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

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

For the quarterly period ended September 30, 1998

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

For the transition period from -------- to --------

Commission file Number 0-16109

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

Delaware	94-2875566
(State or other jurisdiction of incorporation or organization)	(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 ---

At October 30, 1998, the number of outstanding shares of the Company's common stock, par value $.01, was 19,991,207.

INDEX

Signatures

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements (unaudited):

CONDENSED BALANCE SHEETS (UNAUDITED)

	September 30, 1998	December 31, 1997
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,437,784	$ 8,672,021
Trade accounts receivable, net	5,940,254	3,388,665
Inventory	2,831,239	2,639,129
Prepaid expenses and other	1,145,521	541,151
Total current assets	13,354,798	15,240,966
Property and equipment, net	8,596,823	6,771,173
Deferred loan costs, net	156,245	353,693
Prepaid license fees, net	20,726	82,880
Goodwill and other intangible assets	1,392,575	1,477,542
Other long-term assets	182,891	254,180
	$ 23,704,058	$ 24,180,434
LIABILITIES & SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,167,231	$ 1,636,189
Accrued expenses	1,866,251	2,832,299
Accrued melanin purchase commitments	1,800,000	1,800,000
Deferred revenues	450,000	348,000
Current portion - long-term debt	3,672,270	2,523,389
Total current liabilities	8,955,752	9,139,877
Deferred revenues	1,493,094	1,743,869
Long-term debt	24,295	3,055,460
Total liabilities	10,473,141	13,939,206
Shareholders' equity:		
Common stock and common stock warrants	84,719,333	82,505,394
Accumulated deficit	(71,488,416)	(72,264,166)
Total shareholders' equity	13,230,917	10,241,228
	$ 23,704,058	$ 24,180,434

See accompanying notes.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1998	1997	1998	1997
Product and technology revenues	$ 5,152,862	$ 4,136,606	$14,822,482	$12,183,254
Milestone payment	--	--	--	1,500,000
Total revenues	5,152,862	4,136,606	14,822,482	13,683,254
Cost of sales	1,950,668	1,757,132	5,653,621	5,200,826
Operating expenses:				
Research & development	996,052	915,361	3,195,894	2,748,652
Selling & marketing	684,585	873,450	2,299,311	2,996,331
General & administration	859,585	818,826	2,451,686	2,731,825
Total operating expenses	2,540,222	2,607,637	7,946,891	8,476,808
Operating income (loss)	661,972	(228,163)	1,221,970	5,620
Interest income	51,001	100,579	205,360	260,106
Interest expense	(193,127)	(260,705)	(633,326)	(800,959)
Other income (expense), net	2,105	(6,978)	(18,254)	(72,845)
Net income (loss)	$ 521,951	$ (395,267)	$ 775,750	$ (608,078)
Basic earnings (loss) per common share	$ 0.03	$ (0.02)	$ 0.04	$ (0.03)
Diluted earnings (loss) per common share	$ 0.03	$ (0.02)	$ 0.04	$ (0.03)
Weighted average common shares outstanding-basic	19,969,391	18,895,691	19,807,934	18,626,475
Weighted average common shares outstanding-diluted	20,248,716	19,927,911	20,349,075	19,732,955

See accompanying notes.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	For the nine months ended September 30, 1998	1997
Cash flows from operating activities:		
Net income (loss)	$ 775,750	$ (608,078)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	761,470	725,224
Amortization of deferred loan costs	197,448	197,448
Provision for deferred compensation	77,204	171,757
Changes in operating assets and liabilities:		
Trade accounts receivable	(2,551,589)	(1,499,214)
Inventory	(192,110)	(576,115)
Prepaid expenses and other	(604,370)	(115,398)
Other assets	71,289	(490,577)
Accounts payable and accrued expenses	(1,462,282)	(205,756)
Deferred revenues	(148,775)	1,500,000
Net cash used in operating activities	(3,075,965)	(900,709)
Cash flows from investing activities:		
Purchases of fixed assets	(2,439,999)	(1,257,731)
Purchases of marketable securities	-	(1,596,617)
Maturities and sales of marketable securities	-	1,596,617
Proceeds from assets held for sale	-	2,181,004
Net cash (used in) provided by investing activities	(2,439,999)	923,273
Cash flows from financing activities:		
Proceeds from the exercise of common stock options and warrants and issuance of restricted stock	2,054,376	4,003,203
Proceeds from shares issued under the Employee Stock Purchase Plan	109,635	-
Repayment of long-term debt	(1,882,284)	(876,408)
Net cash provided by financing activities	281,727	3,126,795
Net (decrease) increase in cash and cash equivalents	(5,234,237)	3,149,359
Cash and cash equivalents, beginning of the period	8,672,021	5,394,509
Cash and cash equivalents, end of the period	$ 3,437,784	$ 8,543,868
Supplemental disclosure of non-cash financing transactions:		
Cash paid for interest	$ 448,026	$ 605,019

See accompanying notes.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 1998 AND 1997 (UNAUDITED)

(1) Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the financial position of Advanced Polymer Systems, Inc. and subsidiaries ("the Company" or "APS") as of September 30, 1998 and the results of their operations for the three and nine months ended September 30, 1998 and 1997, and their cash flows for the nine months ended September 30, 1998 and 1997.

These condensed consolidated statements should be read in conjunction with the Company's audited consolidated financial statements for the years ended December 31, 1997, 1996 and 1995 included in the Company's Annual Report on Form 10-K.

The condensed consolidated financial statements include the financial statements of the Company and its subsidiaries, Premier, Inc. ("Premier") and APS Analytical Standards, Inc. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company considers all short-term investments which have original maturities of less than three months to be cash equivalents.

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

(2) Common Shares Outstanding and Earnings (Loss) Per Share Information

Common stock outstanding as of September 30, 1998 is as follows:

	Number of Shares
Common stock outstanding as of December 31, 1997	19,464,821
Warrants exercised	310,278
Options exercised	77,494
Restricted stock issued	100,000
Shares issued under the Employee Stock Purchase Plan	17,465
Total shares	19,970,058

The following table sets forth the computation of the Company's basic and diluted earnings (loss) per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1998	1997	1998	1997
Net income (loss) (numerator)	$ 521,951	$(395,267)	$ 775,750	$ (608,078)
Shares calculation (denominator):				
Weighted average shares outstanding - basic	19,969,391	18,895,691	19,807,934	18,626,475
Effect of dilutive securities:				

Stock options and employee stock purchase plan	142,023	608,896	393,347	665,831
Warrants	137,302	423,324	147,794	440,649
Weighted average shares outstanding - diluted	20,248,716	19,927,911	20,349,075	19,732,955
Earnings (loss) per share - basic	$ 0.03	$ (0.02)	$ 0.04	$ (0.03)
Earnings (loss) per share - diluted	$ 0.03	$ (0.02)	$ 0.04	$ (0.03)

The following options with expiration dates ranging from November 19, 2001 to June 23, 2008 were outstanding during the periods presented, but were not included in the computation of diluted earnings per share since the exercise prices of the options were greater than the average market price of the common shares:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1998	1997	1998	1997
Number outstanding	1,844,556	859,955	1,185,630	818,024
Range of exercise prices	$5.63-$15.00	$7.75-$15.00	$6.82-$15.00	$8.125-$15.00

(3) Comprehensive Income

During the first quarter of 1998, the Company adopted Statement of Financial Accounting Standards No. 130 "Reporting Comprehensive Income" which establishes standards for reporting and display of comprehensive income and its components in a full set of general purpose financial statements. For the three and nine months ended September 30, 1998 and 1997, comprehensive income (loss) was the same as net income (loss).

(4) New Accounting Standards

In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 131 "Disclosures about Segments of a Business Enterprise" which is effective for financial statements beginning after December 15, 1997, and establishes standards for disclosures about segments of an enterprise. In its consolidated financial statements for the year ending December 31, 1998, the Company will make the required disclosures.

In April 1998, the AICPA Accounting Standards Executive Committee issued Statement of Position 98-5 (SOP 98-5), "Reporting on the Costs of Start-Up Activities" which is effective for financial statements for fiscal years beginning after December 15, 1998. The SOP requires that costs incurred during start-up activities, including organization costs, be expensed as incurred. Initial application of SOP 98-5 should be as of the beginning of the fiscal year in which the SOP is first adopted and should be reported as the cumulative effect of a change in accounting principle. Earlier application is encouraged. The Company will adopt SOP 98-5 in its fiscal year beginning January 1, 1999. The Company anticipates that adoption of this SOP will not have a material effect on the consolidated financial statements.

In June 1998, the FASB issued SFAS No. 133 "Accounting for

Derivative Instruments and Hedging Activities" (SFAS 133) which will be effective for all fiscal quarters of fiscal years beginning after June 15, 1999. SFAS 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The Statement generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of (a) the changes in the fair value of the hedged asset or liability that are attributed to the hedged risk or (b) the earnings effect of hedged forecasted transactions. Earlier application of all provisions of this Statement is encouraged but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. The Company anticipates that adoption of this Statement will not have a material effect on the consolidated financial statements.

(5) Inventory

The major components of inventory are as follows:

	September 30, 1998	December 31, 1997
Raw materials and work-in-process	$ 796,190	$ 834,496
Finished goods	2,035,049	1,804,633
Total inventory	$2,831,239	$2,639,129

(6) Legal Proceedings

In November, 1997 Biosource Technologies, Inc. ("Biosource") filed a complaint against the Company in the San Mateo Superior Court. Biosource claims damages from the Company of an amount not less than $1,050,000, on the grounds that the Company has failed to pay certain minimum amounts allegedly due under a contract for the supply of melanin. Biosource also claims interest on that sum and costs.

The Company has denied liability, basing its defense on the assertion that obligations under the contract have been suspended, because the expected FDA approval of the Company's melanin-based product has not yet been forthcoming. The Company is vigorously defending the action, and has cross claimed for rescission of the contract and restitution of money paid thereunder, and for a declaratory judgment that it is not indebted to Biosource.

The Company expects that the outcome of this legal proceeding will not have a material adverse effect on the consolidated financial statements considering amounts accrued at September 30, 1998.

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

Overview

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

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

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

Results of Operations for the Three Months Ended September 30, 1998 and 1997

Product and technology revenues for the three months ended September 30, 1998 totaled $5,153,000 compared to $4,137,000 in the corresponding quarter of the prior year, representing an increase of $1,016,000 or 25%. This was due primarily to increased sales of proprietary cosmeceutical products including two new product launches, increased royalties from Johnson & Johnson on higher sales of Retin-A(R) Micro (TM), and upfront technology revenues received from new corporate partners for access to new products.

Gross profit for the third quarter of 1998 of $3,202,000 represented 62% of product and technology revenues, an increase of four percentage points over the corresponding quarter of the prior year. This was primarily attributable to increased royalties from Johnson & Johnson, an increase in revenues from higher margin cosmeceutical products and license fees received from new corporate partners in the quarter.

Total operating expenses for the three months ended September 30, 1998 decreased by $67,000 or 3% to $2,540,000 compared to the corresponding period of the prior year.

Research and development expense increased by $81,000 or 9% to $996,000 due mainly to increased headcount, clinical studies and increased expenditure in the companies new bioerodible technologies. This was offset by a decrease in selling and marketing expense of $189,000 or 22% to $685,000 due to decreased headcount. General and administrative expense increased by $41,000 or 5% to $860,000 due mainly to a modest increase in the use of outside services.

Operating income for the three months ended September 30, 1998 totaled $662,000 compared to an operating loss of $228,000 in the year-ago period, an improvement of $890,000.

Interest income decreased by $50,000 or 49% to $51,000 compared with the corresponding quarter of the prior year due to lower interest rates on lower average cash balances. Interest expense decreased by $68,000 or 26% to $193,000 due mainly to scheduled debt principal repayments.

Net income for the quarter was $522,000 compared to a net loss in the third quarter of the prior year of $395,000.

Results of Operations for the Nine Months Ended September 30, 1998 and
- --
1997
- ----

Product and technology revenues for the nine months ended September 30, 1998 totaled $14,822,000, an increase of $2,639,000 or 22% over the corresponding period of the prior year. This increase was mainly due to increased sales of cosmeceutical products, increased royalties from Johnson & Johnson on sales of Retin-A Micro and upfront technology revenues received from new corporate partners for access to new products. Total revenues for the first nine months of 1997 also included a milestone payment of $1,500,000 from Johnson & Johnson upon receipt of marketing clearance from the FDA for Retin-A Micro in February 1997.

Gross profit on product and technology revenues for the first nine months of 1998 was $9,169,000, an increase of $2,186,000 or 31% over the corresponding period of the prior year. As a percentage of sales, gross profit increased by five percentage points to 62%. The increase was due primarily to increased sales of higher margin cosmeceutical products, increased royalties from Johnson & Johnson on sales of Retin-A Micro and license fees paid by new corporate partners for access to new products.

Total operating expenses for the nine months ended September 30, 1998 decreased by $530,000 or 6% to $7,947,000 compared to the corresponding period of the prior year.

Research and development expense for the nine months period increased by $447,000 or 16% due mainly to increased headcount, increased expenditure in new technology and expenses resulting from the Company's move to new facilities in the first quarter of 1998. This was offset by a decrease in selling and marketing expense of $697,000 or 23% to $2,299,000 due to decreased headcount and one-time expenses related to the relocation of a senior executive in the year-ago period. General and administrative expense decreased by $280,000 or 10% due mainly to a continued decrease in the use of outside services.

Operating income for the nine month period ended September 30, 1998 totaled $1,222,000, an increase of $1,216,000 over the corresponding period of the prior year.

Interest income decreased by $55,000 or 21% to $205,000 for the nine month period due mainly to lower interest on lower cash balances. Interest expense decreased by $168,000 or 21% to $633,000 due to scheduled debt principal repayments.

Net income for the nine months ended September 30, 1998 amounted to $776,000 compared to a loss of $608,000 in the corresponding period of the prior year.

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

Total assets as of September 30, 1998 were $23,704,000 compared with $24,180,000 at December 31, 1997, and working capital decreased to $4,399,000 from $6,101,000, mainly due to an increase in the current portion of long-term debt. In the same period, cash and cash equivalents decreased to $3,438,000 from $8,672,000. During the first nine months of 1998, the Company's operating activities used $3,076,000 of cash. This principally related to an increase in receivables as a result of increased shipments for the launches of new products by corporate partners. The Company invested approximately $3,196,000 in product research and development and $2,299,000 in selling and marketing the Company's products and technologies.

Capital expenditures for the nine months ended September 30, 1998 totaled $2,440,000 compared to $1,258,000 in the same period of the prior year. The increase in capital expenditures is mainly due to capital projects that have increased capacity and improved automation in the Company's manufacturing facility in Lafayette, Louisiana in order to meet anticipated higher volume requirements. This plant expansion and modernization project has now been completed. In addition, the Company's lease on its facilities in Redwood City expired and the increase in capital expenditures also included leasehold improvements, primarily laboratories, in the Company's new facilities in Redwood City.

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

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

Year 2000 Compliance

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

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

The second phase consists of determining whether Company systems not addressed in Phase One (including non-IT systems) are year 2000 compliant. The second phase is expected to be complete by the first quarter of 1999 for critical systems and the second quarter of 1999 for non-critical systems.

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

Based on current estimates, management expects the total cost to remediate non-compliant systems will be less than $650,000 (approximately $510,000 of which has been incurred to date). The estimate may change materially as the Company continues to review and audit the result of its work.

The Company has not yet developed any formal contingency plans for addressing any problems which may result if the work performed in phase two does not successfully resolve all issues by the Year 2000.

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

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

In November, 1997 Biosource Technologies, Inc. ("Biosource") filed a complaint against the Company in the San Mateo Superior Court. Biosource claims damages from the Company of an amount not less than $1,050,000, on the grounds that the Company has failed to pay certain minimum amounts allegedly due under a contract for the supply of melanin. Biosource also claims interest on that sum and costs.

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The Company expects that the outcome of this legal proceeding will not have a material adverse effect on the consolidated financial statements considering amounts accrued at September 30, 1998.

ITEM 6. Exhibits and Reports on Form 8-K

(a) Exhibits: 27 Financial Data Schedule as of and for the nine months ended September 30, 1998.

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.

ADVANCED POLYMER SYSTEMS, INC.

Date: November 12, 1998 By: /s/ John J. Meakem, Jr.

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

Date: November 12, 1998 By: /s/ Michael O'Connell

Michael O'Connell
Executive Vice President,
Chief Administrative Officer
and Chief Financial Officer

EXHIBIT INDEX

Form 10-Q

EXHIBIT	DESCRIPTION
27	Financial Data Schedule

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THE SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEET AS OF SEPTEMBER 30, 1998, AND CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 1998, AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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SEP-30-1998
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