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

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

For the quarterly period ended September 30, 2004

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

For the transition period from to

Commission file Number 0-16109

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

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

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

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

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

Yes X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes [ ] No [X]

At October 29, 2004, the number of outstanding shares of the Company's common stock, par value $.01, was 25,010,215.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements:

A.P. PHARMA, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (in thousands)

	September 30, 2004 (Unaudited)	December 31, 2003 (Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 673	$ 97
Marketable securities	14,574	9,387
Accounts receivable, net	1,238	1,340
Prepaid expenses and other	500	434
Total current assets	16,985	11,258
Property and equipment, net	1,313	1,430
Other long-term assets	281	467
Total assets	$ 18,579	$ 13,155
LIABILITIES & STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 701	$ 476
Accrued expenses	1,387	1,173
Accrued disposition costs	164	53
Deferred revenue	--	190
Total current liabilities	2,252	1,892
Stockholders' equity:		
Common stock	98,895	86,844
Accumulated deficit	(82,562)	(75,598)
Accumulated other comprehensive income	(6)	17
Total stockholders' equity	16,327	11,263
Total liabilities and stockholders' equity	$ 18,579	$ 13,155

See accompanying notes to condensed consolidated financial statements.

A.P. PHARMA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Royalties	$ 1,258	$ 1,149	$ 3,515	$ 3,211
Contract revenues	200	119	407	279
Total revenues	1,458	1,268	3,922	3,490
Operating expenses:				
Research & development	2,656	1,854	8,655	6,391
General & administrative	760	649	2,245	2,193
Total operating expenses	3,416	2,503	10,900	8,584
Operating loss	(1,958)	(1,235)	(6,978)	(5,094)
Interest income, net	70	55	126	197
Other income (expense), net	1	165	23	153
Loss from continuing operations	(1,887)	(1,015)	(6,829)	(4,744)
Gain (loss) from discontinued operations	(34)	(43)	(135)	1,759
Net loss	$(1,921)	$(1,058)	$(6,964)	$(2,985)
Basic and diluted loss per share:				
Loss from continuing operations	$ (0.08)	$ (0.05)	$ (0.31)	$ (0.23)
Net loss	$ (0.08)	$ (0.05)	$ (0.31)	$ (0.15)
Weighted average common shares outstanding-basic and diluted	24,936	20,571	22,212	20,527

See accompanying notes to condensed consolidated financial statements.

A.P. PHARMA, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands, except for share amounts)

	For the nine months ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net loss	$(6,964)	$(2,985)
Adjustments to reconcile net loss to net cash used in operating activities:		
Gain (loss) from discontinued operations	135	(1,759)
Gain on sale of marketable securities	(2)	--
Depreciation and amortization	283	341
Recovery of doubtful accounts and note receivable	(10)	(16)
Stock-based compensation to non-employees	99	119
Accretion of premium/discount to marketable securities	(65)	44
Loss on retirements of property and equipment	7	15
Changes in operating assets and liabilities:		
Accounts receivable	8	--
Prepaid expenses and other current assets	(56)	(97)
Other long-term assets	186	(283)
Accounts payable	224	27
Accrued expenses	214	197
Deferred revenue	(190)	(193)
Net cash used in continuing operating activities	(6,131)	(4,590)
Net cash received from (used in) discontinued operations	70	(333)
Cash flows from investing activities:		
Proceeds from discontinued operations	--	2,139
Purchases of property and equipment	(173)	(185)
Purchases of marketable securities	(15,922)	(5,649)
Sales of marketable securities	10,779	6,784
Net cash (used in) provided by investing activities	(5,316)	3,089
Cash flows from financing activities:		
Proceeds on issuance of common stock, net of issuance costs	11,756	--
Proceeds from the exercise of stock options	151	--
Proceeds from issuance of shares under the Employee Stock Purchase Plan	46	25
Net cash proceeds provided by financing activities	11,953	25
Net increase (decrease) in cash and cash equivalents	576	(1,809)
Cash and cash equivalents, beginning of the period	97	3,282
Cash and cash equivalents, end of the period	$ 673	$ 1,473

See accompanying notes to condensed consolidated financial statements.

A.P. PHARMA, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2004 and 2003 (UNAUDITED)

(1) Basis of Presentation

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

In the opinion of management, the accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments of a normal recurring nature considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004 or any future operating periods. The condensed consolidated balance sheet as of December 31, 2003 has been derived from the audited financial statements as of that date. For further information, refer to the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2003.

The condensed consolidated financial statements include the financial statements of the Company and its subsidiary, APS Analytical Standards, Inc through the date of sale (February 13, 2003). All significant intercompany balances and transactions have been eliminated in consolidation.

Critical Accounting Policies

We believe there have been no significant changes in our critical accounting policies during the nine months ended September 30, 2004 compared to those previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the SEC on March 26, 2004.

Use of Estimates

The preparation of our financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in our financial statements and accompanying notes. Estimates were made relating to useful lives of fixed assets, valuation allowances, impairment of assets and accruals. Actual results could differ materially from those estimates.

Revenue Recognition

Our revenue arrangements with multiple deliverables are divided into separate units of accounting if certain criteria are met, including whether the delivered element has stand-alone value to the customer and whether there is objective and reliable evidence of the fair value of the undelivered elements. The consideration we receive is allocated among the separate units based on their respective fair values, and the applicable revenue recognition criteria are considered separately for each

of the separate units. Advance payments received in excess of amounts earned are classified as deferred revenue until earned.

* Royalties

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

Generally, contractually required minimum royalties are recorded ratably throughout the contract period. Royalties in excess of minimum royalties are recognized as earned when the related product is shipped to the end customer by our licensees based on information provided to us by our licensees.

* License Fees

We have licensing agreements that generally provide for periodic minimum payments, royalties, and/or non-refundable license fees. These licensing agreements typically require a non-refundable license fee and allow our partners to sell our proprietary products in a defined field or territory for a defined period. The license agreements provide for the Company to earn future revenue through royalty payments. These non-refundable license fees are initially reported as deferred revenues and recognized as revenues over the estimated life of the product to which they relate as we have continuing involvement with licensees until the related product is discontinued or the related patents expire, whichever is earlier. Revenue recognized from deferred license fees is classified as license fees in the accompanying consolidated statements of operations. License fees received in connection with arrangements where we have no continuing involvement are recognized as license fees when the amounts are received or when collectibility is assured, whichever is earlier. No such fees were recorded during the three or nine months ended September 30, 2004.

A milestone payment is a payment made by a third party or corporate partner to us upon the achievement of a predetermined milestone as defined in a legally binding contract. Milestone payments are recognized as license fees when the milestone event has occurred and we have completed all milestone related services such that the milestone payment is currently due and is non-refundable. No such fees were recorded during the three or nine months ended September 30, 2004.

* Contract Revenues

Contract revenues relate to research and development arrangements that generally provide for the company to invoice research and development fees based on full-time equivalent hours for each project. Revenues from these arrangements are recognized as the related development costs are incurred. These revenues approximate the costs incurred.

Cash Equivalents and Short-term Investments

We consider all short-term investments in debt securities which have original maturities of less than three months at date of purchase to be cash equivalents. Investments which have original maturities of three months or longer are classified as marketable securities in the accompanying balance sheets.

Accrued Disposition Costs

Costs relating to disposal of discontinued operations are reported as accrued disposition costs in the accompanying balance sheets. Accrued disposition costs include severance costs and gross profit guarantees (see note 5).

Concentrations of Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of cash equivalents, short-term investments and trade accounts

receivable. We invest excess cash in a variety of high grade short-term, interest-bearing securities. This diversification of risk is consistent with our policy to ensure safety of principal and to maintain liquidity.

Approximately 87% of the receivables were concentrated with two customers in the pharmaceutical industry as of September 30, 2004. To reduce credit risk, we perform ongoing credit evaluations of our customers' financial conditions. We do not generally require collateral for customers with accounts receivable balances.

Segment and Geographic Information

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

Stock-Based Compensation

We have elected to account for stock-based compensation related to employees using the intrinsic value method. Accordingly, except for stock options issued to non-employees and restricted stock awards to employees and directors, no compensation cost has been recognized for our stock option plans and stock purchase plan. Compensation related to options granted to non-employees is periodically remeasured as earned.

In accordance with FAS No. 123, "Accounting for Stock-Based Compensation," as amended by FAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," we have provided below the pro forma disclosures of the effect on net loss and net loss per share as if FAS No. 123 had been applied in measuring compensation expense for all periods presented (in thousands, except per share amounts).

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss, as reported	$(1,921)	$(1,058)	$(6,964)	$(2,985)
Deduct:				
Stock-based employee compensation expense determined under FAS No. 123	(102)	(99)	(308)	(326)
Pro forma net loss	$(2,023)	$(1,157)	$(7,272)	$(3,311)
Basic and diluted loss per share as reported	$ (0.08)	$ (0.05)	$ (0.31)	$ (0.15)
Basic and diluted pro forma loss per share	$ (0.08)	$ (0.06)	$ (0.33)	$ (0.16)

Fair values of awards granted under the stock option plans and employee stock purchase plan were estimated at grant or purchase dates using the Black-Scholes option pricing model. For pro forma disclosure, the estimated fair value of the options is amortized to expense over the vesting period of the options using the straight line method. The multiple option approach is used to value the purchase rights granted under the employee stock purchase plan. We used the following assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Expected life in years (from vesting date):				
Stock options	5	5	5	5
Employee stock purchase plan	1.5 - 2	1.5 - 2	1.5 - 2	1.5 - 2
Interest rate:				
Stock options	3.4%	2.8%	3.2%	2.8%
Employee stock purchase plan	1.47%-2.32%	1.20%-3.26%	1.20%-2.32%	1.20%-4.22%
Volatility:				
Stock options	75%	66%	69%	66%
Employee stock purchase plan	65% - 68%	68	65 - 69%	65 - 68%
Expected dividend yield:	0%	0%	0%	0%

In March 2004 the Financial Accounting Standard Board ("FASB") issued an exposure draft entitled "Share-Based Payment, an amendment of FASB Statements No. 123 and 95" (proposed FAS 123R). The proposed FAS 123R would require stock-based compensation to employees to be recognized as a cost in the financial statements and that such cost be measured according to the fair value of the stock options. In the absence of an observable market price for the stock awards, the fair value of the stock options would be based upon a valuation methodology that takes into consideration various factors, including the exercise price of the option, the expected term of the option, the current price of the underlying shares, the expected volatility of the underlying share price, the expected dividends on the underlying shares and the risk-free interest rate. The proposed requirements in the exposure draft would be effective for interim or annual periods beginning after June 15, 2005. The cumulative effect of adoption, if any, applied on a modified prospective basis, would be measured and recognized on the date of implementation, July 1, 2005. The FASB expects to issue a final standard by December 31, 2004. A.P. Pharma is currently evaluating option valuation methodologies and assumptions in light of the proposed FAS 123R. Current estimates of option values using the Black-Scholes method (as shown above) may not be indicative of results from valuation methodologies ultimately adopted in the final rules.

Reclassifications

Certain immaterial amounts in the prior year financial statements have been reclassified to conform with the current year presentation.

(2) Loss Per Share Information

Basic loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding. Because the Company is in a net loss position for the three and nine months ended September 30, 2004 and 2003, diluted earnings per share is also calculated using the weighted average number of common shares outstanding and excludes the effects of options which are antidilutive.

(3) Comprehensive Loss

Comprehensive loss for the three and nine months ended September 30, 2004 and 2003 consists of the following (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003

Net loss	$(1,921)	$(1,058)	$(6,964)	$(2,985)
Unrealized losses on available-for-sale securities	(5)	(19)	(23)	(41)
Comprehensive loss	$(1,926)	$(1,077)	$(6,987)	$(3,026)

(4) Stockholders' Equity

In June 2004, we sold 4,153,335 shares of common stock at a price of $3.00 per share, for net proceeds of approximately $11.8 million after deducting placement agent fees and costs associated with the offering. The shares were offered under our shelf registration statement on Form S-3, as amended.

During the nine months ended September 30, 2004, 68,448 and 50,750 shares of common stock were issued through the exercise of stock options and purchased under the Employee Stock Purchase Plan, respectively. Additionally, in May 2004, shareholders approved the increase in shares reserved for issuance under the 2002 Stock Incentive Plan and 1997 Employee Stock Purchase Plan by 400,000 and 100,000, respectively.

(5) Discontinued Operations

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

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

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

	For the Nine Months Ended September 30,	
	2004	2003
Analytical Standards Division		
Gain on sale of Analytical Standards division	$ 3	$1,870
Income from Analytical Standards division	$ --	$ 7
	3	1,877
Cosmeceutical and Toiletry Business		
Recovery of doubtful accounts receivable	--	4
Change in estimates for gross profit guarantees	(138)	(132)
Change in estimate of provision for income taxes and tax refunds	--	10
	(138)	(118)
Total gain (loss) from discontinued operations	$ (135)	$1,759

Basic and diluted loss per common share from discontinued operations excluding the gain on sale of the Analytical Standards and cosmeceutical product lines were less than ($0.01) per share for the nine months ended September 30, 2004 and 2003, respectively.

Liabilities related to the discontinued operations as of September 30, 2004 in the amount of $164,000 include severance costs and accruals for gross profit guarantees compared to $53,000 as of December 31, 2003. These liabilities are reported as accrued disposition costs in the accompanying consolidated balance sheets.

Net cash received from (used in) discontinued operations of $70,000 and $(333,000) for the nine months ended September 30, 2004 and 2003, respectively, relates to royalties received from GFS offset by payments of severance costs to former employees who were terminated as a result of the sale of the Analytical Standards division.

Analytical Standards Division

On February 13, 2003, we completed the sale of our Analytical Standards division to GFS Chemicals, Inc. ("GFS"), a privately held company based in Columbus, Ohio. In this transaction, we received $2.1 million on closing and are entitled to receive royalties on sales of Analytical Standards products for a period of five years at rates ranging from 5% to 15%. The net present value of the guaranteed minimum royalties is included in the gain (loss) from discontinued operations. Royalties in excess of the guaranteed minimum royalties are included in the gain (loss) from discontinued operations when they are realized in accordance with our revenue recognition policy. We recorded additional royalties of $20,000 as income for the nine months ended September 30, 2004.

As a result of the sale of the Analytical Standards division, we recorded severance charges of $210,000 for the year ended December 31, 2003 as a partial offset to the gain on disposition of the Analytical Standards division. In the nine months ended September 30, 2004, a reduction to the estimated severance charges of $19,000 was recorded. Approximately $184,000 of these severance charges has been paid through September 30, 2004 and approximately $7,000 is included in accrued disposition costs.

Cosmeceutical and Toiletry Business

On July 25, 2000, we completed the sale of certain technology rights for our topical pharmaceuticals and cosmeceutical product lines and other assets ("cosmeceutical and toiletry business") to RP Scherer Corporation, a subsidiary of Cardinal Health, Inc. We received $25 million at closing and were entitled to receive further earnout amounts for the subsequent three years up to a maximum of $26.5 million, the amounts of which were dependent on the performance of the business sold. During the first two years of the earnout period, we received an aggregate of $3.8 million. No earnout income was received or reported for the third and final earnout year.

Under the terms of the agreement with RP Scherer, we guaranteed a minimum gross profit percentage on RP Scherer's combined sales of products to Ortho Neutrogena and Dermik ("Gross Profit Guaranty"). The guaranty period commenced on July 1, 2000 and ends on the earlier of July 1, 2010 or the end of two consecutive guaranty periods where the combined gross profit on sales to Ortho and Dermik equals or exceeds the guaranteed gross profit percentage. The Gross Profit Guaranty aggregated $527,000 for the first four guaranty years. We expect the annual Gross Profit Guaranty payments to range from approximately $100,000 to $150,000 for the remainder of the guaranty period. As there is no minimum amount of Gross Profit Guaranty due, no accrual for the guaranty is estimable for future years.

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

Overview

We are a specialty pharmaceutical company focused on the development of ethical (prescription) pharmaceuticals utilizing our proprietary polymer-based drug delivery systems. Our primary focus is the development and commercialization of our bioerodible injectable and implantable systems under the trade name Biochronomer(TM). Initial target areas of application for our drug delivery technology include pain management, anti-nausea, inflammation, vaccines and ophthalmology applications. Our product development programs are funded by the sale of common stock in June 2004, royalties from topical products currently marketed by pharmaceutical partners, proceeds from the divestitures of our cosmeceutical and analytical standards product lines and by fees we receive from collaborative partners.

Except for statements of historical fact, the statements herein are forward-looking and are subject to a number of risks and uncertainties that could cause actual results to differ materially from the statements made. These include, among others, uncertainty associated with timely development, approval, launch and acceptance of new products, establishment of new corporate alliances, progress in research and development programs, and other risks described below or identified from time to time in our Securities and Exchange Commission filings.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

We believe there have been no significant changes in our critical accounting policies during the nine months ended September 30, 2004 as compared to what was previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2003 filed with the SEC on March 26, 2004. For a description of our critical accounting policies, please refer to our 2003 Annual Report on Form 10-K.

In March 2004 the Financial Accounting Standard Board ("FASB") issued an exposure draft entitled "Share-Based Payment, an amendment of FASB Statements No. 123 and 95" (proposed FAS 123R). The proposed FAS 123R would require stock-based compensation to employees to be recognized as a cost in the financial statements and that such cost be measured according to the fair value of the stock options. In the absence of an observable market price for the stock awards, the fair value of the stock options would be based upon a valuation methodology that takes into consideration various factors, including the exercise price of the option, the expected term of the option, the current price of the underlying shares, the expected volatility of the underlying share price, the expected dividends on the underlying shares and the risk-free interest rate. The proposed requirements in the exposure draft would be effective for interim or annual periods beginning after June 15, 2005. The cumulative effect of adoption, if any, applied on a modified prospective basis, would be measured and recognized on the date of implementation, July 1, 2005. The FASB expects to issue a final standard by December 31, 2004. A.P. Pharma is currently evaluating option valuation methodologies and assumptions in light of the proposed FAS 123R. Current estimates of option values using the Black-Scholes method (as shown above) may not be indicative of results from valuation methodologies ultimately adopted in the final rules.

Results of Operations for the Three and Nine Months Ended September

30, 2004 and 2003

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

Royalties for the three and nine months ended September 30, 2004 were $1,258,000 and $3,515,000, respectively, compared to $1,149,000 and $3,211,000, respectively, in the same periods in 2003. These increases were due mainly to growth in sales of Retin-A Micro(R) and Carac. We expect royalty revenue to continue to increase in the fourth quarter of 2004.

Contract revenues for the three and nine months September 30, 2004 were $200,000 and $407,000, respectively, compared to $119,000 and $279,000, respectively, in the same periods in 2003. The increase is mainly due to the initiation of a new collaborative research and development arrangement in 2004.

Research and development expense increased by approximately $802,000 and $2,264,000 during the three and nine months ended September 30, 2004, respectively, from $1,854,000 and $6,391,000, respectively, for the same periods in 2003. These increases were due mainly to the cost of Phase 2 clinical trials with APF112 for the treatment of post-surgical pain as well as the initiation of a Phase 1 clinical trial using APF530 for the prevention of acute and delayed chemotherapy-induced nausea and vomiting. The Phase 1 clinical trial using APF530 for the treatment of acute and delayed chemotherapy-induced nausea and vomiting and our pre-clinical toxicology studies have now been completed. A U.S. regulatory submission is planned for early in 2005 and we expect to initiate pivotal studies later in 2005. We and our consultants have considered a variety of alternatives regarding the future development of APF112, and a Phase 2b clinical study is in the advanced stages of planning. However, due to the current and anticipated demands on our resources for the planned clinical program for APF530, we will delay the start of the Phase 2b study with APF112 until a partner or additional resources have been secured.

General and administrative expense increased by approximately $111,000 and $52,000 during the three and nine months ended September 30, 2004 respectively, from $649,000 and $2,193,000, respectively, due primarily to additional costs associated with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

Net interest income for the three months ended September 30, 2004 increased by $15,000 to $70,000 and decreased for the nine months ended September 30, 2004 by $71,000 to $126,000. These changes were due to lower interest rates earned on lower average cash balances in the first half of the year and higher cash balances in the third quarter of 2004 as a result of the stock issuance in June 2004. We expect interest income to increase in the fourth quarter of 2004 due to the receipt of approximately $11.8 million from the common stock sale in June 2004 under our shelf registration statement.

Gain (loss) from discontinued operations represents the gain on sale of the Analytical Standards division in February 2003, partially offset by the loss from discontinued operations attributable to the Analytical Standards division and the cosmeceutical and toiletries product lines. The loss from discontinued operations totaled $34,000 for the three months ended September 30, 2004, compared to $43,000 for the three months ended September 30, 2003. The loss from discontinued operations totaled $135,000 for the nine months ended September 30, 2004, compared with the gain on the disposition of the Analytical Standards division of $1,759,000 in the nine months ended September 30, 2003.

Capital Resources and Liquidity

Cash, cash equivalents and marketable securities increased by $5,763,000 to $15,247,000 at September 30, 2004 from $9,484,000 at December 31, 2003 due primarily to the sale of 4,153,335 shares of common stock in June 2004 at a price of $3.00 per share for net proceeds of approximately $11.8 million.

Net cash used in continuing operating activities for the nine months

ended September 30, 2004 and 2003 was $6,131,000 and $4,590,000, respectively. The increase in net cash used in operating activities was mainly due to increased clinical and preclinical study costs.

Net cash used in investing activities for the nine months ended September 30, 2004 was $5,316,000 compared to net cash provided by investing activities of $3,089,000 for the nine months ended September 30, 2003. The increase in the cash used in investing activities was primarily due to the purchase of $15,922,000 of marketable securities, partially offset by the sale of $10,779,000 of marketable securities.

In June 2004, we sold 4,153,335 shares of common stock in a public offering at a price of $3.00 per share which yielded net proceeds of approximately $11.8 million.

We have funded our operations, including technology and product research and development, primarily through royalties received on sales of Retin-A Micro and Carac, fees received in connection with collaborative research and development arrangements, the proceeds received from the sales of our Analytical Standards division and our cosmeceutical and toiletry business, sale of common stock in June 2004 and interest earned on short-term investments. Our existing cash and cash equivalents, marketable securities, collections of accounts receivable, together with interest income and other revenue-producing activities including royalties, license and option fees and research and development fees are sufficient to meet our cash needs through at least the first half of 2006.

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

In March 2004, we renegotiated the lease for our facilities. The following is a summary of fixed payments related to certain contractual obligations as of September 30, 2004 (in thousands):

	Total	Less than 1 year	2 to 3 years	4 to 5 years	More than 5 years
Operating Leases	$3,068	$425	$943	$951	$749
Total	$3,068	$425	$943	$951	$749

Under the terms of the agreement with RP Scherer, we guaranteed a minimum gross profit percentage on RP Scherer's combined sales of products to Ortho Neutrogena and Dermik ("Gross Profit Guaranty"). The guaranty period commenced on July 1, 2000 and ends on the earlier of July 1, 2010 or the end of two consecutive guaranty periods where the combined gross profit on sales to Ortho and Dermik equals or exceeds the guaranteed gross profit percentage. The Gross Profit Guaranty aggregated $527,000 for the first four guaranty years. We expect the annual Gross Profit Guaranty payments to range from approximately $100,000 to $150,000 for the remainder of the guaranty period. As there is no minimum amount of Gross Profit Guaranty due, no accrual for the guaranty is estimable for future years.

ITEM 3. Quantitative and Qualitative Disclosure about Market Risk

Since December 31, 2003, there have been no material changes in the Company's market risk exposure.

ITEM 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures: We carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operations of our disclosure controls and procedures pursuant to Rule 13a-15(e) and 15(d)-15(e) of the Exchange Act. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2004, the end of period covered by this report, our disclosure controls and procedures were sufficiently effective to ensure that the information required to be disclosed by us in this Quarterly Report on Form 10-Q was recorded, processed, summarized and reported within the time periods specified in the SEC's rules and Form 10-Q.

(b) Changes in internal controls: During the quarter ended September 30, 2004, there have been no significant changes in our internal control over financial reporting that materially affected, or are reasonable likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

On October 22, 2003, Tristrata Technology, Inc. (Tristrata) filed an amended complaint joining A.P. Pharma, Inc. and other companies as defendants in Tristrata's action first filed July 12, 2002 against Cardinal Health, Inc. and others in the Federal District Court of Delaware. Tristrata's complaint alleges infringement of patents pertaining to alpha-hydroxy acids used in cosmetics. A.P. Pharma answered Tristrata's amended complaint on December 22, 2003. A.P. Pharma is vigorously defending this action. At this early stage of the proceedings we cannot state the amount, if any, which might be recovered by Tristrata from A.P. Pharma. In our opinion, this litigation should not have a material effect on our results of operations or financial condition.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits

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

Exhibit 31.2 Certification of Chief Financial Officer pursuant to Rules 13A-15(e) Promulgated under the Securities Exchange Act of 1934 as amended.

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

SIGNATURES

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

A.P. PHARMA, INC.

Date: November 15, 2004

By: /S/ Michael O'Connell

Michael O'Connell
President and Chief
Executive Officer

Date: November 15, 2004

By: /S/ Gordon Sangster

Gordon Sangster
Chief Financial Officer

Exhibit 31.1

SECTION 302 CERTIFICATIONS

Certifications:

I, Michael O'Connell, certify that:

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

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

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

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

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

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

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

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

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

Date: November 15, 2004

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

Exhibit 31.2

SECTION 302 CERTIFICATIONS

Certifications:

I, Gordon Sangster, certify that:

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

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

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

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

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

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

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

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

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

Date: November 15, 2004

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

Exhibit 32

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

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael O'Connell, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

/s/ Michael O'Connell
Michael O'Connell,
Chief Executive Officer

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

In connection with the Quarterly Report of A.P. Pharma, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gordon Sangster, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

/s/ Gordon Sangster
Gordon Sangster,
Chief Financial Officer