UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K

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[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Fiscal Year ended July 31, 1998

OR

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from _____ to _____

Commission file number 0-20772
CYPROS PHARMACEUTICAL CORPORATION
(Exact name of registrant as specified in its charter)

California	33-0476164
(State or other jurisdiction of incorporation or organization)	(I.R.S.Employer Identification No.)
2714 Loker Avenue West Carlsbad, California	92008
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code:
(760) 929-9500

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, no par value
(Title of class)
Indicate by mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act 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.
[X] YES [ ] NO
As of October 26,1998, the Registrant had 15,711,877 shares of Common Stock, no par value, outstanding, and the aggregate market value of the shares held by non-affiliates on that date was $29,563,000 based upon the last sales price of the Registrant's Common Stock reported on the American Stock Exchange.*

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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]

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* Excludes 3,264,437 shares of Common Stock held by directors, executive officers and shareholders whose beneficial ownership exceeds ten percent of the shares outstanding on October 26, 1998. Exclusion of shares held by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of 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
Portions of the Registrant's Proxy Statement for the 1999 Annual Meeting of Shareholders to be filed on or before November 28, 1998 are incorporated by reference into Part III.

PART I.

Item 1. Business.

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those discussed here. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the description of the Company's business below and the sections entitled "Licenses", "Manufacturing", "Sales and Marketing", "Competition", "Government Regulation", "Patents and Proprietary Rights" and "Management's Discussion and Analysis of Financial Condition and Results of Operations", those discussed in the S-3 Registration Statement File No. 333-25661 filed with U.S. Securities and

Exchange Commission, as well as those discussed in any documents incorporated by reference herein or therein.

General

Cypros Pharmaceutical Corporation (the "Company") is a specialty pharmaceutical company which develops and markets products for the critical care market. The Company's sales and marketing force is currently marketing three products, Glofil and Inulin, two injectable drugs that assess kidney function by the measurement of glomerular filtration rate, and Ethamolin, an injectable drug that treats bleeding esophageal varices. In addition, the Company intends to launch two burn/wound care products, Neoflo and Sildaflo, in the next year. The Company's development programs target ischemic (impaired blood flow) disorders and the Company is currently conducting a Phase III clinical trial on Cordox (formerly CPC-111) in sickle cell crisis patients. The Company is also planning (i) Phase III clinical trials of Cordox in other ischemic disorders, such as coronary artery bypass grafting surgery ("CABG") and (ii) other pivotal clinical trials of Ceresine in closed head injury patients.

Acquisitions of Approved Products to Build Commercial Capabilities. The Company has an 11-person sales and marketing force directed at the critical care market. In advance of the potential approval of Cordox and Ceresine by the U.S. Food and Drug Administration ("FDA"), the Company is building a sales, marketing and distribution capability through the acquisition of already approved products; Glofil-125 and Inulin, which it acquired in August 1995, and Ethamolin, which it acquired in November 1996 from Schwarz Pharma, Inc. In November 1997, the Company acquired a patented drug delivery technology, Dermaflo, and two FDA-approved products, Neoflo and Sildaflo, which it is planning to launch during the next year into the burn and wound care markets. The Company will continue to build its sales and marketing force as it completes additional acquisitions. During the fiscal year ended July 31, 1998, the net sales of the Company's three acquired products reached $3,446,000, a 42% increase over the $2,428,000 recorded during the prior fiscal year.

Cordox and Ceresine: Ischemia Therapies in Late Stage Development Serving Unmet Medical Needs. There are several million cases of ischemia-induced disorders annually in the United States, resulting in over seven hundred thousand deaths and several billion dollars in annual costs for physical and mental rehabilitation and ongoing care, and yet there are currently no FDA-approved drugs to avoid or reverse the massive cell damage caused by ischemia (termed "cytoprotective drugs"). Ischemic disorders include heart attack, stroke, surgery, trauma and various anemias. Currently approved drugs for treating cardiovascular ischemia, such as "clot busting" drugs, serve to re-establish blood flow but do not have direct cytoprotective effects on the ischemic tissue. The Company believes that the drugs it is developing, Cordox and Ceresine, if approved by the FDA and successfully marketed, should reduce significantly the number of fatalities and the rehabilitation and ongoing care costs associated with ischemic disorders.

Impairment of blood flow reduces the supply of oxygen to body cells, interrupting normal aerobic metabolism and causing depletion of adenosine triphosphate ("ATP"), the cells' primary energy source. Ischemia-induced depletion of ATP produces a myriad of increasingly destructive cellular events known as the "toxic ischemic cascade." The Company believes that the cytoprotective drugs under development by others for treatment of ischemia are focused on treating specific elements of the toxic ischemic cascade, leaving other elements free to cause cell, tissue and organ damage.

The Company's approach, based on preventing or reversing the toxic ischemic cascade, is comprehensive in nature and, the Company believes, potentially more effective. Cordox and Ceresine are designed to act during and after ischemia by maintaining cellular ATP levels or accelerating their restoration. Cordox (a natural substance) and Ceresine are more amenable to being used early in the patient management process, which is critical in acute care settings.

Further, Cordox and Ceresine are small molecules, easily deliverable and inexpensive to produce. Significant human data, available from the Company's own studies and independent, physician-sponsored Investigational New Drug applications ("INDs"), show that each of these drugs is well tolerated when administered at clinically relevant doses to healthy subjects. The minimal side effects associated with Cordox and Ceresine should reduce their development risk and may permit their broad, early use in acute care settings, such as emergency rooms, where

rapid access to treatment is of utmost importance.

During the fiscal year ended July 31, 1998, the Company released positive data in its Phase II trial of Cordox in sickle cell anemia crisis patients, completed and filed a Phase III protocol with the FDA and began recruiting clinical trial sites for the Phase III trial. In addition, the Company also filed a U.S. patent application during the year based upon the data from the Phase II trial and in September 1998 was informed by the U.S. Patent and Trademark Office that all claims had been allowed. This patent provides specific coverage for the use of Cordox in sickle cell anemia crisis patients to reduce the painful occlusive ischemic episodes.

Pre-clinical Programs Focused on Ischemic Disorders. Further implementing its overall strategy of developing drugs that protect cells from ischemic damage, the Company is conducting pre-clinical studies on additional compounds intended to reduce the neurodegeneration associated with stroke and traumatic head injury. The Company believes that these drugs may reduce "excitotoxicity," the excess release of excitatory amino acid ("EAA") neurotransmitters in the brain that stems from ischemically-caused ATP depletion in certain brain cells. Drugs being developed in these studies include: (i) a new class of neuronal calcium channel blockers which block excessive EAA neurotransmitter release; (ii) a patented series of novel compounds which augment levels of adenosine (a naturally occurring substance which inhibits EAA release) in ischemic tissue by inhibiting its metabolism for which the Company received a $100,000 Small Business Innovation Research Phase I grant during the past year; and (iii) a novel series of compounds which inhibit the release of EAA (especially glutamate) from glial cells in the brain. The Company is attempting to develop lead compounds from all three of the above pre-clinical programs to treat a variety of ischemic disorders of both the cardiovascular and cerebrovascular systems.

The Company is also pursuing the development of Cordox prodrugs with improved pharmacokinetic and pharmacodynamic properties that will permit oral delivery of Cordox and also access to the central nervous system.

Acquired Pharmaceutical Products

The Company's strategy includes building near-term sustainability with the cash flow from acquired pharmaceutical products with the goal of reducing its overall cash consumption rate and building its sales, marketing and distribution infrastructure in advance of the potential approval of Cordox and Ceresine by the FDA.

Glofil-125 and Inulin. Kidney disease afflicts more than 2 million persons in the United States and is increasing primarily due to the growth in diabetes and systemic lupus erythromatosis cases. Kidney disease results in over $12 billion annually in healthcare costs in the United States. The measurement of kidney function (glomerular filtration rate or "GFR") is critical to the understanding of the disease state and its appropriate therapeutic intervention. GFR has historically been estimated by the measurement of endogenous serum creatinine and by creatinine clearance. These diagnostic assays overestimate kidney function by as much as 100 percent in patients. The Company believes that the injection of a renal filtration marker, such as Inulin and Glofil-125, is the most accurate and direct means of determining GFR.

Glofil-125 and Inulin are FDA-approved products for the measurement of GFR. Nephrologists and nuclear medicine departments at major medical centers are the primary users of these products. During the fiscal year ended July 31, 1998, the Company recorded sales from these two products of $1,227,000 and one customer using Glofil-125 for clinical trials of a renal therapeutic accounted for 33% of these sales and 12% of the Company's total sales. That customer has terminated those trials and the Company expects its sales of Glofil to suffer for the next six to nine months.

Glofil-125 is an injectable radioactive diagnostic drug, which provides rapid information on GFRs with great accuracy. It is currently sold by the Company in 4ml vials and in prefilled syringes through the 117 nationwide radiopharmacies of Syncor International pursuant to a distribution agreement entered into with the Company in February 1996. Inulin is an injectable diagnostic drug, which provides a measure of GFRs. Inulin is currently sold in 50 ml ampules with actual patient dosing correlated to patient weight.

The Company believes there is substantial opportunity for increased utilization of Glofil-125. Present diagnostic

procedures for measuring kidney function include serum creatinine and creatinine clearance tests. These two tests are the most commonly performed methods of measuring kidney function because of their low cost, however both methods significantly overestimate kidney function in the estimated 500,000 patients with severe renal disease. The use of Glofil-125 has been established in published clinical studies as being a more direct, true measure of kidney function yielding much more accurate results than serum creatinine or creatinine clearance tests. This improved accuracy can be essential to reliably monitoring disease progression and intervention, as well as assessing renal impairment in its early and most treatable stage.

In addition, the serum creatinine test involves blood draws and an average time of 3-4 hours to complete, and the creatinine clearance test involves 24-hour urine collection, followed by an additional 3-4 hours of analysis time. The Company is currently funding a clinical study of Glofil-125 at the University of Texas Southwest Medical Center to prove the viability of a 45 minute test. If the study is successful, the Company believes that Glofil will have a significant competitive advantage over the other tests.

The biggest impediment to the continued growth in the sales of Glofil-125 would be a change in the ability of the end users to obtain reimbursement for the test or the inability of the Company to include Glofil in the protocols of other clinical studies of renal therapeutics.

Inulin, which is sold by the Company, and 99mTc-DTPA (which is not sold by the Company and must be prepared onsite by the end user) are alternative agents for GFR measurement, however the preparation and use of these two drugs is difficult and they do not provide the practical advantages of Glofil-125. The Company is aware of no new diagnostic drugs being introduced or in development that the Company is aware of as a competitive threat to Glofil-125.

Ethamolin. Approximately 75,000 people in the United States have or are approaching end stage liver disease. Liver disease (hepatic cirrhosis) results in approximately 25,000 deaths annually and ranks ninth among the leading causes of death. Hepatic cirrhosis promotes the formation of esophageal varices through development of portal hypertension. When intravenous blood pressure rises, these varicosities may cause a life threatening form of upper gastrointestinal hemorrhage associated with a 35-50% mortality rate. At least 50,000 patients in the United States either have actively bleeding esophageal varices or are at imminent risk of bleeding.

Early and effective treatment of esophageal varices to achieve hemostasis is essential to the outcome of the bleeding patient. The most common pharmaceutical treatment protocol involves the injection of a sclerosing agent into the varix, achieving clot formation and obliteration of the varix. This form of hemostasis is called sclerotherapy and usually requires multiple treatment sessions. Ethamolin is the only sclerotherapy agent cleared by the FDA for the treatment of bleeding esophageal varices and has recently become the market leader in this therapeutic category. During the fiscal year ended July 31, 1998, the Company recorded sales from this product of $2,296,000 and one wholesaler accounted for 35% of these sales and 23% of total sales. However, there is strong competition from another drug, Sotradecol, which is being prescribed off-label, and from band ligation, a form of surgery.

The Dermaflo Technology and the Neoflo and Sildaflo Products. In November 1997, the Company acquired the Dermaflo technology, a patented topical drug delivery system, from Enquay, Inc. for a combination of cash and royaties on net sales. The technology is a polymer matrix system that can store a variety of different drugs and release them at a desired rate over an extended period of time so that optimal clinical response is obtained. Included in the assets acquired were two FDA-approved products, Neoflo and Sildaflo, and a substantial amount of manufacturing equipment.

Neoflo and Sildaflo, the first two products that the Company expects to launch using the Dermaflo technology address consumer needs in both the over-the-counter and acute care markets. Neoflo is a dressing that incorporates the triple antibiotic, polymyxin B sulfate, bacitracin zinc and neomycin sulfate. The Company intends to manufacture Neoflo in various sizes, small sizes to address the over-the-counter market (through a distributor) and larger sizes for the hospital market. Sildaflo is a dressing that incorporates silver sulfadiazine, the most widely-used topical antimicrobial for the treatment of burns. The Company intends to manufacture Sildaflo in various large sizes to address the hospital/burn clinic market. Initially, the Company intends to

address the critical care markets with its own sales force.

The Company believes the extended-release nature of the technology will result in decreased treatment-related costs, increased patient compliance and reduced pain and discomfort, resulting in a marketing advantage for the products sold using the Dermaflo technology. While it is difficult to determine the market potential of Neoflo and Sildaflo, it is known that silver sulfadiazine and the triple antibiotic have combined sales of approximately $60 million in the United States in their non-controlled-release forms.

The Company will be manufacturing the Dermaflo products itself, has located a facility in Kansas City, Missouri for that purpose, has installed some of the equipment in that facility and is beginning to manufacture test batches of the Neoflo product. The facility will require tenant improvements and a series of validations to manufacture the Sildaflo product, and therefore, the Company believes that Neoflo in both its over-the-counter and acute care sizes will be on the market before Sildaflo. Both products are expected to be on the market in the next year.

Cytoprotection Market Opportunities

Cytoprotective drugs for acute care settings that treat ischemic injury are not currently available and the market opportunities for the Company's drugs are large, totalling several million cases annually in the United States. The Company believes that its drugs, if approved, could substantially reduce not only the large number of fatalities associated with ischemia-related disorders but also reduce significantly the billions of dollars spent annually in rehabilitation and ongoing care in the United States of these victims.

The Company's drugs are designed to be administered intravenously in order to speed their delivery to the ischemic tissue. In order to ensure early interventions, they are intended to be standard components in hospital emergency rooms, operating theater suites, endoscopy suites and radiology suites. Their lack of acute toxicity should suit them for this purpose.

Circulatory System Ischemia. Cardiovascular ischemia can result in a spectrum of clinically significant events ranging from angina (pain) to heart attack and sudden death. In addition to the numerous trauma or disease related causes of ischemia, there are a variety of voluntary surgical procedures which result in ischemia to vital organ systems. Procedures such as coronary artery bypass grafting surgery, which are performed to improve blood flow to the heart, induce temporary ischemia which can result in tissue damage. Thus, Cordox, if approved, could also be a part of the treatment regimen for these disorders. All of these conditions or procedures represent potential opportunities for use of the Company's drugs to reduce the tissue damage known to be associated with them.

Cerebrovascular ischemia (stroke) can result in temporary loss of consciousness, permanent behavioral and neurologic impairment, coma and death. Traumatic injury to the head is caused by accidents, near drownings and similar incidents. The resultant medical problems are, in large part, caused by ischemia to the brain. The biochemical processes associated with stroke and head trauma are thought to be very similar; thus, the Company expects drugs developed for one indication to be useful for the other.

Sickle Cell Anemia. Sickle cell anemia is an autosomal recessive genetic disease carried by about 8% of African-Americans and a lesser number of people native to the Mediterranean region. Approximately 72,000 African-Americans suffer from the most severe form (homozygous) of the disease, where the red blood cells form "sickle" shapes that can occlude capillaries and result in severe and disseminated ischemia (termed vaso-occlusive events or "VOE"). Most sickle cell patients undergo multiple VOEs each year. Cordox has been shown pre-clinically to help reduce this "sickling" process and to reduce pain in sickle cell disease patients. The Company is evaluating it in a Phase III trial of sickle cell anemia crisis patients. The FDA has granted orphan drug designation to Cordox in this indication.

The Pathology of Ischemia

Metabolic Aspects (All Tissues). All living animal cells require glucose and oxygen to survive, both of which are supplied to tissues by the blood. Glucose is transformed into carbon dioxide and water with the resultant formation of ATP. ATP is the universal fuel which is required to keep the cell alive. During and after ischemia, the decrease in cellular ATP levels damages the cell and, the Company believes, results in the toxic ischemic cascade, a myriad of cell-damaging processes discussed below

which cause further cell damage.

ATP generation occurs in two phases. The first phase, called glycolysis or anaerobic metabolism, does not require oxygen. The second phase, called aerobic metabolism or the Krebs cycle, requires oxygen and occurs in mitochondria. Glycolysis is a means of producing cellular energy in ischemic conditions, and therefore, represents the body's natural defense against ischemic damage. For this reason, the facilitation of glycolysis is of interest therapeutically in the prevention of ischemic damage to tissues and organs. When pyruvic acid builds up during ischemia due to the inability of aerobic metabolism to utilize it, an enzyme converts it to lactic acid which blocks glycolysis. The therapeutic principle underlying Cordox and Ceresine is to facilitate glycolysis during and after ischemia so the cell continues to produce ATP and the toxic ischemic cascade is pre-empted or reversed. Specifically, Cordox bypasses the lactic acid block and does not need to be energized by ATP to be metabolized. Ceresine reduces ischemia induced lactic acid accumulation by removing the cause of the metabolic block, and therefore, allows energy metabolism to continue.

Excitotoxicity (Nerve Tissue). The destructive impact of ATP depletion in nerve tissue is further complicated by the over-production in nerve cells of various excitatory amino acids, chemicals that transmit nerve impulses from one nerve cell to another. The over-production and release of EAAs (predominately glutamate and aspartate) by nerve cells exposed to ischemia over-stimulates adjacent postsynaptic nerve cells, causing them in time to succumb to metabolic exhaustion and cell death. This ischemia-induced process, called delayed excitotoxicity, is associated with a number of acute (stroke and traumatic head injury) and chronic (Alzheimer's, Parkinson's Disease and Amyotrophic Lateral Sclerosis) neurologic disorders. Controlling delayed excitotoxicity by blocking the postsynaptic EAA receptors has recently attracted the attention of both academic and pharmaceutical scientists. To date, the drugs in development that act by this mechanism have considerable side effects and only block selected receptor subtypes, therefore only dealing with part of the problem since all receptor subtypes appear to cause damage.

Recent evidence has shown that specific presynaptic channels, neuronal calcium channels, regulate the release of neurotransmitters in nerve cells. The Company has shown that compounds which block excessive EAA neurotransmitter release from nerve cells greatly reduce excitotoxicity and post-ischemic tissue damage in animal models of stroke and head trauma. The Company is seeking to develop drugs that specifically block neuronal calcium channels and therefore, if successful, would block the excitotoxic process and reduce the resultant cell damage. These drugs are believed to have a more comprehensive effect on excitotoxicity than the specific postsynaptic EAA receptor blockers, since they will reduce the stimulation of all and not just some EAA receptors.

The Company has also shown that adenosine, a natural compound, has cytoprotective properties. The Company is seeking to develop a series of drugs, called adenosine metabolism inhibitors, which, if successful, would augment adenosine levels in ischemic tissue and have cytoprotective effects in both brain and heart tissue. See "Adenosine Metabolism Inhibitor Program."

Additionally, the Company is developing a novel series of compounds which inhibit the release of EAA (especially glutamate) from glial cells in the brain.

The Toxic Ischemic Cascade. Ischemia-induced cell damage triggers a number of processes which cause further damage to each affected cell and its surrounding cells. This myriad of destructive processes is facilitated by reperfusion injury, which occurs after blood flow is re-established. The traumatized, ATP-depleted cell enters into the toxic ischemic cascade, resulting in the release of a host of toxic agents, including damaging reactive chemicals called free radicals, as well as other molecules that are products of cell membrane breakdown, all of which damage cells. Excessive intracellular calcium buildup is also an element of the toxic ischemic cascade and also triggers a host of other damaging processes, such as activation of proteolytic enzymes which break down proteins and digest cells and activation of protein kinases which regulate cell metabolism. The traumatized cell also releases agents which stimulate the immune system, activating various blood cells, such as neutrophils and macrophages which actually eliminate the cell affected by ischemia. Rather than target each of these myriad events, the Company's drugs, Cordox and Ceresine, address ATP replenishment so that the cell can correct the ischemic cascade naturally.

There are currently no known FDA-approved cytoprotective drugs. Those under development are, to the Company's knowledge, primarily aimed at specific elements of the toxic ischemic cascade. The Company believes that its approach to cytoprotective drug development is unique in that it seeks to pre-empt or reverse the entire cascade by decreasing the initial metabolic trauma which triggers it (i.e., ATP depletion). The Company believes that this approach is preferable to treating specific elements of the cascade, since it more comprehensively addresses the underlying pathology and should therefore result in more efficacious therapy.

Cardiovascular and Cerebrovascular Ischemia Drugs in Development-The Metabolism Program

The Company is starting a Phase III clinical trial on Cordox in sickle cell crisis patients. The Company has also released substantial amounts of data from its CABG trial of Cordox and its traumatic head injury trial of Ceresine and is planning Phase III trials in both of these indications.

Cordox. Cordox is a small phophoryllated sugar that the Company believes (based on extensive pre-clinical and mechanistic data) stimulates and maintains glycolysis in cells undergoing ischemia by circumventing the ischemia-induced blockage of this process. The drug also appears to inhibit various aspects of immune system activation which underlie reperfusion injury. The Company has licensed or obtained several issued U.S. patents which cover the use of Cordox in several acute ischemic indications and a U.S. patent on a novel formulation of Cordox.

There are numerous published U.S. and foreign clinical studies with Cordox, where more than 500 patients were administered the drug, indicating that Cordox is well tolerated in humans with little or no side effects. These studies indicate that the drug improves heart function and recovery in various ischemic situations where the heart is injured. In addition, 317 patients have participated in the four Phase II trials of Cordox under the Company's IND and the drug continues to be well tolerated.

A total of 125 CABG patients participated in the Company's double-blind, placebo-controlled Phase II trial, and the data released demonstrates that in patients receiving the active drug, Cordox (a) has a cardioprotective effect on heart muscle, (b) improves key parameters of heart function, including cardiac output, left ventricular stroke work index and cardiac index and (c) reduces the need for inotope support post-operatively in the intensive care unit (the "ICU") and results in shorter patient stays in the ICU.

In October 1997, the Company released positive data from a 47-patient double-blind, placebo-controlled, dose-ranging Phase II clinical trial with Cordox in sickle cell anemia crisis patients showing that the drug significantly reduced pain during crisis using two different measures of pain, the visual analog scale and the categorical assessment scale.

Ceresine. Ceresine is also a small non-peptide molecule which acts on glycolysis at a different site from Cordox. The Company has licensed or obtained two issued U.S. patents covering the use of Ceresine in cerebral ischemia. The Company believes that Ceresine stimulates a specific enzyme which is present in the membrane of mitochondria that removes a precursor of lactic acid (pyruvic acid) from the cytoplasm of the cell by transporting it into the mitochondria and converting it to acetyl coA. This results in a reduction of lactic acid in the cell. Increased post-ischemia accumulation of lactic acid is a major causal factor in the cessation of glycolysis, the resultant decrease in cellular ATP levels and eventual cell death. Numerous studies have shown that Ceresine reduces post-ischemia lactic acid levels in humans subjected to various traumatic events which would otherwise have resulted in increased lactic acid (lactic acidosis).

Ceresine has been employed by clinical investigators in patients on an experimental basis for the intravenous treatment of lactic acidosis. Published clinical studies and the Company's own Phase I data have established that Ceresine reduces serum lactic acid and exhibited no serious side effects at the dose levels in that study. It has also been shown in human studies to permeate the blood-brain barrier and to reduce brain lactic acid levels in congenital lactic acidosis patients.

The Company's Phase II clinical trial data on Ceresine in closed head injury patients showed that the drug crosses the blood-brain barrier at high levels and very quickly thereafter reduces brain lactate levels substantially. This effect lasted for at least 12

hours. Serum lactate levels were also reduced substantially in the drug-treated group. The strength of this data has led the Company to announce that it will pursue the Phase III development of Ceresine in this indication and in July 1998, the FDA granted expedited development status to Ceresine in head injury under Subpart E of the FDA regulations. In addition, the Company has completed enrollment in a Phase II clinical trial on Ceresine in stroke patients. 103 patients have participated in the Phase I and two Phase II trials of Ceresine under the Company's IND and the drug continues to be well tolerated.

Ischemia Drugs in Pre-clinical Research-The Metabolism and Excitotoxicity Programs

The Company is also seeking to develop new drugs for the treatment of ischemia-related disorders involving neurological damage, such as stroke, traumatic head injury, epilepsy and chronic neurodegenerative disorders such as Alzheimer's and Parkinson's disease. These pre-clinical research programs are focused on either the metabolic or the excitotoxicity aspects of ischemia therapeutics, and involve the chemical modification of identified lead molecules that regulate adenosine metabolism, various calcium ion channels on neuronal cells and chloride channels on glial cells.

Adenosine Metabolism Inhibitor Program. The Company is seeking to develop CPC-405 and certain of its derivatives, which are novel small molecules with demonstrated potency as inhibitors of adenosine metabolism. Adenosine is a natural cytoprotective agent which is generated in ischemic tissue and serves to protect cells from a variety of traumatic situations. Naturally generated adenosine is rapidly degraded by enzymes. The Company expects that CPC-405 will increase the level of adenosine in tissue traumatized by ischemia and thereby increase its cytoprotective effect. A U.S. patent has been issued on the composition of the CPC-400 series of drugs. During the past yeart, the Company licensed an additional U.S. patent from the University of Rhode Island which covers the composition of additional CPC-400 series compounds.

Neuronal Calcium Channel Blocker Program. The Company believes that the therapeutic approach to excitotoxicity currently attracting the most commercial attention involves the development of specific EAA receptor blockers which inhibit the excessive postsynaptic EAA action that is triggered by ischemia. Although these EAA receptor blockers have neuroprotective properties in cell culture and animal models of ischemia, their usefulness is hampered by toxic side effects associated with the blockage of EAA receptors and by the fact that there are multiple EAA receptor subtypes, all of which appear to cause post-ischemic damage when they are excessively stimulated. Also, a number of these EAA receptor blockers have recently failed in various stroke and head injury clinical trials.

The Company is seeking to develop new classes of drugs that are designed to remedy excitotoxicity in a potentially more complete and effective manner by reducing EAA release from nerve cells, thereby reducing the over-stimulation of all EAA receptor subtypes. This pre-synaptic approach to neuroprotection is viewed by the Company as potentially more effective than blocking receptors post-synaptically.

Specifically, the Company is seeking to develop separate classes of small-molecule drugs that act as neuronal calcium channel blockers, which it has labelled as the CPC-300, CPC-800 and CPC-8000 series and has synthesized over 100 compounds in this series. If successful, these drugs would have the ability to normalize or decrease EAA release and thereby comprehensively reduce the over-stimulation of EAA receptors. Prototype agents such as CPC-8027 have shown the desired effect of acting at the neuronal calcium channels, which controls EAA release. The Company has demonstrated neuroprotection in several pre-clinical models with CPC-304, CPC-317, CPC-877 and CPC-8027 and intends to further modify them structurally with the goal of improved drug delivery to the central nervous system. These modifications will require additional pre-clinical testing.

Glial Chloride Channel Blockers. The Company has synthesized a series of agents designated as the CPC-700 series. These agents act to inhibit glial cell swelling in the brain which occurs after injury in disorders such as stroke and head injury. These agents inhibit the excess release of EAAs from glial cells and have demonstrated neuroprotective properties. The Company is currently filing patents on these compounds.

Licenses

The Company believes its strategic objectives can best be met by combining its in-house research and development efforts with licenses and research collaborations with scientists at outside academic and clinical research centers.

The principal sources of the Company's existing licenses are:

Angel K. Markov, M.D.

Cordox. The Company has obtained an exclusive license from Dr. Markov to four U.S. patents covering the use of Cordox in a number of ischemic indications. As part of the license, the Company is funding clinical development in Dr. Markov's laboratories at the University of Mississippi Medical Center. In this regard, the Company has undertaken certain development obligations which must be met in order to maintain this license in force. In the event the Company breaches the license agreement, such as by not meeting certain milestones within the specified time periods or by failing to expend certain amounts in connection with clinical trials within specified time periods, the license will automatically terminate and all rights under the license and information acquired by the Company concerning any products based on the licensed technology will revert to Dr. Markov. In the event of such termination, the Company will retain the rights to market products for which sales occurred within the calendar year prior to the termination, and all other products and information related thereto based on the licensed technology will revert to Dr. Markov. To date, the Company has met all such milestones.

University of Cincinnati

Ceresine. The Company has an exclusive license from the University of Cincinnati ("UC") to a U.S. patent covering the use of Ceresine in cerebral ischemia. The Company has undertaken certain development obligations which must be met in order to maintain its rights in force. If certain milestones are not met by the Company within specified time periods, UC may, in its sole discretion, elect to continue the agreement, negotiate in good faith with the Company to modify the agreement or terminate the agreement upon 30 days' written notice in which event all rights under the license would revert to UC. To date, the Company has met all such milestones.

Manufacturing

The Company does not currently manufacture any of its acquired products or its products in development but is undertaking to manufacture the Dermaflo products. The finished forms of Glofil, Inulin, Ethamolin, Cordox and Ceresine are manufactured for the Company under contract by established manufacturers and alternative manufacturers have been qualified for Cordox and Ceresine. In the case of Inulin, Cordox and Ceresine, the Company is responsible for obtaining the bulk drug from a third party and delivering it to the finished goods manufacturer. In the case of Inulin and Ceresine, the Company has qualified alternative sources of supply for the bulk drug. There can be no assurance that any of the Company's bulk or finished goods contract manufacturers will continue to meet the Company's requirements for quality, quantity and timeliness or the FDA's current Good Manufacturing Practice ("cGMP") requirements or that the Company would be able to find a substitute bulk manufacturer for Cordox, or a substitute finished goods manufacturer for Inulin, Glofil and Ethamolin or any other of its products which would meet these requirements or that lots will not have to be recalled with the attendant financial consequences to the Company.

In addition, the Dermaflo product line is the Company's first attempt at in-house manufacturing of any of its products and there can be no assurance that the Kansas City facility will be completed, or when completed, will be approved by the FDA, or when approved will have the capacity to meet demand. Although the Company believes the facility will meet cGMP requirements, the Company has not manufactured any products using the Dermaflo technology yet in the facility. The Company also faces risks inherent in the operation of a single facility for the manufacture of Dermaflo products, including risks of unforeseen plan shutdowns due to personnel, equipment or other factors. Any delay in the manufacturing of Dermaflo products could result in delays of product shipments, which could have a material adverse effect on the Company's business, financial condition and results of operations. Further, the Company is relying on third parties to supply it with the active ingredients for the Neoflo and Sildaflo products in bulk form, and there can be no assurance that such third parties may not cause delays in the manufacture or shipments of these Dermaflo products.

The Company's limited manufacturing experience and its dependence

upon others for the manufacture of bulk or finished forms of its products may adversely affect the future profit margin, if any, on the sale of those products and the Company's ability to develop and deliver products on a timely and competitive basis. In the event the Company is unable to manufacture its products, directly or indirectly through others, on commercially acceptable terms, it may not be able to commercialize its products as planned.

Sales and Marketing

The Company currently has a director of marketing, a customer service representative, a product manager, a national sales manager and six field sales representatives for Glofil, Inulin and Ethamolin and is hiring additional sales representatives. The Company believes that it will be able to serve the hospital market in North America with a 50 to 70 person sales and marketing staff. There can be no assurance that the Company will be able to establish sales and distribution capabilities or be successful in gaining market acceptance for its drugs.

Competition

The Company faces competition from specialized biotechnology companies, pharmaceutical companies of all sizes, academic institutions, government agencies and public and private research organizations, many of which have extensive resources and experience in research and development, clinical testing, manufacturing, regulatory affairs, distribution and marketing. Some of these entities have significant research activities in areas upon which the Company's programs focus. Many of the Company's competitors possess substantially greater research and development, financial, technical, marketing and human resources than the Company and may be in a better position to develop, manufacture and market drugs. These entities may discover and develop drugs competitive with or superior to those developed by the Company.

Government Regulation

The manufacture and sale of the Company's products are subject to extensive regulation by United States and foreign governmental authorities prior to commercialization. In particular, drugs are subject to rigorous preclinical and clinical testing and other approval requirements by the FDA, state and local authorities and comparable foreign regulatory authorities. The process for obtaining the required regulatory approvals from the FDA and other regulatory authorities takes many years and is very expensive. There can be no assurance that any produuct developed by the Company will prove to meet all of the applicable standards to receive marketing approval in the United States or abroad. There can be no assurance that any such approvals will be granted on a timely basis, if at all. Delays and costs in obtaining these approvals and the subsequent compliance with applicable federal, state and local statutes and regulations could materially adversely affect the Company's ability to commercialize its products and its ability to receive sales revenues.

The research activities required by the FDA before a drug can be approved for marketing begin with extensive preclinical animal and laboratory testing. The tests include laboratory evaluation of product chemistry and animal studies for the safety and efficacy of the drug. The results of these studies are submitted to the FDA as part of an IND which is reviewed by the FDA prior to beginning clinical trials, first in normal volunteers and then in patients with the disease.

Clinical trials involve the administration of the investigational new drug to healthy volunteers or to patients, under the supervision of a qualified physician/principal investigator. Clinical trials are conducted in accordance with governmental statutes, regulations and guidelines and under protocols that detail the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Each protocol must be submitted to the FDA as part of the IND. Further, each clinical study must be evaluated by an independent Institutional Review Board ("IRB") at the institution at which the study will be conducted. The IRB considers, among other things, ethical factors, the safety of human subjects and the possible liability of the institution, and approves the informed consent to be obtained from all subjects and patients in the clinical trials. The Company will have to monitor the conduct of clinical investigators in performing clinical trials and their compliance with FDA requirements.

Clinical trials are typically conducted in three sequential phases (Phase I, Phase II and Phase III), but such phases may

overlap. There can be no assurance that Phase I, Phase II or Phase III testing will be completed successfully within any specified time period, if at all, with respect to any of the Company's drugs. Furthermore, the Company or the FDA may suspend clinical trials at any time if it is felt that the subjects or patients are being exposed to an unacceptable health risk or that the investigational product lacks any demonstrable efficacy.

The results of the pharmaceutical development, preclinical studies and clinical studies are submitted to the FDA in the form of a New Drug Application ("NDA") for approval of the marketing and commercial shipment of the drug. The testing and approval process is likely to require substantial time (frequently five to eight years or more) and expense and there can be no assurance that any approval will be granted on a timely basis, if at all. The FDA may deny an NDA if applicable regulatory criteria are not satisfied, require additional testing or information, or require post-marketing testing and surveillance to monitor the safety of the Company's drugs. Notwithstanding the submission of the NDA and any additional testing data or information, the FDA may ultimately decide that the application does not satisfy its regulatory criteria for approval. Finally, drug approvals may be withdrawn if compliance with labeling and cGMP regulatory standards is not maintained or if unexpected safety problems occur following initial marketing.

Among the conditions for clinical studies and NDA approval is the requirement that the prospective manufacturer's quality control and manufacturing procedures conform to cGMP, which must be followed at all times. In complying with standards set forth in these regulations, manufacturers must continue to expend time, monies and effort in the area of production and quality control to ensure full technical compliance.

Also, the Prescription Drug Act of 1997 requires that companies engaged in pharmaceutical development, such as the Company, pay user fees of at least $100,000 upon submission of an NDA. In addition to regulations enforced by the FDA, the Company is subject to regulation under the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act, the Resource Conservation and Recovery Act and other present and potential future federal, state or local regulations. For marketing outside the United States, the Company is subject to foreign regulatory requirements governing human clinical trials and marketing approval for drugs. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursement vary widely from country to country.

Patents and Proprietary Rights

The Company's success may depend in large measure upon its ability to obtain patent protection for its products, maintain confidentiality and operate without infringing upon the proprietary rights of third parties. The Company has obtained patent coverage, either directly or through licenses from third parties, for certain of its products. The Company currently owns or has licensed a total of 13 U.S and foreign patents covering Cordox and Ceresine in a variety of ischemic disorders. It also holds an exclusive license to 5 U.S. and foreign patents on the Dermaflo technology, 2 issued U.S. patents on adenosine metabolism inhibitors, 2 issued U.S. patents on the use of disulfiram in ischemic disorders and an issued U.S. patent of aminoglycosides as neuroprotective agents.

In addition to the patents issued and allowed as mentioned above, the Company has also filed several other patent applications in the United States and abroad on its various products and expects to file additional applications in the future. There can be no assurance that any of these patent applications will be approved, except where claims have already been examined and allowed, or that the Company will develop additional proprietary products that are patentable. Nor can there be any assurance that any patents issued to the Company or its licensors will provide the Company with any competitive advantages or will not be challenged by third parties or that patents issued to others will not have an adverse effect on the ability of the Company to conduct its business. Furthermore, because patent applications in the United States are maintained in secrecy until issue, and because publication of discoveries in the scientific and patent literature often lag behind actual discoveries, the Company cannot be certain that it was the first chronologically to make the inventions covered by each of its pending U.S. patent applications, or that it was the first to file patent applications for such inventions. In the event that a third party has also filed a U.S. patent application for any of its inventions, the Company may have to participate in interference proceedings declared by the United States Patent and Trademark Office to determine priority of the invention, which could result

in substantial cost to the Company, even if the eventual outcome is favorable to the Company. In addition, there can be no assurance that the Company's U.S. patents, including those of its licensors, would be held valid by a court of law of competent jurisdiction. If patents are issued to other companies that contain competitive or conflicting claims which ultimately may be determined to be valid, there can be no assurance that the Company would be able to obtain a license to any of these patents.

Under Title 35 of the United States Code, as amended by the General Agreement on Tariffs and Trade implementing the Uruguay Round Agreement Act of 1994 ("GATT"), patents that issue from patent applications filed prior to June 8, 1995 will enjoy a 17-year period of enforceability as measured from the date of patent issue while those that issue from applications filed on or after June 8, 1995 will enjoy a 20-year period of enforceability as measured from the date the patent application was filed or the first claimed priority date, whichever is earlier. Patents that issue from applications filed on or after June 8, 1995 may be extended under the term extension provisions of GATT for a period up to five years to compensate for any period of enforceability lost due to interference proceedings, government secrecy orders or appeals to the Board of Patent Appeals or the Federal Circuit.

Under the Drug Price Competition and Patent Term Restoration Act of 1984, including amendments implemented under GATT (the "Patent Term Restoration Act"), the period of enforceability of a first or basic product patent or use patent covering a drug may be extended for up to five years to compensate the patent holder for the time required for FDA regulatory review of the product. This law also establishes a period of time following FDA approval of certain drug applications during which the FDA may not accept or approve applications for similar or identical drugs from other sponsors. Any extension under the Patent Term Restoration Act and any extension under GATT are cumulative. There can be no assurance that the Company will be able to take advantage of such patent term extensions or marketing exclusivity provisions of these laws. While the Company cannot predict the effect that such changes will have on its business, the adoption of such changes could have a material adverse effect on the Company's ability to protect its proprietary information and sustain the commercial viability of its products. Furthermore, the possibility of shorter terms of patent protection, combined with the lengthy FDA review process and possibility of extensive delays in such process, could effectively further reduce the term during which a marketed product could be protected by patents.

The Company also relies on trade secrets and proprietary know-how. The Company has been and will continue to be required to disclose its trade secrets and proprietary know-how to employees and consultants, potential corporate partners, collaborators and contract manufacturers. Although the Company seeks to protect its trade secrets and proprietary know-how, in part by entering into confidentiality agreements with such persons, there can be no assurance that these agreements will not be breached, that the Company would have adequate remedies for any breach or that the Company's trade secrets will not otherwise become known or be independently discovered by competitors.

Scientific Advisory and Clinical Trials Advisory Boards

Scientific Advisory Board

The Company currently has a Scientific Advisory Board ("SAB") whose members periodically advise the Company with respect to the Company's scientific research and development programs. The SAB does not meet as a group; rather, individual members are contacted for advice on an as-needed basis. The members are compensated through the grant of stock options and, if meetings are held, will receive fees for attending meetings as well as reimbursement for expenses. The Company has hired certain SAB members to perform services for the Company such as assay development and compound preparation.

The members of the Company's SAB are:

Name and Affiliation	Area of Expertise
Chung Hsu, M.D., Ph.D. Director of Stroke Clinical Trials, Washington University, St. Louis School of Medicine	Animal models of stroke/clinical trials
Ronald Hayes, Ph.D. Professor of Neurosurgery, University of Texas, Houston	Animal models of head trauma

Bruce P. Bean, Ph.D. Professor of Neurobiology, Harvard University	Neuronal ion channels
Robert Parks, M.D., Ph.D. Professor Emeritus of Pharmacology, Brown University	Biochemical pharmacology
John Olney, M.D. Professor of Psychiatry and Neuropathology, Washington University, St. Louis	Excitotoxicity; animal models of stroke
Edward J. Cragoe, Ph.D. Former Senior Director of Medicinal Chemistry, Merck Sharp & Dohme Research Laboratories	Medicinal chemistry/ion channels
K.C. Nicolaou, Ph.D. Head of Chemistry, The Scripps Research Institute Professor of Chemistry, University of California, San Diego	Medicinal chemistry
Harold Kimelberg, Ph.D. Professor, Division of Neurology, Albany Medical College	Glial cell release of glutamate
Elie Abushanab, Ph.D.	Medicinal chemistry/ adenosine
Thomas J. Maloney President, The Iso-Tex Companies, Friendswood, Texas	Radioisotopes/Nuclear Medicine
Claude Wasterlain, M..D. Chief of Neurology Services, Sepulveda VA Medical Center, Professor of Neurology, University of California Los Angeles	Stroke and epilepsy

Clinical Trials Advisory Boards

The Company has assembled two Clinical Trials Advisory Boards ("CTABs"), composed of physician "thought leaders" in the cardiology and neurology area, to assist in the planning, design and execution of the Company's clinical trials involving Cordox and Ceresine. The individuals who constitute each of the CTABs are paid consultants to the Company and are listed below:

Cardiovascular Clinical Trials Advisory Board

Eric J. Topol, M.D. (Chair)
Chairman, Department of Cardiology,
Director, Center for Thrombosis and Vascular Biology,
Cleveland Clinic and Foundation

David R. Holmes, Jr., M.D.
Associate Professor of Medicine,
Mayo Clinic Medical School

Robert M. Califf, M.D.
Associate Professor of Medicine,
Duke University Medical Center

Cerebrovascular Clinical Trials Advisory Board

William G. Barsan, M.D. (Chair)
Director of Emergency Medicine,
University of Michigan Medical School

Patrick M. Kochanek, M.D.
Safar Center for Resuscitation Research
University of Pittsburgh
Pittsburgh, Pennsylvania

Randall M. Chestnut, M.D.
Oregon Health Sciences Center
School of Medicine, Division of Neurosurgery
Portland, Oregon

Patrick D. Lyden, M.D.
Chief, Stroke Clinic
University of California, San Diego

Charles F. Contant, Jr., Ph.D.
Baylor College of Medicine

Department of Neurosurgery
Houston, Texas

Anthony Marmarou, Ph.D.
Medical College of Virginia
Division of Neurosurgery
Richmond, Virginia

The members of the SAB and the CTABs may be employed by or have consulting agreements with entities other than the Company, some of which may compete with the Company. These other obligations may limit the availability of the members to the Company. Most are not expected to participate actively in the Company's development. Certain of the institutions with which the members are affiliated may have regulations or policies which are unclear with respect to the ability of such persons to act as part-time consultants or in other capacities for a commercial enterprise. Regulations or policies now in effect or adopted in the future may limit the ability of the members to consult with the Company. The loss of the services of certain of the members could adversely affect the Company.

Furthermore, inventions or processes discovered by the SAB and CTAB members will not, unless otherwise agreed, become the property of the Company but will remain the property of such persons or of their full-time employers. In addition, the institutions with which the members are primarily affiliated may make available the research services of their scientific and other skilled personnel, including the members, to entities other than the Company. In rendering such services, such institutions may be obligated to assign or license to a competitor of the Company patents and other proprietary information which may result from such services, including research performed by a member for a competitor of the Company.

Scientific and Other Personnel

As of October 26, 1998, the Company had 42 full-time employees, eight of whom hold Ph.D. degrees, two of whom also hold an M.D. degree and one of whom holds a J.D. degree. Twelve of the full-time employees are employed in finance and general administration, seven in clinical and regulatory affairs, eight in quality control and quality assurance, four in pre-clinical research and development, and eleven in sales and marketing, customer service and business development. The Company believes that it maintains good relations with its employees.

Executive Officers of Registrant

Set forth below is certain information with respect to the executive officers of the Company at October 26, 1998:

Name	Age	Position
Paul J. Marangos, Ph.D.	51	Chairman of the Board, President and Chief Executive Officer
Zofia E. Dziewanowska, Ph.D, M.D.	59	Senior Vice President, Drug Development and Regulatory Affairs
David W. Nassif, J.D.	44	Senior Vice President, Chief Financial Officer and Secretary
Larry A. Risen	36	Vice President of Corporate Development
Brian W. Sullivan	39	Vice President of Product Development

Paul J. Marangos, Ph.D., has been President and Chairman of the Board since he founded the Company in November 1990. In February 1993, he became Chief Executive Officer. From April 1988 to November 1990, he was Senior Director of Research at Gensia Pharmaceuticals, Inc., a biotechnology company. From 1980 to 1988, he was Chief of Neurochemistry in the Biological Psychiatry Branch, National Institute of Mental Health. Dr. Marangos obtained his doctorate in biochemistry from the University of Rhode Island and did his post-doctoral work at the Roche Institute of Molecular Biology. He has published 250 research papers and four books in the field of biochemistry and pharmacology, the most recent of which is entitled Emerging Strategies in Neuroprotection. He is a member of the Society for Neuroscience and the American Academy for the Advancement of Science. Dr. Marangos is the founding editor of the Journal of Molecular Neuroscience published by Humana Press.

Zofia E. Dziewanowska, Ph.D., M.D., joined the Company in October 1997 as the Senior Vice President of Drug Development and Regulatory Affairs. From May 1994 to October 1997, she was the Senior Vice President, Global Clinical Affairs, of Genta

Incorporated ("Genta"), a publicly-traded pharmaceutical company principally engaged in developing a proprietary drug delivery technology to develop oral controlled-release formulations. Prior to joining Genta, Dr. Dziewanowska spent 17 years at Hoffman-La Roche in various research and development positions, including Vice President and Director of International Therapeutic Research and Medical Affairs Advisor. Dr. Dziewanowska currently holds a faculty appointment at the Cornell University Medical School. She also has held various positions in the Pharmaceutical Research and Manufacturers Association of America, the most recent being a Vice-Chairman of the Medical Section Steering Committee, American Association of Pharmaceutical Physicians and the International Federation of Pharmaceutical Medicine. Dr. Dziewanowska received an M.D. degree from the University of Warsaw Medical School and a Ph.D. in physiology from the Institute of Immunology and Experimental Therapeutics, Polish Academy of Science.

David W. Nassif, J.D., joined the Company in August 1993 as Vice President, Chief Financial Officer and Secretary, and was promoted to Senior Vice President in September 1997. From January 1993 to August 1993, he was a consultant to various public and private companies in the areas of capital raising, mergers and acquisitions, investor relations and securities law compliance. From July 1992 to January 1993, he was the Vice President, Chief Financial Officer and Assistant Secretary of 999, Inc., a diversified manufacturing and environmental services company. From December 1987 to July 1992, he was the Vice President and Assistant Secretary of Showscan Corporation, a technology company. Mr. Nassif holds honors finance, management information systems and law degrees from the University of Virginia.

Larry A. Risen joined the Company in November 1994 as Associate Director of Business Development, was promoted to Director of Business Development in August 1995 and to Vice President of Corporate Development in September 1998. From August 1990 to November 1994, Mr. Risen was employed at Gen-Probe, Inc., a developer, manufacturer and marketer of diagnostic tests; first as Product Manager from August 1990 to November 1993 and as Marketing Manager from November 1993 to November 1994. Mr. Risen holds a B.Sc. degree in Biology from the University of Iowa.

Brian W. Sullivan, Ph.D., joined the Company in April 1994 as Associate Director, Chemistry, was promoted to Director of Pharmaceutical Chemistry in November 1995 and to Vice President of Product Development in September 1998. From 1985 to April 1994, Dr. Sullivan was employed at Hybritech, Inc., a developer, manufacturer and marketer of in vitro diagnostic products; first as Research Scientist from 1985 to 1991 and then as a Scientific Investigator from 1991 to 1994. Dr. Sullivan holds a B.A. in Chemistry and a Ph.D. in Marine Natural Products Chemistry from the University of California, San Diego.

Item 2. Properties.

The Company leases two buildings in Carlsbad, California at a total monthly rental of $37,651. All of the Company's operations are located in 18,339 square feet of space located at 2714 Loker Avenue West (the "2714 Space"). In April 1997, the Company subleased its other building at 2732 Loker Avenue West (the "2732 Space") to another pharmaceutical company (the "Subtenant").

The Company has leases on two floors in the 2714 Space, one of which commenced in April 1996 and has a term of 69 months, and the other of which commenced in November 1996 and has a term of 61 months. The lease on the 2732 Space commenced in December 1993 and has a term of 81 months. Both leases have clauses providing for rent increases at various points in time during the terms of the leases. The Subtenant's lease covers the remainder of the Company's original lease term plus a 36-month option, and the Subtenant's rental payments to the Company exceed the Company's rental payments to the landlord. In addition, the sublease provides for annual rent increases. Under the sublease, the Company spent approximately $200,000 on tenant improvements (the "Tenant Improvement Obligation") to the 2732 Space, however, the net present value of the Subtenant's rental payments over the term of the sublease greatly exceeds the Tenant Improvement Obligation.

Item 3. Legal Proceedings.

In July 1998, the Company was served with a complaint in the United States Bankruptcy Court for the Southern District of New York by the Trustee for the Liquidation of the Business of A.R. Baron & Co., Inc. ("A.R. Baron") and the Trustee of The Baron Group, Inc. (the "Baron Group"), the parent of A.R. Baron. The complaint alleges that A.R. Baron and the Baron Group made

certain preferential or fraudulent transfers of funds to the Company prior to the commencement of bankruptcy proceedings involving A.R. Baron and the Baron Group. The Trustee is seeking return of the funds, totalling $3.2 million. The Company believes that the Trustee's claims are unfounded and intends to contest the allegations in the complaint vigorously. The Company contends that the transfers challenged by the Trustee relate to (i) the exercise by A.R. Baron in 1995 of unit purchase options issued to it in 1992 as part of its negotiated compensation for underwriting the Company's initial public offering and (ii) the repayment by the Baron Group of the principal and interest (at 12% per annum) payments and certain loan extension fees related to certain collateralized loans made to it by the Company in 1995 and 1996. The Company believes that it has insurance coverage sufficient to cover any costs, expenses or losses that might be incurred in connection with this action.

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

No matters were submitted to a vote of the Company's security holders during the fourth quarter of the fiscal year ended July 31, 1998.

PART II.

Item 5. Market for Registrant's Common Equity and Related Shareholder Matters.

The Common Stock of the Company was quoted on the Nasdaq National Market System under the symbol "CYPR" until January 1998. In January 1998, the Company was listed on the American Stock Exchange, Inc. under the symbol "CYP". The Redeemable Class B Warrants of the Company were also quoted on the Nasdaq National Market System under the symbol "CYPRZ" until November 3, 1997, when they expired.

The following table sets forth for the calendar quarters indicated, the high and low sales prices of the Common Stock on the Nasdaq National Market System and the American Stock Exchange, Inc., as reported in published financial sources, for the periods that the Common Stock was quoted or listed.

Year ended July 31, 1998	High	Low
First Quarter	$6.12	$3.75
Second Quarter	$6.00	$3.81
Third Quarter	$4.75	$3.50
Fourth Quarter	$5.43	$3.37
Year ended July 31, 1997	**High**	**Low**
First Quarter	$5.75	$3.48
Second Quarter	$5.75	$3.63
Third Quarter	$5.88	$4.00
Fourth Quarter	$5.81	$4.00

The last sales price of the Common Stock on October 26, 1998 was $2.375.

According to a survey of non-objecting beneficial owners as of August 23, 1998, there were 2,373 beneficial owners of the Common Stock.

The Company has not paid any dividends since its inception and does not intend to pay any dividends on its Common Stock in the foreseeable future.

Item 6. Selected Financial Data.

The following table sets forth certain financial data with respect to the Company. The selected financial data should be read in conjunction with the Company's Financial Statements (including the Notes thereto) and "Management's Discussion and Analysis of Financial Condition and Results of Operations" appearing elsewhere in this Report.

	Years Ended July 31,				
	1994	1995	1996	1997	1998
	(in thousands, except per share data)				
Statement of					

Operations Data:					
Net sales	$ -	$ -	$ 1,275	$ 2,428	$ 3,446
Gross profit	-	-	870	1,890	2,675
Total operating expenses	2,565	3,910	4,988	7,466	9,139
Loss from operations	(2,565)	(3,910)	(4,118)	(5,576)	(6,464)
Other income (expense), net	190	797	1,028	(1,099)	891
Net loss	(2,375)	(3,113)	(3,090)	(6,675)	(5,573)
Net loss per share - basic and diluted	(0.32)	(0.32)	(0.27)	(0.54)	(0.37)
Shares used in computing net loss per share - basic and diluted	7,358	9,860	11,518	12,303	15,187

	At July 31,				
Balance Sheet Data:	1994	1995	1996	1997	1998
	(in thousands)				
Cash, cash equivalents and short-term investments	$ 5,666	$13,442	$15,997	$14,567	$13,444
Working capital	5,284	12,934	15,384	13,076	13,378
Total assets	6,206	14,175	20,266	21,345	19,736
Long-term debt	240	195	6,624	4,176	217
Common stock	9,927	20,945	23,421	32,345	41,328
Accumulated deficit	(4,279)	(7,392)	(10,482)	(17,157)	(22,730)
Total shareholders' equity	5,476	13,366	12,635	15,026	18,511

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Except for the historical information contained herein, the following discussion contains forward-looking statements that involve risks and uncertainties, including statements regarding the period of time during which the Company's existing capital resources and income from various sources will be adequate to satisfy its capital requirements. The Company's actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in this section, as well as in the sections entitled "Business", "Licenses", "Manufacturing", "Sales and Marketing", "Competition", "Government Regulation", "Patents and Proprietary Rights", those discussed in the S-3 Registration Statement File No. 333-25661 filed with U.S. Securities and Exchange Commission, as well as those discussed in any documents incorporated by reference herein or therein.

The Company was founded in 1990, commenced its research and development activities in 1991, completed an initial public offering (the "IPO") in November 1992, commenced clinical trials in December 1994, acquired two FDA-cleared products, Glofil and Inulin, (the "Acquisitions") in August 1995, acquired a third FDA-cleared product, Ethamolin, in November 1996, and acquired the Dermaflo technology in November 1997. The Company has sustained an accumulated deficit of $22,730,000 from inception through July 31, 1998. As the Company will not have positive net operating cash flow for the next few years and the Company's research and development, clinical testing and regulatory, sales and marketing and general and administrative expenses during these years will be substantial and increasing, the Company expects to incur increasing losses for the foreseeable future.

Results of Operations

Year ended July 31, 1998 compared to year ended July 31, 1997

During the fiscal year ended July 31, 1998, the Company sustained a loss of $5,573,000 (or $.37 per share, basic and diluted) compared to a loss of $6,675,000 (or $.54 per share, basic and diluted) for the prior fiscal year. Gross profit for 1998 of $2,676,000 on sales of Glofil, Inulin and Ethamolin, plus other income of $1,150,000 (interest, grant, and rental income) were offset by $9,139,000 in expenses for sales and marketing, general and administrative, clinical testing and regulatory, pre-clinical research and development and depreciation and amortization and $259,000 in amortization of discount and costs on its mandatorily convertible notes (the "Notes"). During the prior fiscal year, the gross profit of $1,890,000 on sales of Glofil and Inulin and other income of $761,000 (principally interest income) was offset by $7,465,000 in expenses for sales and marketing, general and administrative, clinical testing and regulatory, and pre-clinical

research and development as well as depreciation and amortization.

During the third quarter, the Company announced that its largest Glofil customer had informed the Company that it would be terminating two clinical trials which require Glofil to be used as part of their protocols. Those trials have terminated and as stated previously in the third quarter, the Company expects the loss of sales to this customer to slow the rate of overall sales growth for the next six to nine months.

Sales and marketing expense increased by 31.8% to $1,310,000 from $994,000 in the prior year, principally as a result of additional promotional costs for Glofil and increased payroll expense from pay raises and the hiring of additional personnel.

General and administrative expense increased by 35.5% to $3,247,000 from $2,396,000 in the prior year. Approximately 52% of the increase was due to the expenditures related to acquiring the Dermaflo technology and scaling up the manufacturing of the Dermaflo products. Sometime during the fiscal year ending July 31, 1999, the Company expects to have at least one Dermaflo product available for sale at which point most of the ongoing Dermaflo expense will be accounted for as cost of sales and the Company's gross profit margin on both an absolute and percentage basis will suffer until sales of the Dermaflo products reach a certain level. The remainder of the increase reflected increased legal fees.

Clinical testing and regulatory expense increased by 28.2% to $2,521,000 from $1,967,000 in the prior year, principally as the result of increased staffing in the quality assurance/quality control department, increased use of data input and management, statistical and other consultants to accelerate, finish and report on the Company's various clinical trials and certain toxicology studies performed during the period.

Pre-clinical research and development expense decreased by 20.4% to $822,000 from $1,032,000 in the prior year, principally due to a decrease in staffing and the completion of certain contract studies.

Depreciation and amortization expense increased by 15.3% to $1,239,000 from $1,075,000 in the prior year, principally as a result of the acquisition of Ethamolin during the prior year and the related amortization of that purchased technology.

Sublease income increased 100% to $171,062 in the current year due to the sublease of the Company's former corporate headquarters. Interest and other income increased by 22.2% to $809,000 from $662,000 in the prior year, principally due to the additional interest earned on the proceeds from the exercise of the Company's Redeemable Class B Warrants in November 1997. Research and grant income increased 71.7% to 170,000 from 99,000 in the prior year, principally due to the receipt of two additional Small Business Innovation Research grants during the current year versus the receipt of one in the prior year. The amortization of discount and costs on the Notes decreased 86.1% to $259,000 from $1,860,000 in the prior year. The majority of the principal amount of the Notes was converted in the prior year, and thus, a larger amount of amortization expense occurred. The remaining principal balance of the Notes was converted in the current year.

Year ended July 31, 1997 compared to year ended July 31, 1996

During the fiscal year ended July 31, 1997, the Company sustained a loss of $6,675,000 (or $.54 per share, basic and diluted) compared to a loss of $3,090,000 (or $.27 per share, basic and diluted) for the prior fiscal year. The gross profit of $1,890,000 on sales of Glofil, Inulin and Ethamolin and other income of $761,000 (principally interest income) during the 1997 fiscal year were offset by $7,465,000 in expenses for sales and marketing, general and administrative, clinical testing and regulatory, pre-clinical research and development and depreciation and amortization and $1,860,000 in amortization of discount and costs on the Notes. During the 1996 fiscal year, the gross profit of $870,000 on sales of Glofil and Inulin and other income of $1,028,000 (principally interest income) was offset by $4,988,000 in expenses for sales and marketing, general and administrative, clinical testing and regulatory, pre-clinical research and development and depreciation and amortization.

Sales and marketing expense increased by 190% to $994,000 in fiscal 1997 from $343,000 in fiscal 1996, principally as a result of increased payroll expense from the hiring of additional field sales representatives, a product manager and an administrative assistant, and related travel, hotel and meal costs.

General and administrative expense increased by 46% to $2,396,000 in fiscal 1997 from $1,642,000 in fiscal 1996. Approximately 38% of the increase was due to the commencement of a comprehensive investor relations program and the remainder reflected the impact of the expansion of the Company's activities on personnel, consulting, business development, investment banking, rent, travel and meals, legal and accounting fees and insurance.

Clinical testing and regulatory expense increased 41.7% to $1,967,000 in fiscal 1997 from $1,389,000 in fiscal 1996, principally as the result of increased site costs and use of data input and management, statistical and other consultants to accelerate, finish and report on the Company's various clinical trials.

Depreciation and amortization expense increased 75.6% to $1,075,000 from $612,000 in the prior year, principally as a result of the acquisition of Ethamolin during the 1997 fiscal year and the related amortization of that purchased technology.

During the 1997 fiscal year, the Company recognized $1,860,000 of expense related to the amortization of (i) the discount on the Notes and (ii) the deferred financing costs related to the private placements of the Notes. This resulted from the re-classification of the Notes from equity to debt resulting from a review of the Company's various filings under the Securities Exchange Act of 1934 by the Securities and Exchange Commission triggered by the filing of a registration statement during the year pertaining to the resale of the Common Stock underlying some of the Notes.

Liquidity and Capital Resources

The Company has principally funded its activities to date through various issuances of equity securities, which have raised total net proceeds of $35.0 million, as well as product sales.

At July 31, 1998, the Company had cash, cash equivalents and short-term investments of $13,444,000 compared to $14,567,000, at July 31, 1997. At July 31, 1998, working capital was $13,378,000, compared to $13,076,000 at July 31, 1997. The increase in both balance sheet items was principally due to the receipt of net proceeds of $4,708,000 from the exercise of 856,026 the Company's Redeemable Class B Warrants prior to their expiration in November 1997, offsetting the Company's cash spent on operations for the year.

The Company expects that its cash needs will increase significantly in future periods due to expansion of its research and development programs, increased clinical testing activity, growth of administrative, clinical and laboratory staff and their related equipment and space needs. Management believes that the Company's working capital will be sufficient to fund the operations of the Company for approximately 24 months dependent, in part, on the timing of the commencement of each phase of the clinical trials on Cordox and Ceresine and the funding priorities that it gives its various research programs, the results of clinical tests and research programs; competing technological and market developments; the time and costs involved in obtaining regulatory approvals and in obtaining, maintaining and enforcing patents; the cost of product acquisitions and their resulting cash flows and other factors.

The Company expects to seek additional funds through exercises of its currently outstanding options, public or private equity financings, collaborations or from other sources. There can be no assurance that funds can be obtained on desirable terms or at all. The Company may seek to raise additional capital whenever conditions in the financial markets are favorable, even if the Company does not have an immediate need for additional cash at that time.

Impact of the Year 2000 Issue

The Year 2000 problem is the result of computer applications being written using two digits rather than four digits to define the applicable year. Any of the Company's computer applications (and computer applications used by any of the Company's customers, collaborators and manufacturers) that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in system failures or miscalculations causing disruption of operations.

The Company has modified or replaced portions of its software so that its computer systems will function properly with respect to dates in the year 2000 and thereafter. The costs associated with such modifications were not materially significant. The Company

believes that, with these modifications to existing software and conversions to new software, the Year 2000 problem will not pose significant operational problems for its computer systems. However, because of the many uncertainties associated with Year 2000 compliance issues, and because the Company's assessment is necessarily based on information from third-party customers, collaborators and manufacturers, there can be no assurance that the Company's assessment is correct or as to the materiality or effect of any failure of such assessment to be correct.

The Company has initiated a program to determne whether the computer applications of its significant customers, collaborators and manufacturers will be upgraded in a timely manner. The Company has not completed its review and it is unknown whether the computer applications of its customers, collaborators and manufacturers will be Year 2000 compliant. The Company has not determined the extent to which any disruption in the computer applications of third parties caused by the Year 2000 issues will affect the Company's operations. However, any disruptions in payments by customers or in the manufacture of the Company's products could have a material adverse effect upon the Company's business, financial condition and results of operations.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk.

The Company invests its excess cash in interest-bearing investment-grade securities. The Company holds all such securities for the remaining term of the security. Therefore, the Company believes that it is not subject to material interest rate risks on such investments, other than the creditworthiness of the issuer of such securities. In addition, the Company does not utilize market risk sensitive instruments, positions or transactions in any material fashion and does not believe it maintains any material exposure to such market risk sensitivities.

Item 8. Financial Statements and Supplementary Data.

The Financial Statements of the Company and Report of Ernst & Young LLP, Independent Auditors are filed as exhibits hereto, listed under Item 14 of this Report and incorporated herein by reference.

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

None.

PART III.

Item 10. Directors and Executive Officers of the Registrant.

The information regarding directors is hereby incorporated by reference to the section entitled "Election of Directors" in the Company's definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Company's 1999 Annual Meeting of Shareholders (the "Proxy Statement").

The information regarding executive officers appears under the section entitled "Executive Officers of Registrant" appearing in Item 1 of Part I of this Report.

Item 11. Executive Compensation.

The information required by this item is hereby incorporated by reference to the section entitled "Executive Compensation" in the Proxy Statement.

Item 12. Security Ownership of Certain Beneficial Owners and Management.

The information required by this item is hereby incorporated by reference to the section entitled "Security Ownership of Certain Beneficial Owners and Management" in the Proxy Statement.

Item 13. Certain Relationships and Related Transactions.

The information required by this item is hereby incorporated by reference to the section entitled "Transactions with Related Parties" in the Proxy Statement.

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

(a) (1)(2) Financial Statements and Schedules.
The financial statements are incorporated herein by reference from Exhibit 99.1, which begins with the Table of Contents on

(a) (3) Exhibits.

See Exhibit Index on page 32.

The following management compensation plans and arrangements are required to be filed as exhibits pursuant to Item 14(c) of this report.

Exhibit Number	Description
10.1	Forms of Incentive Stock Option and Nonstatutory Stock Option.*
10.2	Amended 1992 Stock Option Plan.
10.3	Employment Agreement, dated July 10, 1991 as amended and restated September 1, 1992, between the Registrant and Paul J. Marangos, Ph.D. *
10.4	Amendment No. 1 to Employment Agreement, dated May 9, 1994, between the Registrant and Paul J. Marangos, Ph.D.**
10.5	Amendment No. 2 to Employment Agreement, dated March 9, 1995, between the Registrant and Paul J. Marangos, Ph.D.***
10.6	Amendment No. 3 to Employment Agreement, dated October 1, 1996, between the Registrant and Paul J. Marangos, Ph.D.****
10.7	Employment Agreement dated December 6, 1997 between the Registrant and Zofia E. Dziewanowska, M.D., Ph.D.*****
10.8	1993 Non-Employee Directors Stock Option Plan and related form of Nonstatutory Stock Option. ******

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* Filed as an exhibit to the Registrant's Registration Statement on Form S-1, Registration No. 33-51682, and incorporated herein by reference.

** Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1994.

*** Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1995.

**** Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1996.

***** Filed as an exhibit to the Registrant's Form 10-Q for the period ended October 31, 1997.

****** Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1993.

(b) Reports on Form 8-K.

There were no reports on Form 8-K filed during the fourth quarter of 1998.

(c) Exhibits.

The exhibits required by this Item are listed under Item 14 (a)

(3).

(d) Financial Statement Schedules.

No financial statement schedules are required.

SIGNATURES

Pursuant to the requirements 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, in the City and County of San Diego, State of California, on the 26th day of October, 1998.

CYPROS PHARMACEUTICAL CORPORATION
By /s/ Paul J. Marangos
- ----------------------
Paul J. Marangos
Chairman of the Board,
President and Chief Executive Officer

POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Paul J. Marangos, and David W. Nassif, and each of them, his attorney-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this report, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

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

Signature	Title	Date
/s/ Paul J. Marangos - -------------------- Paul J. Marangos	Chairman of the Board, President and Chief Executive Officer and Director (Principal Executive Officer)	October 26, 1998
/s/ David W. Nassif - -------------------- David W. Nassif	Senior Vice President, Chief Financial Officer and Secretary (Principal Financial and Accounting Officer)	October 26, 1998
/s/Robert F. Allnutt - -------------------- Robert F. Allnutt	Director	October 26, 1998
/s/ Digby W. Barrios - -------------------- Digby W. Barrios	Director	October 26, 1998
/s/ Virgil Thompson - -------------------- Virgil Thompson	Director	October 26, 1998
/s/Robert A.Vukovich - -------------------- Robert A. Vukovich	Director	October 26, 1998

Exhibit Index

Exhibit Number	Description
2.1 (1)	Pharmaceutical Products Purchase and Distribution Support Agreement as of August 9, 1995 by and among Iso-Tex Diagnostics, Inc., Cypros Pharmaceutical Corporation and Thomas J. Maloney. (2)
2.2 (1)	Glofil Contract Manufacturing and Royalty Agreement as of August 9, 1995 by and among Iso-Tex Diagnostics, Inc., Cypros Pharmaceutical Corporation and Thomas J. Maloney. (2)
2.3 (1)	Merger Agreement as of August 9, 1995 among Cypros Pharmaceutical Corporation, Iso-Tex Diagnostics "B", Inc. and Jean and Thomas Maloney. (2)
2.4 (3)	Asset Purchase Agreement by and among Cypros Pharmaceutical Corporation and Schwarz Pharma, Inc. dated as of October 31, 1996
2.5 (3)	Note and Security Agreement by and among Cypros Pharmaceutical Corporation and Schwarz Pharma, Inc. dated November 4, 1996
2.6 (3)	Assumption Agreement by and among Schwarz Pharma, Inc. and Cypros Pharmaceutical Corporation dated November 4, 1996
2.7 (3)	Trademark Assignment by and among Schwarz Pharma, Inc. and Cypros Pharmaceutical Corporation dated November 4, 1996
2.8 (3)	Trademark Agreement by and among Schwarz Pharma, Inc. and Cypros Pharmaceutical Corporation dated November 4, 1996
3.1 (4)	Restated Articles of Incorporation of the Registrant.
3.2 (5)	Amendment to Restated Articles of Incorporation.
3.3 (4)	Bylaws.
3.4	Certificate of Adoption of Bylaw Amendment.
4.1 (4)	Specimen stock certificate.
4.2	Reference is made to Exhibits 3.1 and 3.2.
10.1 (4)	Forms of Incentive Stock Option and Nonstatutory Stock Option.
10.2	Amended 1992 Stock Option Plan.
10.3 (4)	Employment Agreement, dated July 10, 1991 as amended and restated September 1, 1992, between the Registrant and Paul J. Marangos, Ph.D.
10.4 (6)	Amendment No. 1 to Employment Agreement, dated May 9, 1994, between the Registrant and Paul J. Marangos, Ph.D.
10.5 (7)	Amendment No. 2 to Employment Agreement, dated March 9, 1995, between the Registrant and Paul J. Marangos, Ph.D.
10.6 (8)	Amendment No. 3 to Employment Agreement, dated October 1, 1996, between the Registrant and Paul J. Marangos, Ph.D.
10.7 (9)	1993 Non-Employee Directors Stock Option Plan and related form of Nonstatutory Stock Option.
10.8 (4)	License Agreement, dated as of August 20, 1992, between the Registrant and Angel K. Markov, M.D. (with certain confidential information in brackets deleted). (8)

Exhibit Number	Description
10.9 (4)	License Agreement, dated as of August 27, 1992, between the Registrant and University E..M., Inc. (with certain confidential information in brackets deleted). (9)
10.10 (5)	Assignment of and Amendment to License Agreement by and between University E.M., Inc., University of Cincinnati and the Registrant.
10.11 (7)	License and Support Agreement, dated as of February 18, 1993, between the Registrant and Elie Abushanab, Ph.D. (with certain confidential information in brackets deleted). (10)
10.12 (12)	Employment Agreement dated December 6, 1997 between the Registrant and Zofia E. Dziewanowska, M.D., Ph.D.
23.1	Consent of Ernst & Young LLP, Independent Auditors.
24.1	Power of Attorney. Reference is made to page 31.
27	Financial Data Schedule. (Exhibit 27 is submitted as an exhibit only in the electronic format of this Annual Report on Form 10-K submitted to the Securities and Exchange Commission.)
99.1	Financial Statements.

_____

(1) Filed as an exhibit to the Registrant's Form 8-K dated August 10, 1995 and incorporated herein by reference.

(2) Certain confidential portions deleted pursuant to an application for Order Granting Confidential Treatment Under the Securities Exchange Act of 1934 and Rule 24b-2 Thereunder filed concurrently with the Form 8-K.

(3) Filed as an exhibit to the Registrant's Form 8-K dated November 4, 1996 and incorporated herein by reference.

(4) Filed as an exhibit to the Registrant's Registration Statement on Form S-1, Registration No. 33-51682, and incorporated herein by reference.

(5) Filed as an exhibit to the Registrant's Form 10-Q for the period ended January 31, 1995, and incorporated herein by reference.

(6) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1994.

(7) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1993.

(8) Filed as an exhibit to the Registrant's Form 10-K for the fiscal year ended July 31, 1996.

(9) Certain confidential portions deleted pursuant to Order Granting Application Under the Securities Act of 1933 and Rule 406 Thereunder Respecting Confidential Treatment, dated November 3, 1992.

(10) Certain confidential portions deleted pursuant to Order Granting Application Pursuant to Rule 24B-2 Under the Securities Exchange Act of 1934 Respecting Confidential Treatment, dated December 20, 1993.

(11) Filed as an exhibit to the Registrant's Form 8-K dated September 20, 1996 and incorporated herein by reference.

(12) Filed as an exhibit to the Registrant's Form 10-Q for the period ended October 31, 1997.

CYPROS PHARMACEUTICAL CORPORATION EXHIBIT 3.4
CERTIFICATE OF ADOPTION OF
BYLAW AMENDMENT

David W. Nassif certifies that:

1. He is a Vice President and Secretary of Cypros Pharmaceutical Corporation (the"Corporation"), a California corporation.

2. In his above capacity as Secretary he has access to the corporate records of said Corporation;

3. The following resolution was duly moved, seconded and adopted by a unanimous written consent of the Board of Directors of the Corporation dated November 6, 1995, and that subsequently the following resolution was duly moved, seconded and adopted by a majority of the 11,404,373 outstanding shares of Common Stock of the Corporation entitled to vote at its Annual Meeting of Shareholders held at the executive offices of the Corporation on January 22, 1996 (the "Annual Meeting") in accordance with Section 903 (a) (1) of the General Corporation Law of the State of California;

RESOLVED, that Article III, Section 2 of the Bylaws of the Company, as amended, is amended to read in its entirety as follows:

"Section 2. - Number and Qualification of Directors.The number of directors of the Corporation shall be not less than four (4) nor more than (7). The exact number of directors shall be five (5) until changed, within the limits specified above, by a bylaw amending this Section 2, duly adopted by the board of directors or by the shareholders. The indefinite number of directors may be changed, or a definite number fixed without provision for an indefinite number, by a duly adopted amendment to the articles of incorporation or by an amendment to this bylaw duly adopted by the vote or written consent of holders of a majority of the outstanding shares entitled to vote. No amendment may change the stated maximum number of authorized directors to a number greater than two (2) times the stated minimum number of directors minus (1)."

I further declare under penalty of perjury under the laws of the State of California that the matters set forth in this certificate are true and correct of my own knowledge.

IN WITNESS WHEREOF, I have hereunto set my hand this 7th day of February, 1996.

/s/ David W. Nassif
- --------------------
David W. Nassif
Vice President and Secretary

EXHIBIT 10.2

CYPROS PHARMACEUTICAL CORPORATION
1992 STOCK OPTION PLAN
Adopted by the Board of Directors and Shareholders on August 20, 1992
Amended by the Committee on August 31, 1993
Amended by the Committee on November 15, 1993
Amended by the Committee on November 4, 1994
Amended by the Committee and the Board of Directors on November 14, 1997

1. PURPOSES.

(a) The purpose of the Plan is to provide a means by which selected Employees and Directors of and Consultants to the Company, and its Affiliates, may be given an opportunity to purchase stock of the Company.

(b) The Company, by means of the Plan, seeks to retain the services of persons who are now Employees or Directors of or Consultants to the Company, to secure and retain the services of new Employees, Directors and Consultants, and to provide incentives for such persons to exert maximum efforts for the success of the Company.

(c) The Company intends that the Options issued under the Plan shall, in the discretion of the Board or any Committee to which responsibility for administration of the Plan has been delegated pursuant to subsection 3(c), be either Incentive Stock Options or Nonstatutory Stock Options. All Options shall be separately designated Incentive Stock Options or Nonstatutory Stock Options at the time of grant, and in such form as issued pursuant to section 6, and a separate certificate or certificates will be issued for shares purchased on exercise of each type of Option.

2. DEFINITIONS.

(a) "Affiliate" means any parent corporation or subsidiary corporation, whether now or hereafter existing, as those terms are defined in Sections 424(e) and (f) respectively, of the Code.

(b) "Board" means the Board of Directors of the Company.

(c) "Code" means the Internal Revenue Code of 1986, as amended.

(d) "Committee" means a Committee appointed by the Board in accordance with subsection 3(c) of the Plan.

(e) "Company" means Cypros Pharmaceutical Corporation, a California corporation.

(f) "Consultant" means any person, including an advisor, engaged by the Company or an Affiliate to render services and who is compensated for such services, provided that the term "Consultant" shall not include Directors who are paid only a director's fee by the Company or who are not compensated by the Company for their services as Directors.

(g) "Continuous Status as an Employee, Director or Consultant" means the employment or relationship as a Director or Consultant is not interrupted or terminated by the Company or any Affiliate. The Board, in its sole discretion, may determine whether Continuous Status as an Employee, Director or Consultant shall be considered interrupted in the case of: (i) any leave of absence approved by the Board, including sick leave, military leave, or any other personal leave; provided, however, that for purposes of Incentive Stock Options, any such leave may not exceed ninety (90) days, unless reemployment upon the expiration of such leave is guaranteed by contract (including certain Company policies) or statute; or (ii) transfers between locations of the Company or between the Company, Affiliates or its successor.

(h) "Director" means a member of the Board.

(i) "Disability" means total and permanent disability as defined in Section 22(e)(3) of the Code.

(j) "Employee" means any person, including Officers and Directors, employed by the Company or any Affiliate of the Company. Neither service as a Director nor payment of a director's fee by the Company shall be sufficient to constitute "employment" by the Company.

(k) "Exchange Act" means the Securities Exchange Act of 1934, as amended.

(l) "Non-Employee Director" means a Director who either (i) is not a current Employee or Officer of the Company or its parent or subsidiary, does not receive compensation (directly or indirectly) from the Company or its parent or subsidiary for services rendered as a consultant or in any capacity other than as a Director (except for an amount as to which disclosure would not be required under Item 404(a) of Regulation S-K promulgated pursuant to the Securities Act ("Regulation S-K")), does not possess an interest in any other transaction as to which disclosure would be required under Item 404(a) of Regulation S-K, and is not engaged in a business relationship as to which disclosure would be required under Item 404(b) of Regulation S-K; or (ii) is otherwise considered a "non-employee" for purposes of Rule 16b-3.

(m) "Incentive Stock Option" means an Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code and the regulations promulgated thereunder.

(n) "Nonstatutory Stock Option" means an Option not intended to qualify as an Incentive Stock Option.

(o) "Officer" means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

(p) "Option" means a stock option granted pursuant to the Plan.

(q) "Option Agreement" means a written agreement between the Company and an Optionee evidencing the terms and conditions of an individual Option grant. The Option Agreement is subject to the terms and conditions of the Plan.

(r) "Optioned Stock" means the common stock of the Company subject to an Option.

(s) "Optionee" means an Employee, Director or Consultant who holds an outstanding Option.

(t) "Outside Director" means a Director who is considered an "outside director" for purposes of Section 162(m) of the Code.

(u) "Plan" means this 1992 Stock Option Plan.

(v) "Rule 16b-3" means Rule 16b-3 of the Exchange Act or any successor to Rule 16b-3, as in effect with respect to the Company when discretion is being exercised with respect to the Plan.

3. ADMINISTRATION

(a) The Plan shall be administered by the Board unless and until the Board delegates administration to a Committee, as provided in subsection 3(c).

(b) The Board shall have the power, subject to, and within the limitations of, the express provisions of the Plan:

(i) To determine from time to time which of the persons eligible under the Plan shall be granted Options; when and how the Option shall be granted; whether the Option will be an Incentive Stock Option or a Nonstatutory Stock Option; the provisions of each Option granted (which need not be identical), including the time or times such Option may be exercised in whole or in part; and the number of shares for which an Option shall be granted to each such person.

(ii) To construe and interpret the Plan and Options granted under it, and to establish, amend and revoke rules and regulations for its administration. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Option Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan fully effective.

(iii) To amend the Plan as provided in Section 11.

(c) The Board may delegate administration of the Plan to a committee composed of not fewer than two (2) members (the "Committee"), all of the members of which Committee may be, in the discretion of the Board, Non-Employee Directors. If administration is delegated to a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board (and references in this Plan to the Board shall thereafter be to the Committee), subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may abolish the Committee at any time and revest in the Board the administration of the Plan.

Notwithstanding anything in this Section 3 to the contrary, at any time, the Board or the Committee may delegate to a committee of one or more members of the Board the authority to grant Options to eligible persons who are not then subject to Section 16 of the Exchange Act.

4. SHARES SUBJECT TO THE PLAN.

(a) Subject to the provisions of Section 10 relating to adjustments upon changes in stock, the stock that may be sold pursuant to Options shall not exceed in the aggregate two million seven hundred sixty-six thousand two hundred and eighty-eight (2,766,288) shares of the Company's common stock. If any Option shall for any reason expire or otherwise terminate without having been exercised in full, the stock not purchased under such Option shall again become available for the Plan.

(b) The stock subject to the Plan may be unissued shares or reacquired shares, bought on the market or otherwise.

5. ELIGIBILITY.

(a) Incentive Stock Options may be granted only to Employees. Nonstatutory Stock Options may be granted only to Employees, Directors or Consultants.

(b) No person shall be eligible for the grant of an Option if, at the time of grant, such person owns (or is deemed to own pursuant to Section 424(d) of the Code) stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or of any of its Affiliates unless the exercise price of such Option is at least one hundred ten percent (110%) of the fair market value of such stock at the date of grant and the Option is not exercisable after the expiration of five (5) years from the date of grant.

(c) In any calendar year, no Employee shall be eligible to be granted Options covering an aggregate number of shares greater than one hundred thousand (100,000) shares.

6. OPTION PROVISIONS.

Each Option shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The provisions of separate Options need not be identical, but each Option shall include (through incorporation of provisions hereof by reference in the Option or otherwise) the substance of each of the following provisions:

(a) Term. No Option shall be exercisable after the expiration of ten (10) years from the date it was granted.

(b) Price. The exercise price of each Incentive Stock Option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the Option on the date the Option is granted. The exercise price of each Nonstatutory Stock Option shall be not less than eighty-five percent (85%) of the fair market value of the stock subject to the Option on the date the Option is granted.

(c) Consideration. The purchase price of stock acquired pursuant to an Option shall be paid, to the extent permitted by applicable statutes and regulations, either (i) in cash at the time the Option is exercised, or (ii) at the discretion of the Board or the Committee, either at the time of the grant or exercise of the Option, (A) by delivery to the Company of other common stock of the Company, (B) according to a deferred payment arrangement or other arrangement (which may include, without limiting the generality of the foregoing, the use of other common stock of the Company) with the person to whom the Option is granted or to whom the Option is transferred pursuant to subsection 6(d), or (C) in any other form of legal consideration that may be acceptable to the Board.

In the case of any deferred payment arrangement, interest shall be payable at least annually and shall be charged at the minimum rate of interest necessary to avoid the treatment as interest, under any applicable provisions of the Code, of any amounts other than amounts stated to be interest under the deferred payment arrangement.

(d) Transferability. An Incentive Stock Option shall not be transferable except by will or by the laws of descent and distribution, and shall be exercisable during the lifetime of the person to whom the Option is granted only by such person. A Nonstatutory Stock Option shall only be transferable by the Optionee upon such terms and conditions as are set forth in the option agreement for such Nonstatutory Stock Option, as the Board

or the Committee shall determine in its discretion.

(e) Vesting. The total number of shares of stock subject to an Option may, but need not, be allotted in periodic installments (which may, but need not, be equal). The Option Agreement may provide that from time to time during each of such installment periods, the Option may become exercisable ("vest") with respect to some or all of the shares allotted to that period, and may be exercised with respect to some or all of the shares allotted to such period and/or any prior period as to which the Option became vested but was not fully exercised. During the remainder of the term of the Option (if its term extends beyond the end of the installment periods), the Option may be exercised from time to time with respect to any shares then remaining subject to the Option. The Option may be subject to such other terms and conditions on the time or times when it may be exercised (which may be based on performance or other criteria) as the Board may deem appropriate. The vesting provisions of individual Options may vary but in each case will provide for vesting of at least twenty percent (20%) of the total number of shares subject to the Option per year. The provisions of this subsection 6(e) are subject to any Option provisions governing the minimum number of shares as to which an Option may be exercised.

(f) Securities Law Compliance. The Company may require any Optionee, or any person to whom an Option is transferred under subsection 6(d), as a condition of exercising any such Option, (1) to give written assurances satisfactory to the Company as to the Optionee's knowledge and experience in financial and business matters and/or to employ a purchaser representative reasonably satisfactory to the Company who is knowledgeable and experienced in financial and business matters, and that he or she is capable of evaluating, alone or together with the purchaser representative, the merits and risks of exercising the Option; and (2) to give written assurances satisfactory to the Company stating that such person is acquiring the stock subject to the Option for such person's own account and not with any present intention of selling or otherwise distributing the stock. These requirements, and any assurances given pursuant to such requirements, shall be inoperative if (i) the issuance of the shares upon the exercise of the Option has been registered under a then currently effective registration statement under the Securities Act of 1933, as amended (the "Securities Act"), or (ii) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws.

(g) Termination of Employment or Relationship as a Director or Consultant. In the event that an Optionee's Continuous Status as an Employee, Director or Consultant terminates (other than upon the Optionee's death or Disability), the Optionee may exercise his or her Option, but only within such period of time as is determined by the Board (which period shall not be less than thirty (30) days from the date of such termination), and only to the extent that the Optionee was entitled to exercise it at the date of termination (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the date of termination, the Optionee is not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after termination, the Optionee does not exercise his or her Option within the time specified in the Option Agreement, the Option shall terminate, and the shares covered by such Option shall revert to the Plan.

(h) Disability of Optionee. In the event an Optionee's Continuous Status as an Employee, Director or Consultant terminates as a result of the Optionee's Disability), the Optionee may exercise his or her Option, but only within twelve (12) months from the date of such termination (or such period of time as is determined by the Board which period shall not be less than six (6) months from the date of such termination), and only to the extent that the Optionee was entitled to exercise it at the date of such termination (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the date of termination, the Optionee is not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after termination, the Optionee does not exercise his or her Option within the time specified herein, the Option shall terminate, and the shares covered by such Option shall revert to the Plan.

(i) Death of Optionee. In the event of the death of an Optionee, the Option may be exercised, at any time within twelve (12) months following the date of death (or such period of time as is determined by the Board which period shall not be less than six (6) months following the date of death) by the Optionee's

estate or by a person who acquired the right to exercise the Option by bequest or inheritance, and only to the extent the Optionee was entitled to exercise the Option at the date of death (but in no event later than the expiration of the term of such Option as set forth in the Option Agreement). If, at the time of death, the Optionee was not entitled to exercise his or her entire Option, the shares covered by the unexercisable portion of the Option shall revert to the Plan. If, after death, the Optionee's estate or a person who acquired the right to exercise the Option by bequest or inheritance does not exercise the Option within the time specified herein, the Option shall terminate, and the shares covered by such Option shall revert to the Plan.

(j) Withholding. To the extent provided by the terms of an Option Agreement, the Optionee may satisfy any federal, state or local tax withholding obligation relating to the exercise of such Option by any of the following means or by a combination of such means: (1) tendering a cash payment; (2) authorizing the Company to withhold shares from the shares of the common stock otherwise issuable to the participant as a result of the exercise of the Option; or (3) delivering to the Company owned and unencumbered shares of the common stock of the Company.

7. COVENANTS OF THE COMPANY.

(a) During the terms of the Options, the Company shall keep available at all times the number of shares of stock required to satisfy such Options.

(b) The Company shall seek to obtain from each regulatory commission or agency having jurisdiction over the Plan such authority as may be required to issue and sell shares of stock upon exercise of the Options; provided, however, that this undertaking shall not require the Company to register under the Securities Act either the Plan, any Option or any stock issued or issuable pursuant to any such Option. If, after reasonable efforts, the Company is unable to obtain from any such regulatory commission or agency the authority which counsel for the Company deems necessary for the lawful issuance and sale of stock under the Plan, the Company shall be relieved from any liability for failure to issue and sell stock upon exercise of such Options unless and until such authority is obtained.

8. USE OF PROCEEDS FROM STOCK.

Proceeds from the sale of stock pursuant to Options shall constitute general funds of the Company.

9. MISCELLANEOUS.

(a) Neither an Optionee nor any person to whom an Option is transferred under subsection 6(d) shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any shares subject to such Option unless and until such person has satisfied all requirements for exercise of the Option pursuant to its terms.

(b) Nothing in the Plan or any instrument executed or Option granted pursuant thereto shall confer upon any Employee, Director, Consultant or Optionee any right to continue in the employ of the Company or any Affiliate (or to continue acting as a Director or Consultant) or shall affect the right of the Company or any Affiliate to terminate the employment or relationship as a Director or Consultant of any Employee, Director, Consultant or Optionee with or without cause.

(c) To the extent that the aggregate fair market value (determined at the time of grant) of stock with respect to which Incentive Stock Options granted after 1986 are exercisable for the first time by any Optionee during any calendar year under all plans of the Company and its Affiliates exceeds one hundred thousand dollars ($100,000), the Options or portions thereof which exceed such limit (according to the order in which they were granted) shall be treated as Nonstatutory Stock Options.

10. ADJUSTMENTS UPON CHANGES IN STOCK.

(a) If any change is made in the stock subject to the Plan, or subject to any Option (through merger, consolidation, reorganization, recapitalization, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure or otherwise), the Plan and outstanding Options will be appropriately adjusted in the class(es) and maximum number of shares subject to the Plan and the class(es) and number of shares and price per share of stock subject to outstanding Options.

(b) In the event of: (1) a merger or consolidation in which the

Company is not the surviving corporation or (2) a reverse merger in which the Company is the surviving corporation but the shares of the Company's common stock outstanding immediately preceding the merger are converted by virtue of the merger into other property, whether in the form of securities, cash or otherwise then to the extent permitted by applicable law: (i) any surviving corporation shall assume any Options outstanding under the Plan or shall substitute similar Options for those outstanding under the Plan, or (ii) such Options shall continue in full force and effect. In the event any surviving corporation refuses to assume or continue such Options, or to substitute similar options for those outstanding under the Plan, then such Options shall be terminated if not exercised prior to such event. In the event of a dissolution or liquidation of the Company, any Options outstanding under the Plan shall terminate if not exercised prior to such event.

11. AMENDMENT OF THE PLAN.

(a) The Board at any time, and from time to time, may amend the Plan. However, except as provided in Section 10 relating to adjustments upon changes in stock, no amendment shall be effective unless approved by the shareholders of the Company within twelve (12) months before or after the adoption of the amendment, where the amendment will:

(i) Increase the number of shares reserved for Options under the Plan;

(ii) Modify the requirements as to eligibility for participation in the Plan (to the extent such modification requires shareholder approval in order for the Plan to satisfy the requirements of Section 422 of the Code); or

(iii) Modify the Plan in any other way if such modification requires shareholder approval in order for the Plan to satisfy the requirements of Section 422 of the Code or to comply with the requirements of Rule 16b-3.

(b) It is expressly contemplated that the Board may amend the Plan in any respect the Board deems necessary or advisable to provide Optionees with the maximum benefits provided or to be provided under the provisions of the Code and the regulations promulgated thereunder relating to Incentive Stock Options and/or to bring the Plan and/or Incentive Stock Options granted under it into compliance therewith.

(c) Rights and obligations under any Option granted before amendment of the Plan shall not be altered or impaired by any amendment of the Plan unless (i) the Company requests the consent of the person to whom the Option was granted and (ii) such person consents in writing.

12. TERMINATION OR SUSPENSION OF THE PLAN.

(a) The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall terminate on August 1, 2002. No Options may be granted under the Plan while the Plan is suspended or after it is terminated.

(b) Rights and obligations under any Option granted while the Plan is in effect shall not be altered or impaired by suspension or termination of the Plan, except with the consent of the person to whom the Option was granted.

13. EFFECTIVE DATE OF THE PLAN.

The Plan shall become effective as determined by the Board, but no Options granted under the Plan shall be exercised unless and until the Plan has been approved by the shareholders of the Company, and, if required, an appropriate permit has been issued by the Commissioner of Corporations of the State of California.

EXHIBIT 23.1

CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in the Registration Statements (Form S-3 and S-8) of our report dated August 21, 1998, with respect to the financial statements of Cypros Pharmaceutical Corporation included in the Annual Report (Form 10-K) for the year ended July 31, 1998.

ERNST & YOUNG LLP

San Diego, California
October 26, 1998

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This schedule contains summary financial information extracted from the Form 10-K for the Period Ended July 31, 1998 and is qualified in its entirety by reference to such financial statements

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JUL-31-1998
JUL-31-1998
3,015,890
10,428,580
516,886
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83,078
214,765
1,893,120
(829,554)
19,735,640
881,483
157,656
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41,328,470
(22,817,138)
19,735,640
3,445,955
3,445,955
770,437
770,437
9,139,410
0
68,293
(5,572,869)
0
(5,572,869)
0
0
0
(5,572,869)
(0.37)
(0.37)

Form 10-K Items 14(a) (1) and (2)

Cypros Pharmaceutical Corporation

Years ended July 31, 1998, 1997 and 1996
with Report of Independent Auditors

Cypros Pharmaceutical Corporation

Form 10-K Items 14(a) (1) and (2)

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Financial Statement Schedules (Item 14(a) (2)):

All financial statement schedules are omitted because the information described therein is not applicable, not required or is furnished in the financial statements or notes thereto.

Report of Ernst & Young LLP, Independent Auditors

The Board of Directors and Shareholders
Cypros Pharmaceutical Corporation

We have audited the accompanying balance sheets of Cypros Pharmaceutical Corporation as of July 31, 1998 and 1997, and the related statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended July 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 financial statements referred to above present fairly, in all material respects, the financial position of Cypros Pharmaceutical Corporation at July 31, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended July 31, 1998, in conformity with generally accepted accounting principles.

ERNST & YOUNG LLP

San Diego, California
August 21, 1998

Cypros Pharmaceutical Corporation
Balance Sheets

	July 31, 1998	1997
Assets		
Current assets:		
Cash and cash equivalents (Note 3)	$ 3,015,890	$ 5,101,710
Short-term investments, held to maturity (Note 3)	10,428,580	9,465,561
Accounts receivable	516,886	355,425
Inventories (Note 3)	83,078	93,177
Prepaid expenses and other current assets	214,765	75,038
Total current assets	14,259,199	15,090,911
Property, equipment and leasehold improvements, net (Note 3)	1,063,566	675,686
Purchased technology, net of accumulated amortization of $2,118,226 and $1,220,838 at July 31, 1998 and 1997,respectively (Note 2)	4,163,487	5,060,875
Deferred financing costs, net of accumulated amortization of $520,011 and $260,884 at July 31, 1998 and 1997, respectively	-	259,127
Licenses and patents, net of accumulated amortization of $160,212 and $118,376 at July 31, 1998 and 1997, respectively	176,927	162,592
Other assets	72,461	95,525
Total assets	$19,735,640	$21,344,716
Liabilities and shareholders' equity		
Current liabilities:		
Accounts payable	$ 551,191	365,386
Accrued compensation	125,434	109,778
Other accrued liabilities	15,641	118,658
Purchased asset obligations (Note 2)	-	1,272,000
Current portion of long-term debt (Note 4)	97,477	41,367
Current portion of capital lease obligations (Note 5)	91,740	106,206
Total current liabilities	881,483	2,013,395
Long-term debt (Note 4)	59,408	-
Capital lease obligations (Note 5)	157,656	148,787
Deferred rent	125,761	129,165
Mandatorily convertible notes (Note 5)	-	4,027,461
Shareholders' equity (Note 6):		
Common stock, 30,000,000 shares authorized, 15,711,877 and 13,650,405 shares issued and outstanding as of July 31, 1998 and 1997, respectively	41,328,470	32,344,793
Deferred compensation	(87,334)	(161,950)
Accumulated deficit	(22,729,804)	(17,156,935)
Total shareholders' equity	18,511,332	15,025,908
Total liabilities and shareholders'equity	$19,735,640	$21,344,716

See accompanying notes.

Cypros Pharmaceutical Corporation
Statements of Operations

	Years ended July 31, 1998	1997	1996
Net sales	$ 3,445,955	$ 2,428,348	$ 1,275,240
Cost of sales	770,437	538,725	405,142
Gross profit	2,675,518	1,889,623	870,098
Operating expenses:			
Sales and marketing	1,309,963	993,765	343,054
General and administrative	3,246,619	2,396,465	1,642,152
Clinical testing and regulatory	2,521,386	1,967,334	1,389,128
Pre-clinical research and development	822,225	1,032,486	1,002,226
Depreciation and amortization	1,239,217	1,075,431	611,848
Total operating expenses	9,139,410	7,465,481	4,988,408
Loss from operations	(6,463,892)	(5,575,858)	(4,118,310)
Research grant income	169,834	98,785	270,510
Interest and other income, net	809,254	662,421	757,692
Sublease income, net(Note 5)	171,062	-	-
Amortization of discount and costs on mandatorily converible notes (Note 5)	(259,127)	(1,860,051)	-
Net loss	$(5,572,869)	$(6,674,703)	$(3,090,108)
Net loss per share, basic and diluted	$(0.37)	$(0.54)	$(0.27)
Shares used in computing net loss per share, basic diluted	15,186,984	12,303,274	11,518,169

See accompanying notes.

Cypros Pharmaceutical Corporation
Statements of Shareholders' Equity
Years ended July 31, 1998, 1997 and 1996

	Common Stock		Deferred
	Shares	Amount	Compensation
Balance at July 31, 1995	11,352,017	$20,944,995	$(186,993)
Discount on mandatorily convertible notes notes	-	1,582,935	-
Issuance of common stock, net of offering costs offering costs	162,500	940,956	-
Issuance of common stock in business acquisitions	169,231	1,032,309	-
Issuance of common stock for services	200,000	284,375	(284,375)
Common stock repurchased	(280,000)	(1,540,000)	-
Exercise of stock options	10,000	35,163	-
Deferred compensation related to grant of stock options grant of stock options	-	140,695	(140,695)
Amortization of deferred compensation	-	-	307,754
Net loss	-	-	-
Balance at July 31, 1996	11,613,748	23,421,428	(304,309)

Conversion of mandatorily convertible notes	953,907	3,972,538	-
Issuance of common stock, net of offering costs	1,075,000	4,714,507	-
Exercise of stock options	7,750	21,963	-
Forfeitures of stock options	-	(52,568)	52,568
Deferred compensation related to grant of stock options	-	266,925	(266,925)
Amortization of deferred compensation	-	-	356,716
Net loss	-	-	-
Balance at July 31, 1997	13,650,405	32,344,793	(161,950)
Conversion of mandatorily convertible notes	1,205,446	4,025,588	-
Issuance of common stock upon exercise of B Warrants	856,026	4,707,576	-
Deferred compensation related to grant of stock options	-	250,513	(250,513)
Amortization of deferred compensation	-	-	325,129
Net loss	-	-	-
Balance at July 31, 1998	15,711,877	$41,328,470	$(87,334)

Cypros Pharmaceutical Corporation
Statements of Shareholders' Equity (Continued)

	Accumulated Deficit	Total Equity
Balance at July 31, 1995	$ (7,392,124)	$13,365,878
Discount on mandatorily convertible notes	-	1,582,935
Issuance of common stock, net of offering costs	-	940,956
Issuance of common stock in business acquisitions	-	1,032,309
Issuance of common stock for services	-	-
Common stock repurchased	-	(1,540,000)
Exercise of stock options	-	35,163
Deferred compensation related to grant of stock options	-	-
Amortization of deferred compensation	-	307,754
Net loss	(3,090,108)	(3,090,108)
Balance at July 31, 1996	(10,482,232)	12,634,887
Conversion of mandatorily convertible notes	-	3,972,538
Issuance of common stock, net of offering costs	-	4,714,507
Exercise of stock options	-	21,963
Forfeitures of stock options	-	-
Deferred compensation related to grant of stock options	-	-
Amortization of deferred compensation	-	356,716
Net loss	(6,674,703)	(6,674,703)
Balance at July 31, 1997	(17,156,935)	15,025,908
Conversion of mandatorily convertible notes	-	4,025,588
Issuance of common stock upon exercise of B Warrants	-	4,707,576
Deferred compensation related to grant of stock options	-	-
Amortization of deferred compensation	-	325,129
Net loss	(5,572,869)	(5,572,869)
Balance at July 31, 1998	$(22,729,804)	$18,511,332

See accompanying notes.

Cypros Pharmaceutical Corporation
Statements of Cash Flows

	Years ended July 31, 1998	1997	1996
Operating activities			
Net loss	$(5,572,869	$(6,674,703)	$(3,090,108)
Adjustments to reconcile net loss to net cash used in operating activities:			
Amortization of deferred compensation	325,129	356,716	307,754
Depreciation and amortization	1,239,217	1,075,431	611,848
Amortization of discount and costs on mandatorily convertible notes	259,127	1,860,051	-
Deferred rent	(3,404)	(16,215)	39,892
Write-off of patent	41,311	-	-
Changes in operating assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(161,461)	(205,799)	(149,626)
Inventory	10,099	(29,791)	18,829
Prepaid expenses and other current expenses	(139,727)	(13,629)	18,536
Accounts payable	185,805	246,294	(19,445)
Accrued compensation and other accrued liabilities	(87,361)	(56,948)	114,305
Net cash flows used in operating activities	(3,904,134)	(3,458,593)	(2,148,015)
Investing activities			
Short-term investments	(963,019)	(2,537,126)	1,486,815
Investment in purchased technology	-	(2,014,048)	(1,835,356)
Installment payment for purchased technology	(1,272,000)	(200,000)	(82,215)
Purchase of property, equipment and leasehold improvements	(587,265)	(239,941)	(100,770)
Increase in licenses and patents	(97,482)	(82,460)	(37,499)
Decrease in other assets	23,064	21,375	6,197
Net cash flows used in investing activities	(2,896,702)	(5,052,200)	(562,828)
Financing activities			
Issuance of common stock, net	4,707,576	4,736,470	976,119
Cash paid for repurchase of mandatorily convertible notes	(1,873)	-	-
Issuance of mandatorily convertible notes	-	-	7,458,498
Repurchase and retirement of common stock	-	-	(1,540,000)
Issuance of long-term debt	209,406	-	-
Repayment of long-term debt	(93,888)	(99,282)	(99,283)
Repayments of capital lease obligations	(106,205)	(93,299)	(42,622)
Net cash flows provided by financing activities	4,715,016	4,543,889	6,752,712
Increase (decrease) in cash and cash equivalents	(2,085,820)	(3,966,904)	4,041,869
Cash and cash equivalents at beginning of year	5,101,710	9,068,614	5,026,745
Cash and cash equivalents at end of year	$3,015,890	$5,101,710	$9,068,614

Supplemental disclosures of cash flow information:			
Cash paid for interest	$ 132,269	$ 123,997	$ 47,953
Noncash investing and financing activities:			
Conversion of mandatorily convertible notes	$4,025,588	$ 3,972,538	$ -
Equipment financed under capital lease obligations	$ 100,608	$ 79,992	$ 234,256
Purchased asset obligation incurred for acquisition	$ -	$ 1,200,000	$ 200,000
Common stock issued for acquisitions	$ -	$ -	$ 1,032,309

See accompanying notes.

Cypros Pharmaceutical Corporation
Notes to Financial Statements
July 31, 1998

1. Organization and Summary of Significant Accounting Policies

Organization and Business Activity

Cypros Pharmaceutical Corporation (the "Company") was incorporated in San Diego, California on November 2, 1990. The Company develops and markets acute-care, hospital-based products. The Company is currently marketing three products, Ethamolin, Glofil and Inulin, will be launching two burn/wound care products and is developing two drugs, Cordox (formerly CPC-111) and Ceresine. The Company's pre-clinical and clinical development programs focus on cytoprotective drugs designed to reduce ischemia (low blood flow) induced tissue damage in acute-care settings and Cordox and Ceresine are in late-stage clinical trials in two settings: sickle cell crisis and traumatic brain injury.

Cash, Cash Equivalents and Short-Term Investments

The Company considers highly liquid investments with remaining maturities of three months or less when acquired to be cash equivalents. Short-term investments consist of certificates of deposit, money market funds, U.S. government obligations and investment grade corporate debt securities. The Company has established guidelines relative to diversification and maturities that maintain safety and liquidity. The Company has not experienced any losses on its cash equivalents or short-term investments. Management believes the credit risk associated with these investments is limited due to the nature of the investments.

Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designations as of each balance sheet date. Debt securities are classified as held-to-maturity when the Company has the positive intent and the ability to hold the securities to maturity. Held-to-maturity securities are carried at cost, adjusted for amortization of premiums and accretion of discounts. Interest, dividends and amortization on the securities classified as held-to-maturity are included in interest income.

Concentration of Credit Risk

The Company extends credit to its customers, primarily hospitals and large pharmaceutical companies conducting clinical research, in connection with its product sales.

The Company has not experienced significant credit losses on its customer accounts. Two customers individually accounted for 23% and 12% of current year sales.

Inventories

Inventories are stated at the lower of cost (first-in, first-out method) or market.

Depreciation and Amortization

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets (generally five years) using the straight-line method. Leasehold

improvements are amortized over the lesser of the estimated useful lives (seven years) or the remaining term of the lease.

Purchased Technology

Purchased technology associated with the acquisitions of Glofil, Inulin and Ethamolin is stated at cost and amortized over the period estimated to be benefited (seven years).

Deferred Financing Costs

The Company deferred banking, legal and accounting fees associated with the issuance of $8 million in principal amount of mandatorily convertible notes in 1996. These costs were amortized over the term of the notes, which was three years, using the effective interest method commencing with the closing of the transactions. In fiscal 1998, upon the conversion of the remaining balance of the notes, all such costs were fully amortized.

License and Patent Costs

The Company capitalizes certain costs related to license rights and patent applications. Accumulated costs are amortized over the estimated economic lives of the license rights and patents (generally six years) commencing at the time the license rights are granted or the patents are issued.

Accounting Standard on Impairment of Long-Lived Assets

In accordance with Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of ("SFAS 121"), the Company regularly evaluates its long-lived assets for indicators of possible impairment. To date, no such indicators have been identified.

Revenue Recognition

Revenues from product sales of Ethamolin and whole vials of Glofil and Inulin are recognized upon shipment. Revenues from Glofil unit dose sales are recognized upon receipt by the Company of monthly sales reports from its third-party distributor. The Company is not obligated to accept returns of products sold that have reached their expiration date.

Net Loss Per Share

In the second quarter of the fiscal year ended July 31, 1998, the Company adopted Statement of Financial Accounting Standards No. 128, Earnings Per Share ("SFAS 128"), which replaced the calculation of primary and fully diluted net loss per share with basic and diluted net income or loss per share. Basic net income or loss per share is calculated using the weighted average number of common shares outstanding. Diluted net income or loss per share is calculated using the weighted average number of common shares outstanding plus the dilutive effect of options and warrants, if any, using the treasury stock method. All net loss per share amounts for all periods have been presented, and where appropriate restated, to conform to the SFAS 128 requirements and the recently effective Securities and Exchange Commission Staff Accounting Bulletin No. 98.

Stock Options

The Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25") and related Interpretations in accounting for its employee stock options because the alternative fair value accounting provided for under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ("SFAS 123") requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB 25, when the exercise price of the Company's employee stock options equals or exceeds the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Recently Issued Accounting Standards

Effective August 1, 1998, the Company will adopt Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (Loss) ("SFAS 130"). SFAS 130 requires that all components of comprehensive income (loss),

including net income (loss), be reported in the financial statements in the period in which they are recognized.

Comprehensive income (loss) is defined as the change in equity during the period from transactions and other events and circumstances from non-owner sources. Net income (loss) and other comprehensive income (loss), including unrealized gains and losses on investments, shall be reported, net of their related tax effect, to arrive at comprehensive income (loss). The Company does not believe comprehensive loss will be different than the net loss previously reported.

Effective August 1, 1998, the Company will adopt Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information ("SFAS 131"). SFAS 131 redefines segments and requires companies to report financial and descriptive information about their operating segments. The Company has determined that it operates in one business segment and therefore the adoption of SFAS 131 will not affect the Company's financial statements.

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 financial statements and disclosures made in the accompanying notes to the financial statements. Actual results could differ from those estimates.

Reclassifications

Certain previously reported amounts have been reclassified to conform with the 1998 presentation.

2. Acquisitions

On August 9, 1995, the Company acquired two businesses, including (i) the New Drug Application for Glofil and finished goods inventory of Glofil on hand at the time of closing from Iso-Tex Diagnostics, Inc., a Texas corporation, (the "Glofil Acquisition") and (ii) the New Drug Application for Inulin and the raw material and finished goods inventory of Inulin on hand at the time of closing from Iso-Tex Diagnostics "B," Inc. ("ITDB"), a Texas corporation (the "Inulin Acquisition"). The Glofil Acquisition was accomplished in an arms' length negotiation through a purchase of assets and the Inulin Acquisition was accomplished through a merger of ITDB with and into the Company (the "Merger"). The total purchase price was $3,149,880, of which the Company paid $1,582,215 in cash from

its working capital and issued 169,231 shares of restricted Common Stock of the Company (the "Restricted Shares") which were paid at closing.

As part of the Glofil Acquisition, the Company made an additional cash payment of $200,000 on January 15, 1996 and a final cash payment of $200,000 on August 9, 1996.

On November 4, 1996, the Company acquired the New Drug Application, the U.S. trademark for Ethamolin Injection (the "Ethamolin Assets") and the finished goods inventory on hand at closing from Schwarz Pharma, Inc., a Delaware corporation. The total purchase price was $3,286,642, of which the Company paid $2,086,642 in cash from its working capital and issued a $1,200,000 8% note (the "Schwarz Note") which was paid in full during fiscal year 1998.

All of these acquisitions were accounted for using the purchase method and, accordingly, the financial statements include the operations of the businesses from the date of acquisition. The following unaudited pro forma data reflects the combined results of operations of the Company as if the Glofil Acquisition and the Inulin Acquisition had occurred on August 1, 1994 and the Ethamolin acquisition had occurred on August 1, 1995:

	Years end July 31,	
	1997	1996
Net sales	$2,752,691	$2,402,006
Net loss	(6,394,987)	(2,679,376)
Net loss per share	(0.52)	(0.23)

3. Financial Statement Details

Short-Term Investments

All short-term investments of the Company are classified as held-to-maturity. The following is a summary of held-to-maturity investments at amortized cost at July 31:

	1998	1997
Corporate debt securities	$ 9,933,424	$10,465,202
Money market funds	2,656,423	2,723,458
U.S. government obligations	495,156	995,770
	13,085,003	14,184,430
Less: amounts classified as cash equivalents	(2,656,423)	(4,718,869)
Short-term investments	$10,428,580	$ 9,465,561

As of July 31, 1998, the difference between cost and estimated fair value of the held-to-maturity investments was not significant. Of the above-referenced 1998 investments, $6,265,682 mature at various dates through July 31, 1999 and $4,162,898 will mature at various dates after July 31, 1999 through December 14, 2001.

Inventories

Inventories consist of the following at July 31:

	1998	1997
Raw materials	$ 2,087	$ 4,252
Finished goods	80,991	88,925
	$83,078	$93,177

Property, Equipment and Leasehold Improvements

Property, equipment and leasehold improvements consist of the following at July 31:

	1998	1997
Laboratory equipment	$756,525	$785,573
Office equipment, furniture and fixtures	783,446	284,902
Leasehold improvements	353,149	134,772
	1,893,120	1,205,247
Less accumulated depreciation and amortization	(829,554)	(529,561)
	$1,063,566	$ 675,686

Depreciation and amortization expense totaled $299,993, $252,453 and $138,471 for the years ended July 31, 1998, 1997 and 1996, respectively.

4. Long-Term Debt

Long-term debt consists of the following at July 31:

CAPTION>

	1998	1997
Note payable to a pharmaceutical company due November 1999, collateralized by certain purchased assets totaling $234,000, bearing interest at 8% until November 1998 and 4% thereafter, payable in three semiannual installments starting November 1998, of $39,300, $46,200 and $48,500, plus interest	$142,025	$ -
Note payable to a leasing company due November 2001, collateralized by real property, bearing interest at 10%, payable in 53 monthly installments of $438 including interest	14,860	-
Note payable to a financial institution due December 1997, collateralized by $84,048 of the Company's short-term investments at July 31, 1997, bearing interest at prime plus 1.6% (10.10% at July 31, 1997)	-	41,367
	156,885	41,367
Less current portion	(97,477)	(41,367)
Total	$ 59,408	$ -

Interest expense incurred on these notes totaled $10,748, $9,524 and $19,897 for the years ended July 31, 1998, 1997 and 1996, respectively.

5. Commitments

Leases

The Company leases its office and research facilities under operating lease agreements and certain equipment under capital lease agreements. A security deposit of $64,260 under one of the facilities lease agreements is included in other assets.

Minimum future obligations under both operating and capital leases as of July 31, 1998 are as follows:

	Operating Leases	Capital Leases
1999	$464,942	$108,903
2000	491,649	87,794
2001	418,356	33,111
2002	127,310	25,061
2003		25,061
Thereafter	-	10,443
	$1,502,257	290,373
Less amounts representing interest		(40,977)
Present value of net minimum lease payments		249,396
Current portion of capital lease obligations		(91,740)
Long-term capital lease obligations		$157,656

Rent expense totaled $445,095, $420,697 and $193,880 for the years ended July 31, 1998, 1997 and 1996, respectively. The net book value of the equipment acquired under capital leases totaled $222,101 and $228,878 (net of accumulated amortization of $288,732 and $181,347) at July 31, 1998 and 1997, respectively.

Rent expense comprises the cost associated with two buildings leased by the Company, its current headquarters located at 2714 Loker Avenue West in Carlsbad, California and its former headquarters located at 2732 Loker Avenue West. In April 1996, the Company subleased its former headquarters for the remainder of the original lease term plus an additional 36 month option. Net sublease income totaled $171,062 for the year ended July 31, 1998. Scheduled aggregate future sublease income at July 31, 1998 is approximately $1,128,081.

Mandatorily Convertible Notes

During the year ended July 31, 1996, the Company issued $8 million in principal amount of non-interest bearing mandatorily convertible notes (the "Notes") to institutional investors in private placements under the provisions of the Securities and Exchange Commission (the "SEC") Regulation D.

The Notes were convertible at the option of the investors into shares of the Company's Common Stock at various dates from January 31, 1997 through July 31, 1999 at a discount to the market price of the stock immediately preceding conversion, ranging from 15% to 25%, with the actual discount depending on the length of time each investor has held the note being converted. The Notes were all converted at various dates through July 31, 1998, except for $1,873 which was paid in cash. The Notes were recorded net of the $1,582,935 discount available upon conversion (assuming full conversion at the earliest possible dates), and the discount represents an effective interest rate of 33%. The discount has been added to Common Stock and was amortized to expense during fiscal year 1997.

License Agreements

The Company has licenses to various patents for Cordox and Ceresine, its two clinical development programs, for the remaining term of the patents. The license agreements require payments of cash, warrants or the issuance of stock options to the licensers upon accomplishment of various milestones and the payment of royalties to the licensers upon the commercial sale of products incorporating the licensed compound. The only remaining significant development milestone under these agreements is the requirement that the Company pay the licensor of Cordox $250,000 upon the filing of a New Drug Application with the Food and Drug Administration (the "FDA") for the approval to market that compound. In the event milestone or royalty payments to the licensor of Cordox are not made by the Company within specified time periods, that licensor may elect to terminate the license agreement and all rights thereunder. Such a termination could have a significant adverse impact upon the Company.

6. Shareholders' Equity

Preferred Stock

The Company has authorized 1,000,000 shares of convertible preferred stock. As of July 31, 1998 and 1997, no such shares were issued or outstanding.

Warrants

As of July 31, 1997, 4,673,512 Redeemable Class B Warrants were outstanding. In November 1997, the Company received net proceeds of $4,707,576 from the exercise of 856,026 Redeemable Class B Warrants and the concurrent issuance of 856,026 shares of

Common Stock. During fiscal year 1998, all Redeemable Class B Warrants expired and none are outstanding at July 31, 1998.

Stock Option Plans

Pro forma information regarding net loss and loss per share is required by SFAS 123, and has been determined as if the Company has accounted for its employee stock options under the fair value method set forth in SFAS 123. The fair value of these options was estimated at the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions for 1998, 1997 and 1996: risk-free interest rates of 6.0%; dividend yields of 0%; volatility factors of the expected market price of the Company's Common Stock of 79% for 1998 and 84% for 1997 and 1996; and the weighted-average life of the options of eight

years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a single reliable measure of the fair value of its employee stock options. For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma net loss for the years ended July 31, 1998, 1997 and 1996 is as follows:

	1998	1997	1996
Pro forma net loss	$(6,844,607)	$(7,658,837)	$(3,943,018)
Pro forma net loss per share, basic and diluted	$(0.45)	$(0.62)	$(0.34)

As of July 31, 1998, 2,766,288 shares of Common Stock were reserved for issuance under the 1992 Stock Option Plan (the "1992 Plan"). The 1992 Plan provides for the grant of incentive and nonstatutory stock options with various vesting periods, generally four years, to employees, directors and consultants. The exercise price of incentive stock options must equal at least the fair market value on the date of grant, and the exercise price of nonstatutory stock options may be no less than 85% of the fair market value on the date of grant. The maximum term of options granted under the 1992 Plan is ten years.

In June 1993, the Company adopted the 1993 Non-Employee Directors' Stock Option Plan (the "1993 Plan"), under which 250,000 shares of Common Stock were reserved for issuance. The 1993 Plan provides for the granting of 25,000 options to purchase Common Stock upon appointment as a non-employee director and an additional 3,000 options each January thereafter, beginning January 1, 1994. Options vest over four years. The exercise price of the options is 85% of the fair market value on the date of grant. The maximum term of options granted under the 1993 Plan is ten years.

The following table summarizes stock option activity under the 1992 and 1993 Plans:

	Options Outstanding	Weighted Average Exercise Price
Balance at July 31, 1995	1,018,000	$3.83
Granted	360,000	$5.30
Exercised	(10,000)	$3.52
Canceled	(12,188)	$5.40
Balance at July 31, 1996	1,355,812	$4.21
Granted	309,499	$4.33
Exercised	(7,750)	$2.83
Canceled	(219,125)	$4.47
Balance at July 31, 1997	(1,438,436)	$4.25
Granted	749,700	$4.85
Exercised	-	$ -
Canceled	(295,647)	$5.08
Balance at July 31, 1998	1,892,489	$4.36

At July 31, 1998, options to purchase 1,254,699 shares of Common Stock were exercisable and there were 623,799 shares available for future grant under the 1992 and 1993 Plans.

The weighted average grant-date fair value for the options granted during 1998, 1997 and 1996 were $3.74, $3.40 and $4.39, respectively.

Exercise prices and weighted average remaining contractual

life for the options outstanding under the 1992 and 1993 Plans as of July 31, 1998 are as follows:

Options Outstanding				Options Exercisable	
Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$1.44	97,500	4.05	$1.44	97,500	$1.44
$2.20-$2.46	93,000	4.78	$2.22	93,000	$2.32
$3.06-$4.00	571,833	7.74	$3.70	398,452	$3.70
$4.05-$4.95	293,449	7.89	$4.68	204,524	$4.42
$5.00-$5.75	717,958	6.03	$5.33	362,762	$5.33
$6.00-$6.80	76,249	5.10	$6.31	67,524	$6.31
$7.86-$8.50	42,500	7.03	$8.08	30,937	$8.08
	1,892,489	$4.36		1,254,699	

The Company has recorded deferred compensation for the difference between the price of options granted and the fair value of the Company's Common Stock. Deferred compensation is amortized to expense during the vesting period of the related stock or options.

7. Income Taxes

The Company accounts for income taxes using the liability method under Financial Accounting Standards Board Statement No. 109, Accounting for Income Taxes. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes.

Significant components of the Company's deferred tax assets and liabilities as of July 31, 1998 and 1997 are as follows:

	1998	1997
Deferred tax liabilities:		
Purchased technology	$ 267,000	$ 423,000
Total Deferred tax liabilities	267,000	423,000
Deferred tax assets:		
Net operating loss carryforwards	6,439,000	4,554,000
Capitalized research and development costs	569,000	547,000
Research and development tax credit carryforwards	836,00	530,000
Other - net	53,000	1,243,000
Total deferred tax assets	7,897,000	6,874,000
Valuation allowance	(7,630,000)	(6,451,000)
Net deferred tax assets	$ -	$ -

At July 31, 1998, the Company has federal and California tax net operating loss carryforwards of approximately $17,520,000 and $5,335,000, respectively. The federal tax loss carryforwards will begin to expire in 2007, unless previously utilized. The California tax loss carryforwards began expiring in 1997 (approximately $340,000 expired in 1998 and will continue to expire unless previously utilized). The Company also has federal and California research and development tax credit carryforwards of approximately $666,000 and $263,000, respectively, which will begin expiring in 2007 unless previously utilized. The above carryforwards were determined as if the Company were filing a tax return at July 31, 1998; however, for tax return purposes the Company uses a calendar year end.

In accordance with the Internal Revenue Code, the use of the Company's net operating loss and credit carryforwards may be

limited upon cumulative changes in ownership of more than 50%.

The valuation allowance increased $1,179,000 from July 31, 1997 to July 31, 1998 due principally to the increase in deferred tax assets resulting from the increase in tax net operating loss carryforwards. Realization of deferred tax assets is dependent on future earnings, the timing and amount of which will be dependent on scientific success, results of clinical trials and regulatory approval of the Company's products currently under development. Accordingly, the full valuation reserve has been established to reflect these uncertainties.

8. Legal Proceedings

In July 1998, the Company was served with a complaint in the United States Bankruptcy Court for the Southern District of New York by the Trustee for the liquidation of the business of A. R. Baron & Co., Inc. ("A.R. Baron") and the Trustee of The Baron Group, Inc. (the "Baron Group"), the parent of A. R. Baron. The complaint alleges that A. R. Baron and the Baron Group made certain preferential or fraudulent transfers of funds to the Company prior to the commencement of bankruptcy proceedings involving A. R. Baron and the Baron Group. The Trustee is seeking return of the funds totaling $3.2 million. The Company believes that the Trustee's claims are unfounded and intends to contest the allegations in the complaint vigorously. The Company contends that the transfers challenged by the Trustee relate to (i) the exercise by A. R. Baron in 1995 of unit purchase options issued to it in 1992 as part of its negotiated compensation for underwriting the Company's initial public offering and (ii) the repayment by the Baron Group of the principal and interest (at 12% per annum) payments and certain loan extension fees related to certain collateralized loans made to it by the Company in 1995 and 1996. The Company believes that it has insurance coverage sufficient to cover any costs, expenses, or losses that might be incurred in connection with this action.

9. Year 2000 Issue (unaudited)

The Company has modified or replaced portions of its software so that its computer systems will function properly with respect to dates in the year 2000 and thereafter. The Company believes that, with these modifications to existing software and conversions to new software, the Year 2000 Issue will not pose significant operational problems for its computer systems.