equipment, as well as implementing certain record keeping and other practices and procedures which are required of all pharmaceutical manufacturers. The Company believes it is in compliance with federal and state laws regarding occupational safety, laboratory practices, environmental protection and hazardous substance control.

Personal Care Products

Under current regulations, the market introduction of non-medicated cosmetics, toiletries and skin care products does not require prior formal registration or approval by the FDA or regulatory agencies in foreign countries, although this situation could change in the future. The cosmetics industry has established self-regulating procedures and most companies perform their own toxicity and consumer tests.

PATENTS AND TRADE SECRETS

As part of the Company's strategy to protect its current products and to provide a foundation for future products, APS has filed a number of United States patent applications on inventions relating to specific products, product groups, and processing technology. The Company also has filed foreign patent applications on its polymer technology with the European Union, Japan, Australia, South Africa, Canada, Korea and Taiwan. The Company received U.S. patent protection for its basic Microsponge system in 1987 and now has a total of 40 issued U.S. patents and an additional 148 issued foreign patents. The Company has over 68 pending patent applications worldwide.

Although the Company believes the bases for these patents and patent applications are sound, they are untested, and there is no assurance that they will not be successfully challenged. There can be no assurance that any patent already issued will be of commercial value, or that any patent applications will result in issued patents of commercial value, or that APS' technology will not be held to infringe on patents held by others.

APS relies on unpatented trade secrets and know-how to protect certain aspects of its production technologies. APS' employees, consultants, advisors and corporate clients have entered into confidentiality agreements with the Company. These agreements, however, may not necessarily provide meaningful protection for the Company's trade secrets or proprietary know-how in the event of unauthorized use or disclosure. In addition, others may obtain access to, or independently develop, these trade secrets or know-how.

COMPETITION

Although Microsponge and Polytrap systems, by virtue of their highly porous structure, are unique delivery systems, there are many alternate delivery systems available. However, in the cosmetic and cosmeceutical fields, Microsponge and Polytrap systems are particularly versatile at allowing the entrapment of active agents and controlled release by simple changes in vehicles.

Other delivery systems based on microparticulate materials could compete with Microsponge and Polytrap systems. Among these are liposomes, microcapsules and microspheres. Liposomes are small phospholipid vesicles capable of entrapping and releasing active agents. However, they are significantly more expensive to manufacture, less versatile and their stability is a concern. While they are primarily used in systemic applications, they are also used in the cosmetic arena.

The most closely related systems are microcapsules and microspheres. Microcapsules are spherical particles containing an active agent in the core, surrounded by a polymeric membrane. Microspheres are spherical particles containing the active agent dispersed in a polymeric matrix. The major distinguishing feature between Microsponge and Polytrap systems and microcapsules, or microspheres is that the structure of Microsponge and Polytrap systems is highly porous, while microspheres or microcapsules are solid particles with no internal voids.

Thus, while only one type if Microsponge system can be used to entrap a variety of active agents and release these at desired rates by vehicle changes, different active agents and different release profiles can only be achieved with microcapsules or microspheres by a complete change in polymer and fabrication methods.

HUMAN RESOURCES

As of February 28, 1997, the Company had 84 full-time employees, 3 of whom hold PhDs. There were 15 employees engaged in research and development, 34 in manufacturing and production activities, 8 in quality control, and 27 working in sales, finance, marketing, human resources and administration.

The Company considers its relations with employees to be satisfactory. None of the Company's employees is covered by a collective bargaining agreement.

Item 2. PROPERTIES

The Company currently occupies 23,040 square feet of laboratory, office and warehouse space in Redwood City, California and 4,800 square feet of office space in Greenwich, Connecticut. Rent expense for these facilities in 1996 was $254,184 and $109,936, respectively.

The Company occupies a production facility and warehouse in Lafayette, Louisiana, with a current annual capacity, depending upon the application, to produce 500,000 to 750,000 pounds of entrapped materials. The existing plant, with contiguous acreage, has been designed to allow significant expansion. In 1995 the Company sold this facility and warehouse along with certain other assets and subsequently leased them back for a certain fixed monthly rent over a period of forty-eight months. The Company reported this transaction as a financing transaction.

The construction of the facility in 1986 was financed primarily by 15-year tax-exempt industrial development bonds. In 1990, the bonds were refinanced. The maturity date of the bonds occurs in installments beginning June 30, 1993, and ending December 31, 2000. The bonds bear a fixed interest rate of 10%. In 1995, the Company extinguished the bond liability through an "insubstance defeasance" transaction by placing U.S. government securities in an irrevocable trust to fund all future interest and principal payments.

The Company's existing research and development and administrative facilities are not yet being used at full capacity and management believes that such facilities are adequate and suitable for its current and anticipated needs. Additional manufacturing capacity could be required as APS expands commercial production. It is anticipated that any additional production facilities would be built on land the Company presently occupies in Lafayette, Louisiana.

Item 3. LEGAL PROCEEDINGS
None.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
None.

PART II

Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

Shares of the Company's common stock trade on the Nasdaq National Market, under the symbol APOS. As of February 28, 1997, there were 595 holders of record of the Company's common stock.

The Company has never paid cash dividends and does not anticipate paying cash dividends in the foreseeable future. The following table sets forth for the fiscal periods indicated, the range of high and low closing sales prices for the Company's common stock on the NASDAQ National Market System.

1996	High	Low	1995	High	Low
First Quarter	9 1/4	5 1/4	First Quarter	6	4
Second Quarter	11 1/4	7 7/8	Second Quarter	5 7/8	4 1/16
Third Quarter	9 5/8	5 7/8	Third Quarter	8 3/8	5 1/8
Fourth Quarter	8 7/8	6 3/8	Fourth Quarter	7 1/2	4 7/8

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

Years Ended December 31	1996	1995	1994	1993	1992
Statements of Operations					
Total revenues	$18,665	$16,108	$15,884	$19,932	$15,527
Research and development, net	3,506	4,139	6,334	7,343	3,726
Selling, marketing and advertising	8,455	6,560	5,669	6,237	4,013
General and administrative	2,984	3,082	2,844	2,988	3,468
Loss on purchase commitment, including related inventory	1,400	600	685	950	-
Net loss	(9,378)	(9,359)	(9,759)	(9,877)	(5,545)
Loss per common share	$ (0.52)	$ (0.57)	$ (0.65)	$ (0.73)	$ (0.43)
Weighted average common shares outstanding	17,987	16,459	15,018	13,527	12,805

December 31	1996	1995	1994	1993	1992
Balance Sheets					
Working capital	$3,800	$4,976	$5,641	$4,555	$14,428
Total assets	18,444	23,082	23,508	24,378	31,115
Long-term debt, excluding current portion	5,579	6,355	979	3,355	3,672
Shareholders' equity	5,010	5,233	11,786	10,501	20,143

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
(Dollar amounts are rounded to nearest $1,000)

To the extent that this report discusses financial projections, information or expectations about our products or markets, or otherwise makes statements about future events, such statements are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely approval, launch and acceptance of new products, establishment of new corporate alliances, progress in research and development programs and other risks listed from time to time in the Company's Securities and Exchange Commission filings.

The Company's revenues are derived principally from product sales, license fees and royalties. The Company is currently manufacturing and selling Microsponge(R) delivery systems for use by customers in almost 100 different cosmetic and personal care products. Under strategic alliance arrangements entered into with certain multinational corporations, APS generally receives an initial cash infusion, future milestone payments, royalties based on third party product sales and revenues from the supply of Microsponge systems.

As of January 1, 1997, the Company licensed its over the counter consumer products to the Lander Company in return for royalties on future product sales. Also as part of its long-term strategic plan to move away from the direct marketing of consumer products, the Company plans to discontinue the marketing of its in-licensed suncare products.

Past results are not indicative of future results.

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

STATEMENTS OF OPERATIONS HIGHLIGHTS	Years Ended December 31, 1996	1995	1994	Annual % Change 96/95	95/94
	$000	$000	$000		
Product revenues	$17,490	$15,203	$14,787	15%	3%
Licensing revenues	1,175	905	1,097	30%	-18%
Total revenues	18,665	16,108	15,884	16%	1%
Cost of sales	10,772	11,047	10,149	-2%	9%
Research and development, net	3,506	4,139	6,334	-15%	-35%
Selling and marketing	5,405	4,756	4,012	14%	19%
Advertising and promotion	3,050	1,805	1,657	69%	9%
General and administrative	2,984	3,082	2,844	-3%	8%
Loss on purchase commitments, including related inventory	1,400	600	685	133%	-12%

STATEMENTS OF OPERATIONS HIGHLIGHTS	1996	1995	1994
Expenses expressed as a percentage of product revenues:			
Cost of sales	62%	73%	69%
Research and development, net	20%	27%	43%
Selling and marketing	31%	31%	27%
Advertising and promotion	17%	12%	11%
General and administrative	17%	20%	19%
Loss on purchase commitments, including related inventory	8%	4%	5%

Results of Operations for the years ended December 31, 1996 and 1995

Total revenues for 1996 totalled $18,665,000 compared to $16,108,000 in the prior year, an increase of $2,557,000 or 16%. Product sales amounted to $17,490,000, an increase of $2,287,000 or 15% over the prior year, and licensing revenues amounted to $1,175,000, an increase of $270,000 or 30% over the prior year. Revenues derived from products which incorporate the Microsponge technology totalled $11,682,000, an increase of $559,000 or 5% over the prior year.

The increase in product revenues over 1995 was due primarily to increased shipments of Microsponge systems to manufacturers of cosmetics and personal care products of $856,000 or 18% and increased sales of consumer products of $1,363,000 or 15%. The Company anticipates an increase in sales of Microsponge systems in 1997 as a result of agreements signed with major corporate customers who are launching new products during the year. These partners include Ortho Dermatological, Avon, Medicis, Lander and Johnson & Johnson Consumer Products, Inc. These increases will be offset by the absence of sales of consumer products due to the licensing of products to the Lander Company effective January 1, 1997, in return for a royalty stream and the Company's plans to discontinue the marketing of its in-licensed suncare products.

The increase in licensing fee revenue during 1996 relates to the receipt of fees received from the Company's new corporate partners as part of the agreements executed in 1996.

Gross profit on product revenues for the year increased by $2,562,000 or 62% to $6,718,000 due to increased manufacturing efficiencies resulting from the higher volume and the sales mix of consumer products.

Research and development expense decreased by $633,000 or 15% due primarily to a change in estimate. Additionally, there was a continuing reduction in outside services as external costs are being borne principally by corporate partners. Selling and marketing expense increased by $649,000 or 14% to $5,405,000 due mainly to an increased focus on opening new markets for Microsponge systems and increased distribution expense attributable to higher sales volume.

Advertising and promotion expense increased by $1,245,000 or 69% due to a consumer products sampling program and expenditures relating to a full year's advertising for the Neet(R) depilatory product line which was licensed from Reckitt and Colman in September, 1995. These costs, together with selling expenses, will decrease significantly in 1997 as a result of the licensing arrangement for the Company's consumer product lines.

General and administrative expense decreased by $98,000 or 3% to $2,984,000 due mainly to reduced spending on external services.

The loss on purchase commitment relates to a contractual commitment for the purchase of melanin in excess of

current estimated requirements. Melanin is the key ingredient in the manufacture of the APS-developed UVA/UVB sun protection cream for which an NDA was filed. This amount includes the final amount due under the contractual commitment.

The Company's operating loss decreased by $869,000 or 9% to $8,452,000 as a result of the factors discussed above.

Interest income was essentially flat between 1996 and 1995, but interest expense increased by $778,000 to $1,223,000 in 1996 as a result of the debt financing arranged in the second half of 1995.

The net loss for the year of $9,378,000 was essentially flat with the loss in the prior year, with the increased gross profit being offset by increases in selling and promotional expense, interest expense and the increased loss on the purchase commitment.

Results of Operations for the years ended December 31, 1995 and 1994

Total revenues for 1995 amounted to $16,108,000 compared to $15,884,000 in the prior year, an increase of $224,000 or 1%. This consisted of product sales of $15,203,000, an increase of $416,000 or 3% over the prior year, and licensing revenues of $905,000, a decrease of $192,000 or 18% from the prior year.

Revenues from products which incorporate the Microsponge technology totalled $10,458,000, an increase of $3,787,000 or 57% over the prior year.

The increase in product revenues over 1994 resulted from increased shipments of Microsponge systems to a variety of personal care and specialty customers, primarily manufacturers of cosmetics and toiletries through the alliance with Dow Corning Corporation. This increase was offset by a slight decrease in sales of consumer products. While sales of the Exact(R) acne line increased by 71% over the prior year and the addition of the line of Neet(R) products under a licensing agreement with Reckitt & Colman also contributed to sales of consumer products, this was offset by an anticipated decrease in sales of in-licensed suncare products which do not incorporate the Company's technology.

The decrease in licensing fees was due mainly to the fact that the prior year included $894,000 of revenues recognized under the percentage-of-completion method on now-completed clinical trials, offset by a milestone payment of $1,500,000 paid to the Company by Ortho-McNeil Pharmaceutical Corporation upon the filing of the New Drug Application for Microsponge-enhanced tretinoin acne cream in February 1995, of which $750,000 was recognized as revenues.

The gross profit on product revenues for the year decreased to 27% from 31% due to a higher percentage of close-out sales of suncare products, partially offset by improved gross profit on the supply of Microsponge systems.

Research and development expense decreased significantly from $6,334,000 to $4,139,000, or by 35%, due to the fact that the prior year included significant external expenses associated with clinical trials for NDAs which have now been filed.

Selling and marketing expense increased by $744,000 or 19% to $4,756,000 due mainly to the Company's investment in the initiation of its ethical pharmaceutical marketing effort. Advertising and promotion expense increased by $148,000 or 9% to $1,805,000 largely due to a sampling program related to the Company's consumer products, the benefits of which should be realized in 1996, partially offset by reduced spending on print media.

General and administrative expense increased by $238,000 or 8% to $3,082,000 due mainly to increased spending on a variety of outside services.

The loss on purchase commitment primarily relates to a contractual commitment for the purchase of melanin in excess of current estimated requirements. Melanin is the key ingredient in the manufacture of the APS-developed UVA/UVB sun protection cream for which an NDA was filed in the third quarter of 1994.

Interest income decreased by $38,000 or 11% to $318,000 due mainly to lower average cash balances. Interest expense increased by $167,000 or 60% to $446,000 due to the debt financing arranged by the Company in the third quarter.

The net loss for the year of $9,359,000 was lower by $400,000 or 4% than the prior year, with reduced research and development expense being offset by increased selling and marketing expense and reduced gross profit.

Capital Resources and Liquidity

Total assets as of December 31, 1996 were $18,444,000 compared with $23,082,000 at December 31, 1995. Cash and cash equivalents at December 31, 1996 increased to $5,395,000 from $5,173,000 at December 31, 1995. The Company's primary investment objectives for those assets are the preservation of capital and the maintenance of a high degree of liquidity. In the same period, working capital decreased to $3,800,000 from $4,976,000, primarily due to the discontinuation of the direct marketing of consumer products which resulted in reduced inventory.

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

In prior years, cash was expended on Phase III clinical tests of tretinoin entrapped in a Microsponge delivery system for the treatment of acne which have now been completed, and of APS' melanin-Microsponge sun protectant product, together with related research and development costs. Additionally, the Company is contractually obligated to purchase minimum annual quantities of melanin. The final amounts due under the contractual commitment are included in current liabilities.

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

In the second quarter of 1996, the Company entered into an agreement for the sale of up to $5,000,000 of its common stock and warrants, which can be initiated at the Company's sole discretion. In May 1996, the Company exercised its right to sell common stock and warrants totalling $2,000,000 under this agreement.

During 1996, Company operations used approximately $6,117,000 of cash. Approximately $3,506,000 was invested in product research and development and $3,050,000 was invested in advertising and promoting products.

In February 1997, upon receipt of approval from the FDA to market Retin-A(R) Micro(TM) (tretinoin gel) microsphere for the treatment of acne, APS received $3,000,000 from J&J as a milestone payment and prepaid royalties.

Also in February 1997, the Company received $653,000 from Lander Company, representing payment for a third of the assets held for sale pursuant to the agreement between the two companies. The final two installments are due on March 31 and April 30, 1997.

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

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
Advanced Polymer Systems, Inc. and Subsidiaries
Consolidated Balance Sheets

December 31,	1996	1995
Assets		
Current Assets:		
Cash and cash equivalents	$5,394,509	$5,172,809
Accounts receivable less allowance for doubtful accounts of $47,527 and $68,650 at December 31, 1996 and 1995, respectively	1,666,148	2,436,815
Accrued interest receivable	3,963	16,473
Inventory	2,085,073	7,858,584
Prepaid expenses and other	324,065	985,199
Assets held for sale	2,181,004	--
Total current assets	11,654,762	16,469,880
Property and equipment, net	4,681,292	5,027,034
Deferred loan costs, net	616,958	832,324
Prepaid license fees, net	165,752	303,638
Goodwill and other intangibles, net of accumulated amortization of $763,424 and $483,668 at December 31, 1996 and 1995, respectively	1,265,801	345,557
Other long-term assets	59,603	103,809
Total Assets	$18,444,168	$23,082,242
Liabilities and Shareholders' Equity		
Current Liabilities:		
Accounts payable	$1,543,143	$3,240,807
Accounts payable, Johnson & Johnson	814,509	4,229,637
Accrued expenses	1,456,512	1,819,541
Accrued melanin purchase commitments	1,800,000	600,000
Current portion - long-term debt	1,490,779	853,987
Deferred revenue	750,000	750,000
Total current liabilities	7,854,943	11,493,972
Long-term debt	5,578,849	6,354,969
Total Liabilities	13,433,792	17,848,941
Commitments and Contingencies		
Shareholders' Equity		
Preferred stock, authorized 2,500,000 shares; none issued or outstanding at December 31, 1996 and 1995	--	--
Common stock, $.01 par value, authorized 50,000,000 shares; issued and outstanding 18,359,744 and 16,594,565 at December 31, 1996 and 1995, respectively	183,597	165,946
Common stock to be issued, $.01 par value, 432,101 shares issuable in 1996	--	4,321
Warrants, issued and outstanding: 1,431,974 at December 31, 1996 and 1,628,611 at December 31, 1995	2,457,692	2,653,076
Additional paid-in capital	73,950,092	64,600,516
Unrealized gain on securities	--	12,348
Accumulated deficit	(71,581,005)	(62,202,906)
Total Shareholders' Equity	5,010,376	5,233,301
Total Liabilities and Shareholders' Equity	$18,444,168	$23,082,242

See accompanying notes.

Advanced Polymer Systems, Inc. and Subsidiaries
Consolidated Statements of Operations

For the Years Ended December 31,	1996	1995	1994
Revenues:			
Product revenues	$17,489,907	$15,203,196	$14,787,048
Licensing revenues	1,175,000	905,000	1,097,402
Total revenues	18,664,907	16,108,196	15,884,450
Expenses:			
Cost of sales	10,771,766	11,047,399	10,149,302
Research and development, net	3,506,161	4,139,441	6,334,168
Selling and marketing	5,404,774	4,755,788	4,011,752
Advertising and promotion	3,050,180	1,804,540	1,657,178
General and administrative	2,984,213	3,081,900	2,844,282
Loss on purchase commitment, including related inventory	1,400,000	600,000	685,000
Operating loss	(8,452,187)	(9,320,872)	(9,797,232)
Interest expense	(1,223,303)	(445,501)	(278,988)
Interest income	322,986	317,948	355,837
Other income (expense), net	(25,595)	89,895	(38,593)
Net loss	$(9,378,099)	$(9,358,530)	$(9,758,976)
Loss per common share	$(0.52)	$(0.57)	$(0.65)
Weighted average common shares outstanding	17,987,153	16,459,446	15,017,753

See accompanying notes.

Advanced Polymer Systems, Inc. and Subsidiaries
Consolidated Statements of Shareholders' Equity

For the Years Ended
December 31, 1996, 1995 and 1994

	Common Stock Shares	Common Stock Amount	Common Stock Warrants Shares	Common Stock Warrants Amount	Additional Paid-In Capital	Unrealized Holding Gain
Balance December 31, 1993	13,646,657	$136,467	1,161,500	$ 2,300,000	$ 51,077,341	$--
Options exercised	471,306	4,713	--	--	1,881,821	--
Agreement with Johnson & Johnson, net of $30,201 in offering costs	1,000,000	10,000	200,000	285,000	4,674,799	--
Private placement, net of $353,183 in offering costs	925,158	9,251	925,158	1,474,500	2,663,066	--
Unrealized holding gain	--	--	--	--	--	113,166
Net loss	--	--	--	--	--	--
Distributions	--	--	--	--	--	--
1994 Total	2,396,464	23,964	1,125,158	1,759,500	9,219,686	113,166
Balance December 31, 1994	16,043,121	$160,431	2,286,658	$ 4,059,500	$ 60,297,027	$ 113,166
Options exercised	236,992	2,370	--	--	1,078,929	--
Private placement, net of $112,383 in offering costs	310,278	3,103	310,278	485,591	898,923	--
Securities issued in debt financing arrangements	4,174	42	193,175	407,985	29,958	--
Common stock to be issued in connection with the agreement with Johnson & Johnson	432,101	4,321	--	--	(4,321)	--
Warrants expired	--	--	(1,161,500)	(2,300,000)	2,300,000	--
Change in unrealized holding gain	--	--	--	--	--	(100,818)
Net loss	--	--	--	--	--	--
1995 Total	983,545	9,836	(658,047)	(1,406,424)	4,303,489	(100,818)
Balance December 31, 1995	17,026,666	$170,267	1,628,611	$ 2,653,076	$ 64,600,516	$ 12,348
Options exercised	416,219	4,162	--	--	1,993,017	--
Shares retired	(12,836)	(128)	--	--	(97,747)	--
Private Placement, net of $62,149 in offering costs	201,922	2,019	86,538	295,751	1,640,081	--
Common stock to be issued in connection with the agreement with Johnson & Johnson	(432,101)	(4,321)	--	--	4,321	--
Common stock issued in connection with the agreement with Johnson & Johnson	432,101	4,321	--	--	(4,321)	--
Common stock issued in connection with the agreement with Lander Company, net of $39,547 in offering costs	356,761	3,567	--	--	2,956,976	--
Common stock issued to Dow Corning, net of $4,000 in offering costs	200,000	2,000	--	--	1,194,000	--
Common stock issued to Biosource	94,000	940	--	--	599,060	--
Securities issued in debt financing arrangements	10,675	107	4,325	(50,935)	78,353	--
Fair value of stock options issued to non-employees	--	--	--	--	161,299	--
Warrants exercised	66,337	663	(87,500)	(155,200)	539,537	--
Warrants expired	--	--	(200,000)	(285,000)	285,000	--
Change in unrealized holding gain	--	--	--	--	--	(12,348)
Net loss	--	--	--	--	--	--
1996 Total	1,333,078	13,330	(196,637)	(195,384)	9,349,576	(12,348)
Balance December 31, 1996	18,359,744	$183,597	1,431,974	$ 2,457,692	$ 73,950,092	$--

See accompanying notes.

For the Years Ended
December 31, 1996, 1995 and 1994

	Accumulated Deficit	Total Shareholders' Equity

Balance December 31, 1993	$(43,012,400)	$ 10,501,408
Options exercised	--	1,886,534
Agreement with Johnson & Johnson, net of $30,201 in offering costs	--	4,969,799
Private placement, net of $353,183 in offering costs	--	4,146,817
Unrealized holding gain	--	113,166
Net loss	(9,758,976)	(9,758,976)
Distributions	(73,000)	(73,000)
1994 Total	(9,831,976)	1,284,340
Balance December 31, 1994	$(52,844,376)	$ 11,785,748
Options exercised	--	1,081,299
Private placement, net of $112,383 in offering costs	--	1,387,617
Securities issued in debt financing arrangements	--	437,985
Common stock to be issued in connection with the agreement with Johnson & Johnson	--	--
Warrants expired	--	--
Change in unrealized holding gain	--	(100,818)
Net loss	(9,358,530)	(9,358,530)
1995 Total	(9,358,530)	(6,552,447)
Balance December 31, 1995	$(62,202,906)	$ 5,233,301
Options exercised	--	1,997,179
Shares retired	--	(97,875)
Private Placement, net of $62,149 in offering costs	--	1,937,851
Common stock to be issued in connection with the agreement with Johnson & Johnson	--	--
Common stock issued in connection with the agreement with Johnson & Johnson	--	--
Common stock issued in connection with the agreement with Lander Company, net of $39,547 in offering costs	--	2,960,543
Common stock issued to Dow Corning net of $4,000 in offering costs	--	1,196,000
Common stock issued to Biosource	--	600,000
Securities issued in debt financing arrangements	--	27,525
Fair value of stock options issued to non-employees	--	161,299
Warrants exercised	--	385,000
Warrants expired	--	--
Change in unrealized holding gain	--	(12,348)
Net loss	(9,378,099)	(9,378,099)
1996 Total	(9,378,099)	(222,925)
Balance December 31, 1996	$(71,581,005)	$ 5,010,376

See accompanying notes.

Advanced Polymer Systems, Inc. and Subsidiaries
Consolidated Statements of Cash Flows

For the Years Ended December 31,	1996	1995	1994
Cash flows from operating activities:			
Net loss	$(9,378,099)	$(9,358,530)	$(9,758,976)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,393,805	1,377,614	1,243,906
Provision for loss on purchase commitments, including inventory	1,400,000	600,000	685,000
Change in allowance for doubtful accounts	(21,123)	2,086	(69,456)
Accretion of pledged long-term marketable securities	--	(121,572)	(150,498)
(Gain) loss on sale of equipment and assets held for sale	--	125,764	(868)
Gain on sale of pledged marketable securities	--	(234,319)	--
Provision for deferred compensation	161,299	--	--
Changes in operating assets and liabilities:			
Accounts receivable	791,790	(1,130,448)	908,738
Accrued interest receivable	12,510	9,570	6,981
Inventory	5,573,511	(856,558)	1,291,126
Prepaid expenses and other	661,134	20,931	(575,003)
Assets held for sale	(2,181,004)	--	--
Deferred loan costs	215,366	(439,824)	--
Other long-term assets	129,425	(10,856)	17,895
Accounts payable and accrued expenses	(1,460,693)	87,394	517,005
Accounts payable, Johnson & Johnson	(3,415,128)	659,112	(1,852,753)
Deferred revenue	--	750,000	(894,000)
Net cash used in operating activities	(6,117,207)	(8,519,636)	(8,630,903)
Cash flows from investing activities:			
Purchase of property and equipment	(719,640)	(901,288)	(645,899)
Proceeds from sale of equipment and assets held for sale	--	797,672	2,290
Purchases of marketable securities	(512,513)	(4,458,891)	(1,448,467)
Maturities and sales of marketable securities	500,165	5,935,087	1,216,394
Net cash provided from (used in) investing activities	(731,988)	1,372,580	(875,682)
Cash flows from financing activities:			
Repayment to Dow Corning	--	--	(274,208)
Repayment of long-term debt	(870,598)	(258,304)	(200,000)
Proceeds from long-term debt and warrants	758,795	7,367,259	--
Proceeds from private placements, net of offering costs	1,937,851	1,387,617	4,146,817
Proceeds from stock issued to Lander Company, net of offering costs	2,960,543	--	--
Proceeds from agreement with Johnson & Johnson	--	--	4,969,799
Distributions	--	--	(73,000)
Proceeds from the exercise of common stock options and warrants, net of common stock retired	2,284,304	1,081,299	1,886,534
Net cash provided from financing activities	7,070,895	9,577,871	10,455,942
Net increase in cash and cash equivalents	221,700	2,430,815	949,357
Cash and cash equivalents at the beginning of the year	5,172,809	2,741,994	1,792,637
Cash and cash equivalents at the end of the year	$5,394,509	$5,172,809	$2,741,994

Supplemental disclosure of non-cash financing transactions:

During the first quarter of 1996, the Company acquired all rights to the Polytrap technology from Dow Corning Corporation ("DCC") in exchange for 200,000 shares of common stock valued at $1,200,000.

During the first quarter of 1996, the Company paid Biosource for the 1995 purchase commitment totalling $600,000 by issuing 94,000 shares of common stock.

The Company offset a deposit of approximately $188,000 and $755,000 for 1996 and 1995, respectively, with a creditor against a loan from the same creditor (Note 8).

In September, 1995, the Company offset its note payable to Dow Corning Corporation against its receivable from DCC. This resulted in a decrease in long-term debt, short-term debt and accounts receivable of $478,935, $100,000 and $578,935, respectively.

In 1995, the Company extinguished a debt through an insubstance defeasance transaction by placing U.S. government securities in an irrevocable trust to fund all future scheduled payments on the debt.

See accompanying notes.

ADVANCED POLYMER SYSTEMS, INC. AND SUBSIDIARIES
Notes to Consolidated Financial Statements
December 31, 1996, 1995 and 1994

Note 1 Business

Advanced Polymer Systems, Inc. ("APS" or the "Company") develops, manufactures and sells patented delivery systems that allow for the controlled release of active ingredients which have benefits in the ethical dermatology, cosmetic and personal care areas. Certain projects are conducted under development and licensing arrangements with large companies, others are part of joint ventures in which APS is a major participant, and a number of projects are exclusive to APS. APS also marketed and distributed a range of consumer products for personal care through its subsidiary, Premier, Inc. ("Premier"). Effective January 1997, APS licensed the consumer products to a third party (Note 6).

Note 2 Summary of Significant Accounting Policies

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

Cash Equivalents and Marketable Securities: For purposes of the Consolidated Statements of Cash Flows and Consolidated Balance Sheets, the Company considers all short-term investments that have original maturities of less than three months to be cash equivalents. Short-term investments consist primarily of certificates of deposit, commercial paper, master notes and repurchase agreements. Investments which have original maturities longer than three months are classified as marketable securities in the accompanying Consolidated Balance Sheets. The Company has classified its investments in certain debt and equity securities as "available-for-sale". Such investments are recorded at fair value with unrealized holding gains and losses reported as a separate component of stockholders' equity.

Inventory: Inventory is stated at the lower of cost or market value, utilizing the average cost method (Note 5).

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

Prepaid License Fees: The fee paid to Biosource Technologies, Inc. ("Biosource") in 1992 is being amortized over a seven-year period consistent with the term of the agreement (Note 3). Amortization of prepaid license fees totalled $137,880, $137,868 and $124,057 in 1996, 1995 and 1994, respectively.

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

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

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

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

arising from the purchase is being amortized over five years on a straight-line basis.

Amortization of intangible assets totalled $279,756, $188,875 and $160,796, in 1996, 1995 and 1994, respectively.

Adoption of Statement of Financial Accounting Standards No. 123: Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," encourages, but does not require companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for "Stock Issued to Employees" and related interpretations. Accordingly, except for stock options issued to non-employees, no compensation cost has been recognized for the Company's fixed stock option plans (Note 10).

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

Advertising and Promotion Costs: Advertising and promotion costs are expensed as incurred.

Earnings (Loss) Per Share: Earnings (loss) per common share are based on the weighted average number of common shares outstanding during each year. The computation assumes that no outstanding stock options and warrants were exercised as they would be anti-dilutive.

Licensing Agreements: The Company has several licensing agreements that generally provide for monthly payments, periodic minimum payments and royalties for exclusivity. Revenue is recorded as services are performed. The agreements do not contain any financial obligations with respect to the Company at the expiration or earlier termination of the agreements. Certain agreements also require the remittance of non-refundable license fees.

Deferred Revenue: Prepaid royalties paid to APS by Ortho-McNeil Pharmaceutical Corporation ("Ortho"), a subsidiary of Johnson & Johnson Inc. ("J&J"), as part of the retinoid licensing agreement are reported as deferred revenues (Note 13).

Concentrations of Credit Risk: Financial instruments which potentially expose the Company to concentrations of credit risk, as defined by Statement of Financial Accounting Standards No. 105, consist primarily of trade accounts receivable. As of December 31, 1996, approximately 53% of the recorded trade receivables were concentrated with two customers in the cosmetic and personal care industries. To reduce credit risk, the Company performs ongoing credit evaluations of its customers' financial conditions. The Company does not generally require collateral.

Reclassifications: Certain reclassifications have been made to the prior year financial statements to conform with the presentation in 1996.

Note 3 Related Party Transactions

APS has entered into agreements with Biosource. One director serves on the Board of Directors of both Biosource and APS. All agreements between APS and Biosource have been, and will continue to be, considered and approved by a vote of the disinterested directors. The agreements provide APS worldwide rights to use and sell Biosource's biologically-synthesized melanin in Microsponge systems for all sun protection, cosmetic, ethical dermatology and over-the-counter skin care purposes. In return, APS is required to make annual minimum purchases of melanin, pay royalties on sales of APS melanin-Microsponge products and was required to prepay $500,000 of royalties. For estimated losses on purchase commitments and related inventory, the Company accrued $1,400,000, $600,000 and $685,000 in 1996, 1995 and 1994, respectively. During 1994, the Company paid Biosource $263,403 for the supply of melanin. All minimum financial commitments under the current agreements have been expensed by APS.

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

Note 4 Cash Equivalents

All investments in debt securities have been classified as cash equivalents in the accompanying balance sheets as they mature in less than three months.

At December 31, 1996 and 1995, the amortized cost and estimated market value of investments in debt securities are set forth in the tables below:

December 31, 1996				
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-Sale:				
Corporate debt securities	$3,556,052	--	--	$3,556,052
Other debt securities	214,790	--	--	214,790
Totals	$3,770,842	--	--	$3,770,842

December 31, 1995				
	Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Value
Available-for-Sale:				
Corporate debt securities	$3,273,602	$12,348	--	$3,285,950
Other debt securities	164,425	--	--	164,425
Totals	$3,438,027	$12,348	--	$3,450,375

Note 5 Inventory

The major components of inventory are as follows:	December 31, 1996	December 31, 1995
Raw materials and work-in-process	$604,852	$1,006,847
Finished goods	1,480,221	6,851,737
Total inventory	$2,085,073	$7,858,584

Consumer products inventory is classified as Assets Held for Sale in the accompanying December 31, 1996 balance sheet (Note 6). J&J has a security interest in the Company's Sundown(R) and Johnson's Baby Sunblock(R) inventory. Inventory subject to their security interest totalled approximately $4,400,000 at December 31, 1995 (Note 14).

Note 6 Assets Held for Sale

As part of the Company's long-term strategic plan to move away from the direct marketing of consumer products, APS entered into an agreement with Lander Company under which Lander will commercialize the APS consumer products. Under the terms of the agreement, certain consumer products inventory, manufacturing equipment and prepaid advertising credits were sold to Lander in January 1997 at the December 31, 1996 book value. In addition, APS will receive revenue from royalties on consumer product sales and the supply of Microsponge systems to Lander. Also, the Company plans to discontinue the marketing of the suncare products licensed from J&J; the related inventory, in which J&J has a security interest, amounted to approximately $198,000 at December 31, 1996. For financial reporting purposes, these consumer product assets are classified as Assets Held for Sale in the accompanying balance sheet and consist of the following at December 31, 1996:

Inventory	$1,703,764
Prepaid Asset	388,021
Property Plant and Equipment	89,219
	$2,181,004

Note 7 Property and Equipment

Property and equipment consist of the following:

	December 31, 1996	December 31, 1995
Building	$1,611,039	$1,610,339
Land and improvements	163,519	163,519
Leasehold improvements	571,223	571,223
Furniture and equipment	11,119,307	10,623,203
Total property and equipment	$13,465,088	$12,968,284
Accumulated depreciation and amortization	(8,783,796)	(7,941,250)
Property and equipment, net	$4,681,292	$5,027,034

Depreciation expense amounted to $976,163, $980,779 and $920,871 for the years ended December 31, 1996, 1995, and 1994, respectively.

Certain consumer products manufacturing equipment is classified as Assets Held for Sale in the accompanying December 31, 1996 balance sheet (Note 6).

Note 8 Long-Term Debt

Long-term debt consists of the following:

	December 31, 1996	December 31, 1995
Bank loan, interest payable monthly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flow of a subsidiary of the Company and guaranteed by the Company	$2,950,000	$3,000,000
Term loan, subordinated to bank loan, interest payable quarterly, principal due in non-equal installments commencing December 1, 1996 through March 1, 1999, secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company	1,622,500	1,500,000
Term loan, principal and interest due in equal monthly installments commencing October 1996 through December 1999, secured by certain real and personal property	2,497,128	2,708,956
Total	$7,069,628	$7,208,956
Less current portion	1,490,779	853,987
Long-term debt	$5,578,849	$6,354,969

Maturities of the long-term debt are as follows:

Years ending December 31:	Amount
1997	$ 1,490,779
1998	2,523,389
1999	3,055,460
	$ 7,069,628

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

The first financing arrangement was a $3,000,000 bank loan with an interest rate equal to two percentage points above the

Prime Rate (8.25% as of December 31, 1996). The loan is secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company.

The second financing arrangement was originally a $1,500,000 term loan with a syndicate of lenders and a fixed interest rate of 14%. In January 1996, an incremental $150,000 was received under this financing arrangement. The loan is also secured by the assets and operating cash flows of a subsidiary of the Company and guaranteed by the Company. The security interest of the debt holders is subordinated to the bank loan's security interest.

In the third quarter of 1995, the Company consummated a transaction whereby certain real and personal properties were sold to a third party and subsequently leased back for a fixed rental stream over a period of forty-eight months. The Company has the option either to purchase all the properties at the expiration of the term of the lease or extend the term of the lease. The Company reported this transaction as a financing transaction since the requirements for consummation of a sale were not met. A deposit of $188,000 and $755,000 with the lender was offset against the loan balance as of December 31, 1996 and 1995 respectively. In 1996, the Company received a refund of $567,000 of the deposit upon satisfaction of certain conditions identified in the financing agreement. This transaction has been reflected in the table above as a term loan.

The terms of certain financing agreements contain, among other provisions, requirements for a subsidiary of the Company to maintain defined levels of earnings, net worth and various financial ratios, including debt to net worth. In conjunction with the debt financing agreements, APS issued a total of 197,500 warrants with an exercise price of $7.00 per share of common stock.

All costs incurred in obtaining the financing arrangements have been capitalized as deferred charges, and are being amortized over the life of the loans using the effective interest method. Interest paid in 1996, 1995 and 1994 approximated interest expense reflected in the Consolidated Statements of Operations.

In September 1995, the Company extinguished $2,500,000 of Industrial Revenue Bonds through an "insubstance defeasance" transaction by placing approximately $2,500,000 of U.S. government securities in an irrevocable trust to fund all future interest and principal payments. The purchase of the government securities was achieved through the sale of the Company's pledged marketable security. The debt extinguishment did not have a material impact on the Company's earnings. The debt balance outstanding as of December 31, 1996 was $2,500,000.

Note 9 Commitments

Lease Commitments: Total rental expense for property and equipment was $655,283, $639,807 and $558,086 for 1996, 1995 and 1994, respectively.

The Company's future minimum lease payments under noncancellable operating leases for facilities as of December 31, 1996, are as follows:

Years Ending December 31,	Minimum Payments
1997	$ 443,442
1998	132,186
1999	100,043
2000	80,869
2001	75,600
	$ 832,140

Note 10 Shareholders' Equity

Private Placements and Common Stock Warrants: In 1994, the Company raised $9,116,616 net of offering costs through two private placements. In the first private placement, APS issued 1,000,000 shares of newly issued common stock to Johnson & Johnson ("J&J") in consideration for $5,000,000. In addition, J&J received 200,000 warrants exercisable for two years at $12.00 per share. In January 1996, in accordance with the 1994 private placement agreement, APS issued J&J 432,101 shares of common stock as a result of the APS stock price not achieving certain

predetermined levels. The 200,000 warrants issued to J&J in conjunction with this private placement expired in 1996 (Note 13).

The second private placement was pursuant to an agreement for the sale of up to $8,000,000 of common stock and warrants in six installments beginning in June, 1994 and ending on September 29, 1995. The Company sold $6,000,000 of common stock and warrants through March 30, 1995. The remaining two optional installments in June and September 1995 totalling $2,000,000 of common stock and warrants were not sold by the Company. In accordance with the agreement, the following shares of common stock and warrants were issued:

Date Issued	Number of shares of Common Stock Issued	Number of Warrants Issued	Exercise Price of Warrants
June 30, 1994	294,314	294,314	$5.61
September 30, 1994	299,066	299,066	$5.52
December 31, 1994	331,778	331,778	$4.97
March 30, 1995	310,278	310,278	$5.32

The warrants issued are exercisable over a three-year period. The value of the warrants was determined using the Black-Scholes model.

In conjunction with certain debt financing agreements made in 1995 (Note 8), APS issued a total of 197,500 warrants with an exercise price of $7.00 per share of common stock. These warrants expire on March 27, 2000.

In the first quarter of 1995, 1,161,500 warrants issued in a 1992 private placement expired.

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

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

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

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

The private placement was pursuant to an agreement for the sale of up to $5,000,000 of common stock and warrants, which can be initiated at the Company's sole discretion.

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

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

In addition, if at the time when there was a 20% shareholder, the Company were to be acquired by merger, shareholders with unexercised Rights could purchase common stock of the acquirer with a value of twice the exercise price of the Rights.

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

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

The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards No. 123, ("SFAS No. 123") "Accounting for Stock-Based Compensation." Accordingly, except for stock options issued to non-employees, no compensation cost has been recognized for the fixed stock option plans. The compensation cost that has been charged against income for the stock options issued to non-employees was $161,000, $0 and $0 for 1996, 1995 and 1994, respectively. Had compensation cost for the Company's fixed stock option plans been determined consistent with the provisions of SFAS No. 123, the Company's net loss and loss per common share would have increased to the pro-forma amounts indicated below:

	1996	1995
Net loss - as reported	$(9,378,099)	$(9,358,530)
Net loss - pro-forma	$(10,462,871)	$(9,815,235)
Loss per common share - as reported	$ (0.52)	$ (0.57)
Loss per common share - pro-forma	$ (0.58)	$ (0.60)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1996 and 1995: dividend yield of 0; expected volatility of 85%; risk-free interest rate of 6.1 percent; and expected life of four years for all the stock option plans.

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

The following table summarizes option activity for 1996, 1995 and 1994:

December 31,	1996		1995		1994	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	2,972,324	$5.98	2,677,162	$6.14	2,588,940	$6.21
Granted	502,500	$7.89	636,500	$5.31	723,500	$5.13
Exercised	(416,219)	$4.80	(236,992)	$4.59	(471,306)	$4.00
Expired or Cancelled	(157,165)	$6.25	(104,346)	$9.14	(163,972)	$9.00
Outstanding at end of year	2,901,440	$6.46	2,972,324	$5.98	2,677,162	$6.14
Options exercisable at year-end	1,945,056		1,877,295		1,529,574	
Shares available for future grant at year end	569,984		167,819		709,973	
Weighted-average fair value of options granted during the year		$7.89		$5.31		$5.13

The following table summarizes information about fixed stock options outstanding at December 31, 1996:

OPTIONS OUTSTANDING				OPTIONS EXERCISABLE	
Range of Exercise Prices	Number Outstanding 12/31/96	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Number Exercisable at 12/31/96	Weighted Avg. Exercise Price
$3.44-$5.25	922,760	6.6 years	$ 4.65	613,035	$ 4.39
$5.38-$5.75	727,180	7.1	$ 5.45	581,772	$ 5.46
$6.13-$8.13	729,500	8.1	$ 7.15	308,249	$ 6.97
$9.25-$11.13	522,000	5.9	$ 10.11	442,000	$ 10.08
$3.44-$11.13	2,901,440	7.0	$ 6.46	1,945,056	$ 6.42

Distributions: Distributions presented in the Consolidated Statements of Shareholders' Equity represent payments to the shareholders of Premier, which was a subchapter S Corporation. Premier's S Corporation election was terminated in conjunction with the merger.

Note 11 Defined Contribution Plan

The Company sponsors a defined contribution plan covering substantially all of its employees. In 1996 and 1995, the Company made matching contributions equal to 50% of each participant's contribution during the plan year up to a maximum amount equal to the lesser of 3% of each participant's annual compensation or $4,750 and $4,500 for the 1996 and 1995 calendar years, respectively. In 1994 the maximum matching contribution made by the Company was equal to the lesser of 1.5% of each participant's salary or $1,000 per calendar year. The Company may also contribute additional discretionary amounts as it may determine. For the years ended December 31, 1996, 1995 and 1994, the Company contributed to the plan approximately $110,000, $89,000 and $55,000, respectively. No discretionary contributions have been made to the plan since its inception.

Note 12 Income Taxes

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

	December 31		
	1996	1995	1994
U.S. Federal statutory rate (benefit)	(34.0)%	(34.0)%	(34.0)%
Net losses without tax benefits	33.75	33.5	34.0
State income taxes, net of U.S. Federal income tax effect	--	--	--
Nondeductible expenses	0.25	0.5	--
Total tax expense	--	--	--

At December 31, 1996, the Company had net Federal operating loss carryforwards of approximately $72,500,000 for income tax reporting purposes and California operating loss carryforwards of approximately $8,400,000. The Federal net operating loss carryforwards expire beginning in 1998 through the year 2011. The California net operating loss carryforwards expire beginning in 1997 through the year 2001. A California net operating loss carryforward from 1989 in the approximate amount of $2,000,000 expired December 31, 1996.

Due to the "change in ownership" provisions of the Tax Reform Act of 1986, approximately $32,000,000 and $5,500,000 of the Company's Federal and California net operating loss carryforwards, respectively, are subject to an annual limitation against taxable income. The balance of the Federal and California loss carryforwards of approximately $40,500,000 and $2,900,000, respectively, which arose subsequent to the Company's change in ownership will be fully available to offset taxable income in excess of the annual limitation until fully utilized or there is another ownership change.

The Company also has investment tax credits and research and experimental tax credits aggregating approximately $1,692,000 and $673,000 for Federal and California purposes, respectively. The Federal credit carryforwards expire beginning in 1998 through the year 2011. The California credits carryover indefinitely until utilized.

There are also California credit carryforwards for qualified manufacturing and research and development equipment of approximately $11,000; these credits expire beginning in 2005 through the year 2006.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1996 and 1995 are presented below:

	1996	1995
Deferred tax assets:		
Deferred research expenditures	$1,445,000	$1,443,000
Accruals and reserves not currently deductible for tax purposes	1,771,000	1,197,000
Net operating loss carryforwards	25,407,000	22,283,000
Credit carryforwards	2,377,000	2,274,000
Other	406,000	572,000
Gross deferred tax assets	31,406,000	27,769,000
Less valuation allowance	(31,182,000)	(27,426,000)
Total deferred tax assets	$224,000	$343,000
Deferred tax liabilities:		
Property and equipment	$(224,000)	$(343,000)
Total deferred tax liabilities	(224,000)	(343,000)
Net deferred taxes	$ --	$ --

The net change in the valuation allowance for the years ended December 31, 1996, 1995 and 1994 was an increase of approximately $3,756,000, $4,534,000 and $3,627,000, respectively. Management believes that sufficient uncertainty exists regarding the realizability of these items and, accordingly, a valuation allowance is required.

Gross deferred tax assets as of December 31, 1996 include approximately $2,594,000 relating to the exercise of stock options, for which any related tax benefits will be credited to equity when realized.

Note 13 Ortho-McNeil Pharmaceutical Corporation

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

The terms of the agreements included an $8,000,000 investment in APS for 723,006 newly issued shares of APS common stock and the payment to APS of $6,000,000 in licensing fees by J&J. The licensing fees were recognized as revenues according to the percentage-of-completion method of accounting whereby income was recognized based on the estimated stage of completion of the related project. Cash payments received in advance of being earned were classified as deferred revenue. Revisions of estimated profits were included in earnings by the reallocation method which spread the change in estimate over the current and future periods. As of December 31, 1994, the project had been completed and all associated revenues had been recognized.

J&J made a second equity investment in the Company in May 1994. Under this agreement, J&J purchased 1,000,000 shares of newly issued common stock in consideration for $5,000,000. In January 1996, APS issued J&J 432,101 shares of common stock as a result of the APS stock price not achieving certain predetermined levels. The 200,000 warrants issued in 1994 to J&J in conjunction with this equity investment expired in 1996. As of December 31, 1996, J&J owns approximately 12% of the APS common shares outstanding.

In February 1995, APS received $750,000 in prepaid royalties and an additional $750,000 as a milestone payment on the submission to the FDA of its New Drug Application for the tretinoin prescription acne treatment. The milestone payment

was recognized as revenue upon receipt. The prepaid royalties of $750,000 were recorded as deferred revenues. In February 1997, upon receipt of approval from the FDA to market Retin-A(R) Micro(TM) (tretinoin gel) microsphere for the treatment of acne, APS received $3,000,000 from Ortho of which one half is a milestone payment which will be recognized as revenue in 1997 and half is prepaid royalties which will be recorded as deferred revenues. APS will earn a mark-up on Microsponge systems supplied to Ortho and Ortho will pay APS a royalty on product sales, subject to certain minimums. Should these minimums not be achieved, Ortho would lose its exclusivity and APS would regain marketing rights to the retinoid products. APS has the ability to earn an additional $4,750,000 in fees if certain research milestones are achieved.

Note 14 Johnson & Johnson

Licensing Agreement: The Company's wholly owned subsidiary, Premier, licensed from J&J the exclusive right to manufacture and distribute a product, Take-Off, in the U.S. The agreement provided for Premier to remit royalty payments to J&J based on net sales, with minimum payments of $375,000 per year. In December 1996, the Company purchased the rights to Take-Off from J&J for a 3% royalty on net sales for the five year period ending December 31, 2001. In January 1997, as part of its long-term strategic plan to move away from the marketing of consumer products, the Company sub-licensed the right to manufacture and distribute Take-Off to Lander Company.

Distribution Arrangement: Premier obtained the rights to market and distribute two suncare products, Sundown and Johnson's Baby Sunblock, in the U.S. Premier & J&J share the profits or losses on sales of suncare products. Premier performs a reconciliation of the payable to J&J annually to determine the portion that is currently due. The portion of the payable that relates to inventory sold during a contract year is due at the end of that contract year, which begins on January 1 and ends on December 31.

As part of the Company's long-term strategic plan to move away from the direct marketing of consumer products, this distribution arrangement with J&J will be terminated in 1997. The remaining inventory on hand as of December 31, 1996 will be sold in 1997.

Independent Auditors' Report

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

We have audited the accompanying consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1996. In connection with our audits of the consolidated financial statements, we also have audited the financial statement schedule as listed in Item 14(a)2. These consolidated financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and the financial statement schedule based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1996, in conformity with generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

KPMG Peat Marwick LLP

San Francisco, California
March 5, 1997

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Part III

Item 10. Directors and Executive Officers of the Registrant

APS incorporates by reference the information set forth under the captions "Nomination and Election of Directors" and "Executive Compensation" of the Company's Proxy Statement (the "Proxy Statement") for the annual meeting of shareholders to be held on June 4, 1997.

Item 11. Executive Compensation

APS incorporates by reference the information set forth under the caption "Executive Compensation" of the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The Company incorporates by reference the information set forth under the caption "Beneficial Stock Ownership" of the Proxy Statement.

Item 13. Certain Relationships and Related Transactions

The Company incorporates by reference the information set forth under the caption "Certain Transactions" of the Proxy Statement.

Part IV

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

(a) 1. Financial Statements

The financial statements and supplementary data set forth on pages 14-27 of Part II of the 10-K Annual Report are incorporated herein by reference.

2. Financial Statement Schedules

Schedule II Valuation Accounts

All other schedules have been omitted because the information is not required or is not so material as to require submission of the schedule, or because the information is included in the financial statements or the notes thereto.

3. Exhibits

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

(b) Reports on Form 8-K

None.

(c) Exhibits

The Company hereby files as part of this Form 10-K the exhibits listed in Item 14(a)3. As set forth above.

(d) Financial Statement Schedules

See Item 14(a)2. of this Form 10-K.

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(1) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Registration Statement on Form S-1 (Registration No. 33-15429) and incorporated herein by reference.

(2) Filed as Exhibit No. 28.1 to Registrant's Registration Statement on Form S-8 (Registration No. 33- 50640), and incorporated herein by reference.

(3) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, and incorporated herein by reference.

(4) To be filed supplementally.

(5) Filed as an Exhibit with corresponding Exhibits 4.1, 4.2, 4.3 and 4.4 to Registrant's Registration Statement on Form S-3 (Registration No.33-82562) and incorporated herein by reference.

(6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995.

(7) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended Deccember 31, 1995, and incorporated herein by reference.

(8) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1996, and incorporated herein by reference.

* Management Contract or Compensatory plans.

For purposes of complying with the amendments to the rules governing Registration Statements on Form S-8 (effective July 13, 1990) under the Securities Act of 1933 ("the Act"), as amended, the undersigned registrant hereby undertakes as follows, which undertaking shall be incorporated by reference into Part II of the registrant's Registration Statements on Form S-8 Nos. 33-18942, 33-21829, 33-29084 and 33-50640 filed on December 8, 1987, May 13, 1988, June 6, 1989 and August 11, 1992, respectively.

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

SIGNATURES

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

ADVANCED POLYMER SYSTEMS, INC.

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

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

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

Signature	Title	Date
/S/ John J. Meakem, Jr. John J. Meakem, Jr.	Chairman, President, Chief Executive Officer	March 28, 1997
/S/ Michael O'Connell Michael O'Connell	Executive Vice President, Chief Administrative Officer and Chief Financial Officer	March 28, 1997
/S/ Carl Ehmann Carl Ehmann	Director	March 28, 1997
/S/ Jorge Heller Jorge Heller	Director	March 28, 1997
/S/ Peter Riepenhausen Peter Riepenhausen	Director	March 28, 1997
/S/ Toby Rosenblatt Toby Rosenblatt	Director	March 28, 1997
/S/ Gregory H. Turnbull Gregory H. Turnbull	Director	March 28, 1997
/S/ C. Anthony Wainwright C. Anthony Wainwright	Director	March 28, 1997
/S/ Dennis Winger Dennis Winger	Director	March 28, 1997

ADVANCED POLYMER SYSTEMS, INC.

Schedule II

Valuation Accounts

	Beginning Balance	Additions Charged to Expense	Deductions	Ending Balance
December 31, 1994				
Accounts receivable, allowance for doubtful accounts	$136,020	$5,833	$75,289	$66,564
December 31, 1995				
Accounts receivable, allowance for doubtful accounts	$66,564	$29,464	$27,378	$68,650
December 31, 1996				
Accounts receivable, allowance for doubtful accounts	$68,650	$9,331	$30,454	$47,527

CONSENT OF INDEPENDENT AUDITORS

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

We consent to incorporation by reference in the Registration Statements (Nos. 33-18942, 33-21829, 33-29084 and 33-50640) on Forms S-8 of Advanced Polymer Systems, Inc. and in the Registration Statements (Nos. 33-47399, 33-51326, 33-82562, 33-88972 and 333-759) on Forms S-3 of Advanced Polymer Systems, Inc. of our report dated March 5, 1997, relating to the consolidated balance sheets of Advanced Polymer Systems, Inc. and subsidiaries as of December 31, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 1996, and the related schedule, which report appears in the December 31, 1996 annual report on Form 10-K of Advanced Polymer Systems, Inc.

KPMG Peat Marwick LLP

San Francisco, California
March 26, 1997

EXHIBIT INDEX

Form 10-K Annual Report

ADVANCED POLYMER SYSTEMS, INC.

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

- ---

(1) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Registration Statement on Form S-1 (Registration No. 33-15429) and incorporated herein by reference.

(2) Filed as Exhibit No. 28.1 to Registrant's Registration Statement on Form S-8 (Registration No. 33-50640), and incorporated herein by reference.

(3) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Annual Report on Form 10-K for the year ended December 31, 1992, and incorporated herein by reference.

(4) To be filed supplementally.

(5) Filed as an Exhibit with corresponding Exhibits 4.1, 4.2, 4.3 and 4.4 to Registrant's Registration Statement on Form S-3 (Registration No.33-82562) and incorporated herein by reference.

(6) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 1995, and incorporated herein by reference.

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(8) Filed as an Exhibit with corresponding Exhibit No. to Registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 1996, and incorporated herein by reference.

* Management Contract or Compensatory plans.

Exhibit 10W

LICENSE, ASSIGNMENT AND SUPPLY AGREEMENT

AGREEMENT effective January 1, 1997, by and between PREMIER CONSUMER PRODUCTS, INC. ("PCP") and ADVANCED POLYMER SYSTEMS, INC. ("SYSTEMS") and its wholly-owned subsidiary, PREMIER, INC. ("PREMIER"), (PREMIER and SYSTEMS are hereafter collectively referred to as "APS").

RECITAL

A. APS is the owner of or possesses a license to the right in the Territory to make, use and sell in all fields the ExAct(R), Every Step(R), Neet(R) and Take-Off(R) Products (the "Licensed Products"), subject to certain obligations.

B. APS is the owner of the Microsponge(R) System technology which is useful in the development of consumer products.

C. PCP desires to obtain the right to manufacture, use, market and sell the Licensed Products, and APS is willing to grant to PCP such right on the terms and conditions set forth in this Agreement.

IT IS, THEREFORE, AGREED as follows:

1. Definitions.

The terms defined in this Article 1 shall, for all purposes of this Agreement, have the following meanings:

"Affiliate" shall mean any corporation or other entity that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the designated party but only for so long as such relationship exists. For the purposes of this section, "Control" shall mean

ownership of at least fifty percent (or such lesser percent as may be the maximum that may be owned by foreign interests pursuant to the laws of the country of incorporation) of the shares of stock entitled to vote for directors in the case of a corporation and at least fifty percent (or such lesser percent as may be the maximum that may be owned by foreign interests pursuant to the laws of the country of domicile) of the interests in profits in the case of a business entity other than a corporation.

"Effective Date" shall mean January 1, 1997.

"ExAct Products" shall mean the acne treatment products currently sold by APS under the ExAct trademark and any and all improvements to the Microsponge System, Patent Rights or Know-How included therein that are made by or on behalf of APS or PCP prior to December 31, 2003.

"Every Step Product" shall mean the foot powder product currently sold by APS under the Every Step trademark and any and all improvements in the Microsponge System, Patent Rights or Know-How included therein that are made by or on behalf of APS or PCP prior to December 31, 2003.

"Know-How" shall mean all inventions, discoveries, trade secrets, and information, whether or not patented or patentable, together with all data, formulas, procedures and results, and improvements thereon, now or hereafter developed or acquired prior to December 31, 2003, by or on behalf of APS or PCP and proprietary or licensed with right to sublicense to APS, which relate to or are used in conjunction with the development,

manufacture or use of the Microsponge System and Licensed Products.

"Licensed Products" shall mean the ExAct, Every Step, Neet and Take-Off Products.

"Manufacturing Equipment and Tooling" means the manufacturing equipment and tooling listed on Schedule I, which schedule shall not include any Microsponge System manufacturing equipment or tooling.

"Microsponge System" shall mean a delivery system comprising highly cross-linked copolymer beads with a mean particle size between 15 and 30 microns and a loading capacity between 40 and 50 percent, having a network of pores and capable of containment and release as exemplified in U.S. Patents No. 4,690,825 and No. 5,145,675 and any and all improvements thereof.

"Neet Agreement" shall mean the Trademark License and Product Development Agreement dated August 31, 1995, by and between Reckitt & Colman (Overseas) and Reckitt & Colman SA as the first party and PREMIER and SYSTEMS as the second party, a copy of which is attached as Exhibit A to this Agreement.

"Neet Products" shall mean the cosmetic depilatory products included in "Licensed Products" as defined in the Neet Agreement.

"Net Sales" shall mean amounts invoiced on sales of a Licensed Product or any other product described in Section 4.3 and subject to royalties thereunder by PCP, its Affiliates, sublicensees and permitted assigns to independent, unrelated third parties in bona fide arms-length transactions, less the following deductions actually allowed and taken by such third

parties and not otherwise recovered by or reimbursed to PCP, its Affiliates, or permitted assigns: (i) cash and quantity discounts in such amounts as are customary in the trade to the extent deducted from the invoiced price and set forth separately in the invoice; (ii) taxes on sales (such as sales or use taxes) to the extent added to the sales price and set forth separately as such in the total amount invoiced; (iii) value added taxes when included as part of the sales price and not refunded to tie payor; (iv) freight, insurance, and other transportation charges to the extent added to the sales price and set forth separately as such in the total amount invoiced; and (v) amounts repaid or credited by reason of rejections, defects or returns. Net Sales shall not include sales of a Licensed Product between or among PCP, its Affiliates, sublicensees and permitted assigns.

"Patent Rights" shall mean any and all patent application or issued patent relating to the Microsponge System or to the Licensed Products or to methods for making or using such System or Licensed Product, which rights are owned or acquired by or licensed to APS and which are filed or have issued prior to or during the term of this Agreement in the United States or any foreign country or territory thereof, including any and all additions, continuations, continuations-in-part, or division thereof or any substitute application thereof, any reissue or extension of any such patent, and any confirmation patent or registration patent or patent of addition based on any such patent. All United States patents and patent applications and all foreign patents and applications currently within this

paragraph and applicable to this Agreement are set forth in Exhibit B, which Exhibit shall be amended as necessary to reflect changes or additions to the APS Patent Rights.

"Supply Agreement" shall mean the Supply Agreement referred to in Article 7 for the supply of this Microsponge System containing an active ingredient by APS to PCP, its Affiliates, sublicensees, and assigns.

"Take-Off Products" shall mean disposable cloths integrated with a cleanser and primarily intended for removing make-up that have been formulated by APS and are currently sold by APS under the Take-Off trademark and any and all improvements to the Microsponge System, Patent Rights or Know-How included therein made by or on behalf of APS or PCP prior to December 31, 2003.

"Territory" shall mean the United States and its possessions and Canada in the case of the ExAct and Every Step Products and the United States in the case of the Take-off and Neet Products.

2. Disclosure of Information.

2.1 Upon execution of this Agreement and thereafter during the term hereof, each party shall disclose to the other, in confidence under the terms of Article 3 hereof, relevant technical information as the same shall become available, including information relating to the safety of the Microsponge System and any active ingredient incorporated therein to the extent necessary or useful to develop or manufacture a Licensed Product. APS shall, at the request of PCP and on a confidential basis subject to Article 3, allow PCP's personnel to visit its manufacturing and research facilities and to consult with its

personnel, at mutually agreeable times, to discuss and review the technical information. All technical information heretofore or hereafter disclosed by APS to PCP relating to a Licensed Product shall be deemed to have been disclosed pursuant to this Agreement including, but not limited to, Article 3 hereof.

3. Confidentiality. Except as specifically authorized by this Agreement, each party shall, for the term of this Agreement and for five years after its expiration or termination, keep confidential, not disclose to others and use only for the purposes authorized herein all technical information provided by the other under this Agreement; provided, however, that the foregoing obligations of confidentiality shall not apply to the extent that any information is (i) already known to the recipient at the time of disclosure as evidenced by its prior written records; (ii) published or publicly known prior to or after disclosure other than through unauthorized acts or omissions of the recipient; (iii) disclosed in good faith to the recipient by a third party entitled to make such disclosure; or (iv) independently developed by or on behalf of the recipient without recourse to the disclosure herein as documented in writing. Notwithstanding the aforesaid, the recipient may disclose information to governmental agencies as required by law, and to vendors having a need to know and as may be necessary for the recipient to perform its obligations hereunder and to actual and prospective acquirors of substantially all of a party's business of which this Agreement is a part, but only if such disclosure to vendors and prospective acquirors, including an APS

toll manufacturer provided by APS pursuant to Section 7.3, is in accordance with a written agreement imposing essentially the same obligation of confidentiality on such party as is imposed upon the recipient hereunder.

4. Product and Trademark Licenses; Royalties.

4.1 APS hereby grants to PCP a license to make, have made, use and sell under the Patent Rights and Know-How (i) the ExAct and Every Step Products and respective trademarks in the United States and its possessions and Canada under their respective trademarks and (ii) the Take-Off Products under the Take-Off trademark in the United States; excluding, however, the Microsponge System included in any such Product which shall be separately supplied by APS to PCP and as to which the right to make and have made is specifically not licensed to PCP pursuant to this Section 4.1.

4.2 APS hereby assigns to PCP all of its rights under the Neet Agreement, including the right to make, have made, use and sell the Neet Product under the Neet trademark in the United States pursuant to the Neet Agreement.

4.3 Notwithstanding Sections 4.1 and 4.2 above, PCP may use the Every Step, ExAct, Neet (subject to the Neet Agreement) and/or Take-Off trademarks in connection with the sale of other products in the respective Territories in consideration of the payment of an earned royalty on Net Sales of any such other product as set forth in Section 4.6 through 4.10 hereof.

4.4 The licenses set forth in Section 4.1 shall include the right to grant sublicensees and shall be exclusive in

all fields of distribution in the respective Territories, provided, nevertheless, that APS may grant licenses in the applicable Territory to the ExAct Products but not to the ExAct trademark (i) to one other company such as Mary Kay for distribution in the market serviced by a distribution system utilizing representatives selling products directly to the general public, and (ii) to other companies that promote the ExAct Products primarily through doctors and other medical professionals. Any such licenses by APS other than to PCP shall be subject to the condition that PCP shall have the first right of negotiation to manufacture the Product (but not the Microsponge System) for APS to supply the other licensees. Except as set forth in this Section 4.4, APS agrees that during the term of this Agreement it will not license or make available to any third party any rights in the Territory to make (other than to a subcontractor of APS), use or sell a Microsponge System containing benzoyl peroxide in or for use in a product for treatment of acne.

4.5 If PCP's manufacturing rights become effective pursuant to Section 7.3 hereof, APS also hereby grants to PCP, and consents to PCP having, a license in its Territories, with the right to grant sublicenses, under APS Patent Rights and Know-How to make and have made the Microsponge System for inclusion only in a Licensed Product sold under the licensed trademark for such Product.

4.6 In consideration for the licenses granted, and that may be granted for no additional royalty or consideration

other than as set forth below in this Section 4.6, PCP will (i) pay to APS an earned royalty of ten percent of Net Sales of each Licensed Product other than the Neet Product and each other product described in Section 4.3 hereof and an earned royalty of seven percent of Net Sales of the Neet Product for a period of seven years from the Effective Date, provided, that the total cumulative royalties payable by PCP to APS on cumulative Net Sales as of the end of each twelve-month period beginning on the Effective Date shall be not less than the amounts set forth on Schedule II and provided, further, that if there should be an underpayment of minimum royalties in any twelve-month period, it may be made up by royalty-bearing Net Sales in the succeeding twelve-month period to the extent that such Net Sales exceed the level of Net Sales required to make the minimum royalty payment applicable to such succeeding twelve-month period, and, if not so made up, payment of the shortfall in royalties for the earlier twelve-month period shall be made with the first quarterly report after the end of the succeeding twelve-month period; and (ii) assume and timely perform all the obligations of PREMIER under the Neet Agreement accruing after the Effective Date, including but not limited to the payment of royalties under Article 6 of said agreement.

4.7 Earned royalty payments under section 4.6 shall be made within 45 days following the end of each calendar quarter, and each payment shall include royalties which shall have accrued during said calendar quarter. Such quarterly payments shall be accompanied by a report setting forth separately the Net Sales of

each Licensed Product sold during said calendar quarter in each country and the calculation of royalties payable for such calendar quarter. In addition, any underpayment of the minimum royalties set forth on Schedule II and not subsequently made up as set forth above shall be paid with the report for the last quarter of the twelve-month period following the twelve-month period in which the shortfall occurred.

4.8 The remittance of royalties payable on Net Sales outside the United States shall be made to APS to the extent permitted by law in United States dollars at the free market rate of exchange of the currency, as published in the most recent issue of the Wall Street Journal, of the country from which the royalties are payable on the particular date the particular United States dollars are transmitted for payment as royalties, less any withholding or transfer taxes which are applicable. PCP shall supply APS with proof of payment of such taxes deducted from the royalties payable to APS and paid on APS' behalf.

4.9 If the transfer or the conversion of all or a part of the remittance into the United States dollar equivalent in any such instance is not lawful or possible, the payment of such part of the royalties shall be made by the deposit thereof, in the currency of the country where the sale on which the royalty was based was made, to the credit and account of APS or its nominee in any commercial bank or trust company of APS' choice located in that country. Notification of such choice of bank or trust company shall be given to PCP at least thirty days prior to the date that any payment is due. Prompt notice of deposits by PCP

shall be given to APS. APS also agrees that any tax burden levied by any country on payments due or made by PCP to APS under this Agreement shall be borne by APS.

4.10 PCP and its Affiliates, licensees and permitted assigns shall keep and maintain records of Net Sales. Such records shall be open to inspection at any mutually agreeable time during normal business hours within two years after the royalty period to which such records relate by an independent certified public accountant (or the equivalent in countries other than the United States) reasonably acceptable to PCP but selected by APS. Said accountant shall have the right to examine the records kept pursuant to this Agreement and report findings of said examination of records to APS only insofar as it is necessary to evidence any error on the part of PCP. This right of inspection shall be exercised only once with respect to each country of sale for any calendar year. The cost of such inspection shall be borne by APS unless the result of such examination is the determination that Net Sales in a particular country have been understated by at least three percent for any calendar year in which event PCP shall bear the reasonable cost of such inspection for such country.

5. Assignments; Returns.

5.1 APS hereby assigns, transfers and sells to PCP all of its right, title and interest to:

(a) All ExAct, Every Step, Take-Off and Neet raw material, work-in-process, finished product and packaging inventories to be listed on Schedule III promptly after

December 31, 1996, that are owned by APS and have a shelf life of at least twelve months on the Effective Date, which inventories shall not include any Microsponge System inventories.

(b) The Manufacturing Equipment and Tooling.

(c) All prepayments and credits for advertising and promotional materials.

(d) All of APS' rights to use the name "Premier, Inc." as a corporate name, and as part of this Agreement APS agrees to change the name of "Premier, Inc." forthwith upon the closing.

5.2 In consideration of the assignments and transfers made by APS pursuant to Section 5.1, PCP agrees to pay to APS, in three equal installments on January 31, 1997, March 31, 1997, and April 30, 1997, the book value of the inventories, Machinery Equipment and Tooling and prepayments and credits for advertising and promotional materials so assigned and transferred, as shown on the books of APS maintained in accordance with generally-accepted accounting principles consistently applied, including write-offs and write-downs of obsolete and unmarketable inventories and other materials.

5.3 Without limitation of any other rights PCP may have hereunder, APS agrees that if any Licensed Products are returned to PCP (i) which were sold by or for the account of APS prior to January 1, 1997 or (ii) as a result of a manufacturing or packaging defect existing when shipped from the APS warehouse, APS shall reimburse PCP in an amount equal to the payment or credit that PCP provides in respect of such returned Licensed

Products; provided, however, that in no case shall the amount of APS' reimbursement obligation hereunder exceed the sum of the invoice price of such returned Licensed Products plus reasonable costs associated with their return; and provided further that PCP shall use commercially reasonable efforts to resolve disputes with customers so as to minimize the amount and frequency of such returns. The amount to be reimbursed to PCP will be adjusted for all saleable finished Products which can be taken into inventory and valued in accordance with the prices set forth in Schedule III hereto.

6. PCP Purchase Option.

6.1 PCP shall have the exclusive option to purchase from APS all rights to make, have made, use and sell the Licensed Products (but not any Microsponge System included therein) and to the ExAct, Every Step and Take-Off trademarks in the Territories on December 31, 2003, by (i) payment to APS on December 31, 2003, of the excess, if any, of $7,000,000 over the total royalties paid by PCP to APS with respect to Net Sales (including minimum royalty payments) from the Effective Date through December 31, 2003, and (ii) PCP's agreement to pay to APS royalties as set forth in Section 4.6 on Net Sales of the Licensed Products and other products described in Section 4.3 hereof for an additional three years through December 31, 2006.

6.2 PCP shall exercise the foregoing option by giving notice in writing to APS of its decision to do so not later than June 30, 2003. In the event PCP exercises the foregoing option, the parties shall enter into an asset purchase agreement

containing seller representations, covenants and warranties equivalent to those contained in Article 12 hereof.

6.3 In the event that PCP does not exercise the foregoing option, (i) all of the licenses granted to PCP by APS under this Agreement shall terminate on December 31, 2003 and all such rights shall revert to APS and (ii) effective on such date PCP shall reassign to APS the right to make, have made, use and sell the Neet Product under the Neet trademark in the United States pursuant to the Neet Agreement.

7. Manufacture and Supply.

7.1 APS agrees to manufacture and supply to PCP, its Affiliates, sublicensees and any permitted assignee, and PCP, its Affiliates, sublicensees and any permitted assignee shall purchase from APS, their entire Microsponge System requirements for inclusion in Licensed Products including Licensed Products as to which PCP has purchased the rights pursuant to Section 6 above. Manufacturing by APS will be conducted to conform with good manufacturing practices as may be required from time to time by governmental regulations. It is intended that the items to be supplied shall be limited to Microsponge Systems shipped in bulk, unless otherwise requested by PCP for good business reasons and within the reasonable capabilities of APS.

7.2 The parties shall enter into one or more appropriate Supply Agreements covering the manufacture and supply of Microsponge Systems for incorporation in Licensed Products. Each Supply Agreement shall include warranty of merchantability or fitness for use, appropriate provisions relating to price,

minimum purchase requirements, specifications, record keeping, term, compliance with specifications and applicable governmental requirements, rights to audit and review cost, quality assurance procedures including optional on-site inspections, aid and assistance to PCP to set up its own manufacturing facility (either within or outside the United States) if permitted, provisions for reasonable notice to APS of supply requirements, and other appropriate terms for agreements of this type. With respect to price, APS will sell all items at no greater than 100 percent of its fully burdened cost of manufacture, calculated on the basis of manufacturing operations at 80 percent capacity and in accordance with generally-accepted accounting principles and other supply agreements between APS and PCP. Such agreement shall provide for the continuing purchase and supply of all of PCP'S, its Affiliates', sublicensees' and permitted assignees' requirements of such items. Each Supply Agreement shall be negotiated in an atmosphere of good faith and reasonableness.

7.3 If APS is unable or shall otherwise fail to supply all of PCP's and its Affiliates', sublicensees' and permitted assignees' requirements of a particular Microsponge System as contemplated in the Supply Agreement described in Section 7.2 above, APS shall use its best efforts to provide for supply from third parties capable of supplying such items. Any such third party shall be a toll manufacturer who has agreed to essentially the same obligations of confidentiality as provided in Section 3 hereof. Such third parties shall demonstrate to PCP's satisfaction that they can supply PCP and its Affiliates', and

permitted assignees' requirements for such Microsponge Systems for a continuous period of 90 days. The 180-day period referred to below shall commence only after such third parties shall fail to supply PCP's and its Affiliates' and permitted assignees' requirements after such 90-day period. In the event of APS supplying such items from such third parties, APS shall cause such items to be supplied to PCP at a price not to exceed 100 percent of APS' fully burdened cost of manufacture in its own manufacturing facility, calculated on the basis of manufacturing at 80 percent of capacity and in accordance with generally-accepted accounting principles. APS hereby grants to PCP, effective upon such failure continuing for 180 days, and PCP shall thereafter have a license under APS Patent Rights and Know-How to manufacture, or have manufactured, the particular Microsponge System. Such right and license shall continue without regard to whether APS shall thereafter become able or willing to supply all such requirements. Further, APS shall notify PCP of its inability or unwillingness to supply PCP with all of PCP's requirements of the Microsponge Systems as soon as APS is aware of such facts. The 90-day and 180-day periods referred to in this Section 7.3 shall not be extended by the force majeure provisions of Section 18 hereof.

8. Transitional Support. APS agrees that through April 30, 1997, it will make available to PCP its facilities and personnel to promote and distribute the Licensed Products in the same fashion as promoted and distributed prior to the Closing Date in order to provide an orderly transition of the business.

In consideration of such transition services, PCP will pay to APS monthly in advance the estimated fully-loaded cost to APS of such services. At the end of the transition period, the actual fully-loaded costs of such services will be computed by the parties and any underpayment will forthwith be paid to APS by PCP and any overpayment will forthwith be refunded by APS to PCP.

9. Additional Products. At the option of PCP, APS agrees to negotiate in good faith from time to time for the development on behalf of PCP by APS, at APS' fully-loaded development cost, of additional 0-T-C consumer products for foot care or benzoyl peroxide products for treatment of acne that utilize APS' Microsponge System and any improvements thereof. Such obligation of APS shall be subject to any preexisting agreements of APS. In addition, APS shall consider at its option any request by PCP that APS develop on behalf of PCP other O-T-C consumer products that utilize APS' Microsponge System and any improvements thereof.

10. Patents, Trademarks, Infringement.

10.1 If in the opinion of either party any issued patent contained in APS Patent Rights has been infringed in the Territory by a product in competition with a Licensed Product or any trademark licensed hereunder has been infringed in the Territory by a third party, such party shall give to the other party notice of such alleged infringement, in which event APS may at its discretion take such steps as it may consider necessary to prosecute such infringement. If APS, after such notice, elects to bring suit, it shall be entitled to all damages recovered as a

result of said infringement. If APS brings suit, other than with respect to the ExAct trademark in Canada, and is unable to terminate the infringement within two years from the date of original notice by PCP of the infringement, Licensed Product covered by such APS Patent Rights or trademark shall thereafter be treated for royalty purposes as if it were not covered by such APS Patent Rights or trademark for so long as the infringement continues. PCP shall have the right, at its own expense, to be represented by counsel in any such litigation. If APS, after such notice from PCP, elects not to bring suit, it shall notify PCP of such election within 30 days after receipt of such notice and PCP shall then have the right to bring suit at its own expense or, if APS does not diligently prosecute such suit in a manner reasonably necessary to protect the rights of PCP hereunder, PCP shall similarly have the right to assume prosecution of the suit at its own expense. PCP shall also have the right to bring suit if APS fails to institute suit within six months from the date of the original notice of infringement by PCP. In any litigation brought by PCP, PCP shall have the right to use and sue in APS' name, and APS shall have the right, at its own expense, to be represented by counsel. If PCP brings such suit, other than with respect to the ExAct trademark in Canada, all royalty obligations with respect to the Licensed Product competitive with the product reasonably believed to be infringing, on a country-by-country basis, shall be suspended and royalties permitted to accrue in a special account on PCP's books for that purpose. APS shall be entitled to be paid such

royalties on termination of any such suit reduced by reasonablE litigation expenses incurred by PCP. If PCP receives any recovery or damages, said recovery or damages shall be retained by PCP. Neither party shall settle any such suit without the written consent of the other party if such settlement would impair or prejudice the rights of the other party.

10.2 In the event PCP is sued by a third party charging infringement of a patent resulting from the manufacture, use or sale of a Microsponge System in a Licensed Product or an infringement of a third party's rights resulting from the use of a trademark pursuant to the license of a trademark hereunder (excluding, however, the use of the ExAct trademark in Canada), PCP shall promptly notify APS. During the pendency of such suit, PCP shall have the right to apply up to 50% of the royalties on such product in the country of suit due to APS from the alleged infringing Licensed Product against its litigation expenses reasonably incurred in such suit.

10.3 In the event that, pursuant to a judgment in any suit claiming infringement of a patent or trademark of a third party by a Microsponge System incorporated in a Licensed Product, PCP is required to pay damages or a royalty to, grant a sublicense to, or enter into a cross-licensing arrangement with a third party as a result of such claimed infringement or in the event of a settlement of such suit consented to by APS (which consent shall not be unreasonably withheld) requiring damages or royalty payments to be made, sublicenses to be granted, or cross-licenses to be entered into, APS shall pay one-half of such

damages or royalty payments.

10.4 APS warrants that it is presently not aware of (i) any patents or patent applications owned by a third party and not licensed to APS and licensed or to be licensed to PCP hereunder which would be infringed by the practice of the presently existing Know-How or Patent Rights that are or may be licensed or sublicensed to PCP hereunder or by the manufacture, use or sale of the Microsponge System based thereon to be incorporated in a Licensed Product or, (ii) except for the right to use the ExAct trademark in Canada, any trademark owned by a third party and not licensed to APS that would be infringed by the sale in the Territory of a Licensed Product under its present trademark, nor has APS received any claims by third parties with respect to such matters.

11. Ownership of Technology. The Microsponge System, including but not limited to Know-How as applicable to the Microsponge System, conceived or reduced to practice during the term of this Agreement or within one year after the term of this Agreement by Employees or agents of APS or PCP shall be the sole property of APS and may be licensed or transferred by APS for any purpose that is not inconsistent with its obligations under this Agreement but subject to the rights of PCP set forth herein.

12. Warranties and Representations.

12.1 APS warrants and represents that, to its knowledge, it has full right, title, and interest in and to or the right to practice all Know-How and Patent Rights relating to the Microsponge System and that it has the right to enter into

the licenses and assignment set forth herein; that there are no outstanding written or oral agreements inconsistent with this Agreement; and that it is empowered to enter into this Agreement and grant the licenses and make the assignments provided herein without burdens, encumbrances, restraints, or limitations of any kind which could adversely affect the rights of PCP under this Agreement except as may be set forth herein.

12.2 APS warrants and represents that it will prosecute and maintain the patent applications and patents included in APS Patent Rights and any federal and state trademark registrations set forth in Exhibit C hereto to the extent that they cover Licensed Products.

12.3 APS warrants and represents that it knows of no rights of others that would impede PCP's ability to sell any Licensed Product except as provided in the Neet Agreement, provided that APS has approved in writing any claims to be made for the Licensed Products.

12.4 APS warrants and represents that this Agreement covers substantially all of PREMIER's business of which the Licensed Products are a part, that the assignment is valid under the Neet Agreement and that by virtue of such assignment PCP will acquire all of PREMIER's rights under such Agreement. APS will promptly inform Reckitt & Colman Overseas and Reckitt & Colman S.A. of the assignment and secure an acknowledgement from them of the assignment and of PCP as the assignee.

12.5 APS warrants and represents that any filings with and consents and approvals of any governmental agencies,

including but not limited to the United States Food and Drug Administration, to the extent required in connection with the offer, shipment and sale of Licensed Products where presently sold in the applicable Territory have been obtained and are in full force and effect and will not expire or be adversely affected as a result of this Agreement.

13. Indemnification. APS agrees to indemnify, defend and hold harmless PCP from and against any and all claims, costs, expenses, damages, losses, actions or liabilities in connection with injuries to persons and property caused or alleged to be caused by defects in or relating to Licensed Products manufactured or sold prior to the Effective Date or sold by APS to PCP hereunder for resale.

14. Term. Unless sooner terminated as herein provided, this Agreement shall become effective on the Effective Date and shall continue in effect thereafter until terminated in accordance with the terms hereof.

15. Termination.

15.1 Either PCP or APS may terminate this Agreement and any licenses granted herein upon breach of any of the material terms herein by the other party (including failure to pay earned royalties when due) upon 45-days' prior written notice; provided that if during said 45 days the party so notified cures the breach complained of then this Agreement shall continue in full force and effect.

15.2 Termination of this Agreement shall not terminate the obligations of PCP to make any payments pursuant to Sections

4.6 and 6.1 or the obligations of confidentiality imposed on either party.

16. Publicity. Neither party will originate any publicity, news release, public comment or other public announcement, written or oral, whether to the press, to stockholders, or otherwise, relating to this Agreement, without the written consent of the other party (which consent shall not be unreasonably withheld), except for such announcement which in accordance with the advice of legal counsel to the party making such announcement is required by law. The party making any announcement which is required by law will, unless prohibited by law, give the other party an opportunity to review the form and content of such announcement and comment before it is made. Either party shall have the right to make such filings with governmental agencies as to the contents and existence of this Agreement as it shall reasonably deem necessary or appropriate.

17. Assignability.

17.1 This Agreement may not be assigned by either party without the prior written consent of the other, which consent shall not be unreasonably withheld, provided, that in any event either party may assign this Agreement an Affiliate or to any party that acquires substantially all of such party's business of which this Agreement may be a part.

17.2 No assignment permitted by this Article 17 shall serve to release either party from liability for the performance of its obligations hereunder.

18. Notices. All notifications, demands, approvals and communications required to be made under this Agreement shall be validly given if and when made by mail prepaid and registered or certified (return receipt requested) addressed to the address of the party to whom directed (as herein set forth or the latest change thereof notified to the addressor). The parties hereto shall have the right to notify each other of changes of address during the life of this Agreement.

If to APS,

ADVANCED POLYMER SYSTEMS, INC.
3696 Haven Avenue
Redwood City, California 94063
Attention: President

If to PCP,

PREMIER CONSUMER PRODUCTS, INC.
106 Grand Avenue
P. O. Box 9610
Englewood, New Jersey 07631
Attention: Chairman

Any such notice mailed as aforesaid shall be deemed to have been received by and given to the addressee on the date specified on the notice of receipt and delivery returned to the sender.

19. Force Majeure. In the event of any failure or delay in the performance by a party of any provision of this Agreement due to acts beyond the reasonable control of such party (such as, for example, fire, explosion, strike or other difficulty with workmen, shortage of transportation equipment, accident, act of God, or compliance with or other action taken to carry out the intent or purpose of any law or regulation), then such party shall have such additional time to perform as shall be reasonably necessary under the circumstances. In the event of such failure or delay, the affected party will use its best efforts, consonant with sound business judgment and to the extent permitted by law,

to correct such failure or delay as expeditiously as possible.

20. Miscellaneous.

20.1 This Agreement is intended to define the full extent of the legally enforceable undertakings of the parties hereto with respect to the subject matter hereof, and no promise or representation, written or oral, which is not set forth explicitly in this Agreement is intended by either party to be legally binding. Both parties acknowledge that in deciding to enter into this Agreement and to consummate the transaction contemplated hereby neither has relied upon any statements or representations, written or oral, other than those explicitly set forth in this Agreement.

20.2 It is the desire and intent of the parties that the provisions of this Agreement shall be enforced to the extent permissible under the laws and public policies applied in each jurisdiction in which enforcement is sought. Accordingly, if any particular provision of this Agreement which substantially affects the commercial basis of this Agreement shall be determined to be invalid or unenforceable, such provision shall be amended as hereinafter provided to delete therefrom or revise the portion thus determined to be invalid or unenforceable, such amendment to apply only with respect to the operation of such provision of this Agreement in the particular jurisdiction for which such determination is made. In such event, the parties agree to use reasonable efforts to agree on substitute provisions, which, while valid, will achieve as closely as possible the same economic effects or commercial basis as the

invalid provisions, and this Agreement otherwise shall continue in full force and effect. If the parties cannot agree to such revision within 60 days after such invalidity or unenforceability is established, the matter may be submitted by either party to arbitration as provided in this Agreement to finalize such revision.

20.3 The waiver by a party of any single default or breach or succession of defaults or breaches by the other shall not deprive either party of any right under this Agreement arising out of any subsequent default or breach.

20.4 All matters affecting the interpretation, validity, and performance of this Agreement shall be governed by the laws of the State of California without regard to the conflicts of laws principles of such state.

20.5 Nothing in this Agreement authorizes either party to act as agent for the other party as to any matter. The relationship between APS and PCP is that of independent contractors.

20.6 Any and all disputes between the parties relating in any way to the entering into of this Agreement and/or the validity, construction, meaning, enforceability, or performance of this Agreement or any of its provisions, or the intent of the parties in entering into this Agreement, or any of its provisions, or any dispute relating to patent validity or infringement arising under this Agreement shall be settled by arbitration. Such arbitration shall be conducted at New York, New York, if initiated by APS, or at Palo Alto, California, if

initiated by PCP, in accordance with the rules then pertaining of the American Arbitration Association with a panel of three arbitrators. Each party shall select one arbitrator and the two selected arbitrators shall select the third arbitrator. If the two selected arbitrators cannot agree on a third arbitrator then the American Arbitration Association shall select said arbitrator from the National Panel of Arbitrators. Reasonable discovery as determined by the arbitrators shall apply to the arbitration proceeding. Judgment upon the award rendered by the arbitrators may be entered in any court having jurisdiction thereof. The successful party in such arbitration, in addition to all other relief provided, shall be entitled to an award of all its reasonable costs and expenses including attorney costs. Both parties agree to waive, and the arbitrators shall have no right to award, punitive or consequential damages in connection with an arbitration proceeding hereunder.

IN WITNESS WHEREOF, the undersigned have caused this Agreement to be duly executed by their duly authorized officers on the date first above written.

PREMIER CONSUMER PRODUCTS, INC.

By:_____

Title:_____

ADVANCED POLYMER SYSTEMS, INC.

By:_____

Title:_____

PREMIER, INC.

By:_____

Title:_____

The undersigned hereby guarantees the performance by Premier Consumer Products, Inc. of all of its obligations under the agreement set forth above.

LANDER CO., INC.

By: _____

Title: _____

EXHIBIT B

Patent Rights

USA Issued Patents -

#4,690,825
#5,145,675

Canadian Issued Patents -

#128,355

EXHIBIT C

Trademarks

Microsponge	1,481,281
EveryStep	1,788,744
ExAct Design	1,971,569
ExAct	1,782,010
Take-Off	1,304,541

SCHEDULE I

Manufacturing Equipment and Tooling

SCHEDULE II

Minimum Royalty Schedule

	Cumulative Total Minimum Royalties
Year I	$ 525,000
Year II	1,050,000
Year III	1,700,000
Year IV	2,350,000
Year V	3,175,000
Year VI	4,000,000
Year VII	5,000,000

In the event that the Neet Agreement should be terminated by Reckitt & Colman (Overseas) Limited and Reckitt & Colman SA in accordance with the provisions of Section 11.2 of the Neet Agreement:

(i) the Minimum Royalties for Years IV through VII set forth above shall be reduced as follows:

Year IV	$ 2,150,000
Year V	$ 2,775,000
Year VI	$ 3,400,000
Year VII	$ 4,200,000

and in consideration of such reduction

(ii) APS shall be entitled to retain any termination payments made by Reckitt & Colman (Overseas) Limited or Reckitt & Colman SA pursuant to Section 11.3 of the Neet Agreement.

SCHEDULE III

Inventories

(To be prepared promptly after December 31, 1996)

12-MOS	
DEC-31-1996	
JAN-01-1996	
DEC-31-1996	
	5,394,509
	0
	1,666,148
	47,527
	2,085,073
	11,654,762
	13,465,088
	8,783,796
	18,444,168
	7,854,943
	5,578,849
	183,597
	0
	0
	4,826,779
	18,444,168
	17,252,166
	18,664,907
	10,771,766
	10,771,766
	16,345,328
	9,331
	1,223,303
	(9,378,099)
	0
	(9,378,099)
	0
	0
	0
	(9,378,099)
	($0.52)
	($0.52)