ORTHOLOGIC CORP
Form 10-K
March 13, 2009

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2008

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number: 0-21214

ORTHOLOGIC CORP.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	86-0585310 (IRS Employer Identification No.)

1275 West Washington Street, Suite 101, Tempe, Arizona 85281
(Address of principal executive offices)
Registrant's telephone number including area code: (602) 286-5520

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $.0005 per share	NASDAQ Global Market
Rights to purchase 1/100 of a share of Series A Preferred Stock	NASDAQ Global Market

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x.

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "small reporting company" in Rule 12b-2 of the Exchange Act. Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer ¨ (Do not check if a smaller reporting company)
Smaller Reporting Company x.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).
Yes ¨ No x.

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based upon the closing sale price of the registrant's common stock as reported on the NASDAQ Global Market on June 30, 2008 was approximately $40,300,000. Shares of common stock held by each officer and director and by each person who owns 10% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily conclusive.

Documents incorporated by reference: Portions of the registrant's proxy statement related to its 2009 annual meeting of stockholders to be held on May 8, 2009 are incorporated by reference into Part III of this Form 10-K.

The number of outstanding shares of the registrant's common stock on February 28, 2009 was 40,775,411.

ORTHOLOGIC CORP.
dba Capstone Therapeutics
FORM 10-K ANNUAL REPORT
YEAR ENDED DECEMBER 31, 2008

TABLE OF CONTENTS

		PAGE
PART I		2
Item 1.	Business	2
Item 1A.	Risk Factors	7
Item 1B.	Unresolved Staff Comments	17
Item 2.	Properties	17
Item 3.	Legal Proceedings	17
Item 4.	Submission of Matters to a Vote of Security Holders	17
PART II		17
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities	17
Item 6.	Selected Financial Data	18
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Item 7A.	Quantitative and Qualitative Disclosures about Market Risk	26
Item 8.	Financial Statements and Supplementary Data	26
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	26
Item 9A(T).	Controls and Procedures	27
Item 9B.	Other Information	27
PART III		27
Item 10.	Directors, Executive Officers and Corporate Governance	27
Item 11.	Executive Compensation	28
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholders Matters	28
Item 13.	Certain Relationships and Related Transactions, and Director Independence	28
Item 14.	Principal Accountant Fees and Services	28
PART IV		28
Item 15.	Exhibits and Financial Statement Schedules	28
SIGNATURES		S-1
EXHIBIT INDEX		E-1
FINANCIAL STATEMENTS		F-1

Table of Contents

PART I

Item 1. Business

Overview of the Business

On October 1, 2008, OrthoLogic Corp. began doing business under the trade name of Capstone Therapeutics.

OrthoLogic Corp., referred to herein as “OrthoLogic”, “Capstone Therapeutics”, “Capstone”, “the Company”, “we”, “us”, or “ a biotechnology company committed to developing a pipeline of novel therapeutic peptides aimed at helping patients with under-served medical conditions. The Company is focused on development and commercialization of two product platforms: AZX100 and Chrysalin® (TP508 or rusalatide acetate).

AZX100

AZX100, a novel 24-amino acid peptide, is believed to relax smooth muscle which modulates blood pressure and the function of blood vessels, airways, sphincters, the gastrointestinal tract and the genitourinary tract. Sustained abnormal contraction of any of these muscles is called a spasm. Any disorders known to be associated with excessive constriction or inadequate dilation of smooth muscle represent potential applications for AZX100.

AZX100 is also believed to inhibit the fibrotic phenotype of fibroblasts and smooth muscle cells in a mechanism similar to that which causes vasorelaxation. Through phenotypic modulation of fibroblasts and smooth muscle cells, AZX100 may inhibit the scarring that results from wound healing and may mitigate fibrotic disease states in the dermis, blood vessels, lungs, liver and other organs.

AZX100 is currently being evaluated for medically and commercially significant applications, such as treatment of pulmonary disease, prevention of hypertrophic and keloid scarring and intimal hyperplasia. We are executing a development plan for this peptide which included filing an IND for dermal scarring in 2007 and commencement of Phase 1 safety studies in this indication in the first quarter of 2008. Our Phase 1a study was completed in May 2008. The study’s Safety Committee reviewing all safety-related aspects of the Phase 1a trial was satisfied with the profile of AZX100. We initiated a second safety study in dermal scarring (Phase 1b), which was completed in the fourth quarter of 2008. The study’s Safety Committee reviewing all safety-related aspects of the Phase 1b trial was satisfied with the profile of AZX100. The Company is preparing to initiate Phase 2 human clinical efficacy studies of AZX100 in dermal scarring in the first quarter of 2009. We expect to continue to perform further pre-clinical studies supporting multiple indications for AZX100 in 2009.

Chrysalin

Chrysalin (TP508), a novel synthetic 23-amino acid peptide, is believed to produce angiogenic and other tissue repair effects in part by 1) activating or upregulating endothelial nitric oxide synthase (eNOS); 2) cytokine modulation resulting in an anti-inflammatory effect; 3) inhibiting apoptosis (programmed cell death); and 4) modulating angiogenic factors. It may have therapeutic value in diseases associated with endothelial dysfunction.

We have conducted clinical trials for two potential Chrysalin applications: acceleration of fracture repair and diabetic foot ulcer healing. We previously conducted a pilot human study for spine fusion, and pre-clinical testing for cartilage defect repair, cardiovascular repair, dental bone repair, and tendon repair. Currently, we are focusing our efforts on pre-clinical studies in vascular applications, such as acute myocardial infarction and chronic myocardial ischemia. If successful, these studies will provide additional support for partnering future development of Chrysalin. We are not currently planning additional pre-clinical or clinical studies in fracture repair, wound healing, spine fusion, cartilage

defect repair, dental bone repair or tendon repair.

Table of Contents

Company History

Prior to November 26, 2003, we developed, manufactured and marketed proprietary, technologically advanced orthopedic products designed to promote the healing of musculoskeletal bone and tissue, with particular emphasis on fracture healing and spine repair. Our product lines included bone growth stimulation and fracture fixation devices including the OL1000 product line, SpinaLogic® and OrthoFrame/Mayo, which we sometimes refer to as our "Bone Device Business."

On November 26, 2003, we sold our Bone Device Business.

On August 5, 2004, we purchased substantially all of the assets and intellectual property of Chrysalis Biotechnology, Inc. ("CBI"), including its exclusive worldwide license for Chrysalin for all medical indications. We became a development stage company commensurate with the acquisition. Subsequently, our efforts were focused on research and development of Chrysalin with the goal of commercializing our product candidates.

On February 27, 2006, we purchased certain assets and assumed certain liabilities of AzERx, Inc. Under the terms of the transaction, OrthoLogic acquired an exclusive license for the core intellectual property relating to AZX100.

Our development activities for Chrysalin and AZX100 represent a single operating segment as they share the same product development path and utilize the same Company resources. As a result, we have determined that it is appropriate to reflect our operations as one reportable segment. Through December 31, 2008, we have incurred $113 million in net losses as a development stage company.

Competition

The biopharmaceutical industry is characterized by intense competition and confidentiality. We may not be aware of the other biotechnology, pharmaceutical companies or public institutions that are developing pharmaceuticals that compete with our potential products. We also may not be aware of all the other competing products our known competitors are pursuing. In addition, these biotechnology companies and public institutions compete with us in recruiting for research personnel and subjects, which may affect our ability to complete our research studies.

Chrysalin

Vascular Endothelial Dysfunction (VED)

Impaired nitric oxide (NO) production reduces the responsiveness of endothelial cells to angiogenic factors and causes loss of endothelial function in ischemic and inflamed blood vessels contributing to a number of chronic diseases. We hypothesize that Chrysalin may produce angiogenic and other tissue repair effects by activating or upregulating nitric oxide synthetase (NOS) in endothelial cells, and if so, that it may have potential therapeutic value in tissues and diseases exhibiting endothelial dysfunction. Currently, we are evaluating multiple VED indications for development potential. While the potential product markets are significant in size, the markets are characterized by intense competition by both large and small companies with a variety of competing technologies.

Table of Contents

Clinical indications associated with VED include the broad areas of coronary artery disease (CAD). Insufficient blood supply to the myocardium can result in myocardial ischemia, injury or infarction, or all three. Atherosclerosis of the larger coronary arteries is the most common anatomic condition that causes diminished coronary blood flow.

Pharmacologic therapies in development for acute myocardial infarction include stem cell-based approaches, selective kinase inhibitors, thrombin-activatable plasminogen and other peptides.

Pharmacologic therapies commonly used in treating myocardial ischemia include 1) aspirin and anticoagulants; 2) ß blockers; 3) nitrates; and 4) calcium channel blockers. Also, the use of angiotensin-converting enzyme (ACE) inhibitors recently has been shown to be beneficial in the treatment of myocardial ischemia. Invasive treatments such as percutaneous transluminal coronary angioplasty (PTCA) and coronary artery bypass surgery (CABG) may be indicated as well.

We are in the preliminary stages of examining these disease states and the suitability of Chrysalin as a therapeutic agent to treat vascular disorders.

AZX100

Dermal Scarring

Approved

There is no approved pharmacologic treatment for scarless healing. In the setting of keloid or hypertrophic scarring the scars are often excised and treated with steroids with variable results.

In Development

Among potential competing products are recombinant transforming growth factor beta 3 (TGF ß3) and antiTGFß1 antibodies. Renovo is conducting Phase 3 clinical trials in Europe and the U.S. with recombinant TGFß3 (Juvista) for various scar prevention indications, including a recently accepted IND for keloid revisions. While preliminary efficacy has been shown in healing in healthy individuals, like other therapeutics, TGFß3 addresses upstream signaling and only one fibrotic pathway and may have limited effectiveness in scar inhibition. AZX100 inhibits fibrotic responses induced by multiple mediators, suggesting it may be more effective than TGFß3 at scarless healing. Renovo has also begun clinical trials using a TGFß1 antibody, which like TGFß3, blocks part of the signaling cascade resulting in scar formation. AZX100 may be more effective than TGFß1 antibodies through more comprehensive inhibition of multiple scarring cascades.

Asthma

Asthma ranks as the third highest reason for preventable hospitalizations in the U.S. with 470,000 hospitalizations and more than 5,000 deaths each year (American Academy of Allergy Asthma and Immunology Report). Acute asthma accounts for an estimated two-million emergency department visits annually. There are many competitors with asthma products approved or in development. AZX100 has been shown to relax ex vivo airway smooth muscle and may be developed for the treatment of asthmatic attacks. Specific markets include severe acute asthma and asthma that is refractory to current therapies. Severe asthma has been defined as asthma that is refractory to current therapeutic approaches in clinical use (anti-inflammatory agents and bronchodilators). The current approach is to use adrenergic agonists, which activate the cAMP/PKA pathway. AZX100 is a mimetic of the molecule downstream of this pathway and hence may be more sensitive and specific for the treatment of severe asthma. In addition, patients with severe asthma usually are treated in an emergency room; hence efficacy can be closely monitored and outcomes

will be apparent in a short timeframe after treatment. Recent data has demonstrated that one out of every six asthmatics has a mutation in the adrenergic receptor. These patients do not respond to adrenergic agonists and in fact do worse when treated with adrenergic agonists. This patient population would be potentially effectively treated with the AZX100 compound in that it acts downstream of the receptors.

Table of Contents

Intimal Hyperplasia

Intimal hyperplasia is the universal response of a vessel to injury. It is characterized by the thickening of the Tunica intima of a blood vessel as a complication of a reconstruction procedure or endarterectomy, the surgical removal of plaque from an artery that has become narrowed or blocked. Scar tissue forms at the point where a blood vessel is manipulated; as it slowly builds up, significant restenosis may develop. Intimal hyperplasia is an important reason for late bypass graft failure, particularly in vein and synthetic vascular grafts. Patients with end-stage renal disease (approximately 300,000 in the U.S. alone) suffer from intimal hyperplasia due to multiple vein insertions. We are not aware of any existing therapy that effectively modulates this healing response.

Marketing and Sales

Neither Chrysalin nor AZX100 are currently available for sale and we do not expect them to be available for sale for some time into the future. Thus, we currently have no marketing or sales staff. External consultants and members of our staff provide some technical marketing support relating to the development of, and market need for, new potential products and additional therapeutic applications of products already under research.

Research and Development

Our Pre-clinical, Clinical, Chemical Materials and Controls, Regulatory and Quality Assurance departments (research and development) consist of approximately 18 employees who are assisted by consultants from the academic and medical practitioner fields. Our employees have extensive experience in the areas of biomaterials, animal modeling, cellular and molecular biology, clinical trial design and data management. Our Clinical department designs, initiates, monitors and manages our clinical trials. Our staff has been focused on clinical trials to advance AZX100 to NDA status in a dermal indication, pre-clinical studies investigating AZX100's potential for the treatment of pulmonary diseases and intimal hyperplasia, pre-clinical work on Chrysalin in vascular indications and exploring the science behind and potential of AZX100 and Chrysalin. We are executing a development plan for AZX100 which included filing an IND for dermal scarring in 2007 and commencement of Phase 1 safety studies in this indication in the first quarter of 2008. Our Phase 1a study was completed in May 2008. The study's Safety Committee reviewing all safety-related aspects of the Phase 1a trial was satisfied with the profile of AZX100. We initiated a second safety study in dermal scarring (Phase 1b), which was completed in the fourth quarter of 2008. The study's Safety Committee reviewing all safety-related aspects of the Phase 1b trial was satisfied with the profile of AZX100. The Company is preparing to initiate Phase 2 human clinical efficacy studies of AZX100 in dermal scarring in the first quarter of 2009.

We incurred $10.7 million and $9.6 million, in 2008 and 2007, respectively, on research efforts on Chrysalin and AZX100. Given the overlapping nature of our research efforts it is not possible to clearly separate research expenditures between Chrysalin and AZX100; however, the substantial majority of expenditures were AZX100 related in 2008 and 2007.

Table of Contents

Manufacturing

Currently, third parties certified under Good Manufacturing Practices manufacture Chrysalin and AZX100 for us in limited amounts for our clinical and pre-clinical studies. We use a primary manufacturer for the peptides used in our human clinical trials, but secondary manufacturers are available as needed. Our current Chrysalin and AZX100 formulation and manufacturing work is focused on an injectable formulation.

Patents, Licenses and Proprietary Rights

As part of our purchase of CBI on August 5, 2004, the license agreements between CBI and OrthoLogic for the development, use, and marketing of the therapeutic products utilizing Chrysalin were replaced by a direct license agreement between OrthoLogic and the University of Texas. Under this direct license, we expanded our current license for Chrysalin from a license for only orthopedic indications to a license for any and all indications. Subsequently, we entered into an agreement whereby the University of Texas assigned to us certain patents previously exclusively licensed to us. We must pay the University of Texas royalties on future sales of products, sublicense fees and various other fees in connection with filing and maintaining Chrysalin-related patents. This obligation will expire upon the expiration of the subject patents. Chrysalin has been patented in the United States and in some other countries for a number of methods of use, including cardiovascular, chronic wounds, and orthopedic indications. A composition of matter patent covering European countries expired in 2007 and the corresponding United States patent expires in 2011. Our other patents for Chrysalin expire between 2021 and 2026.

As part of the February 27, 2006 AzERx transaction, we acquired a license from AzTE, an affiliate of Arizona State University, for worldwide rights to AZX100 for all indications. Under the license agreement with AzTE, we are required to pay patent filing, maintenance and other related patent fees as well as royalties on future sales of products that contain AZX100. These obligations will end on the expiration of the last patent. The license is supported by patents that expire from 2021 to 2024.

As part of the February 27, 2006 AzERx transaction we also acquired a non-exclusive license from Washington University for transduction domain carrier patents which form part of AZX100. Under the license, we are required to pay license maintenance payments and royalties on future sales of products that contain the licensed technology. These obligations will end on the expiration of the last patent.

Chrysalin, Capstone Therapeutics and OrthoLogic are registered United States domestic trademarks of OrthoLogic Corp.

Insurance

Our business entails the risk of product liability claims. We maintain a product liability and general liability insurance policy and an umbrella excess liability policy. There can be no assurance that liability claims will not exceed the coverage limit of such policies or that such insurance will continue to be available on commercially reasonable terms or at all. Consequently, product liability claims or claims arising from our clinical trials could have a material adverse effect on our business, financial condition and results of operations. We have not experienced any material liability claims to date resulting from our clinical trials.

Employees

As of December 31, 2008, we had twenty-six permanent employees in our operations, including eighteen employees in research and development and eight in administration. As a research and development business, we believe that the success of our business will depend in part on our ability to identify, attract and retain qualified research personnel,

both as employees and as consultants. We face competition from private companies and public institutions for qualified research personnel. None of our employees are represented by a union and we consider our relationship with our employees to be good.

Table of Contents

Additional Information about OrthoLogic

OrthoLogic Corp. was incorporated as a Delaware corporation in July 1987 as IatroMed, Inc. We changed our name to OrthoLogic Corp. in July 1991. Effective October 1, 2008, OrthoLogic Corp. began doing business as Capstone Therapeutics. Our executive offices are located at 1275 West Washington Street, Suite 101, Tempe, Arizona 85281, and our telephone number is (602) 286-5520.

Our website address is www.capstonethx.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments to those reports, are available free of charge through our website as soon as reasonably practical after we file or furnish them to the U.S. Securities and Exchange Commission. Once at our website, go to the “Investors” section to locate these filings.

In March 2004, we adopted a code of ethics that applies to all of our employees and has particular sections that apply only to our principal executive officer and senior financial officers. We posted the text of our code of ethics on our website in the “Investors” section of our website under “Code of Ethics.” In addition, we will promptly disclose on our website (1) the nature of any amendment to our code of ethics that applies to our principal executive officer and senior financial officers, and (2) the nature of any waiver, including an implicit waiver, from a provision of our code of ethics that is granted to one of these specified officers, the name of such officer who is granted the waiver and the date of the waiver.

In this document, references to “we”, “our” and the “Company” refer to OrthoLogic Corp., now doing business as Capstone Therapeutics. References to our “Bone Device Business” refer to our former business line of bone growth stimulation and fracture fixation devices, including the OL1000 product line, SpinaLogic®, OrthoFrame® and OrthoFrame/Mayo.

Item 1A. Risk Factors

Risks

The Company may from time to time make written or oral forward-looking statements, including statements contained in our filings with the Securities and Exchange Commission and our reports to stockholders. The safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 protects companies from liability for their forward looking statements if they comply with the requirements of that Act. This Annual Report on Form 10-K contains forward-looking statements made pursuant to that safe harbor. These forward-looking statements relate to future events or to our future financial performance, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. In some cases, you can identify forward-looking statements by the use of words such as “may,” “could,” “expect,” “intend,” “plan,” “seek,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “continu of these terms or other comparable terminology. You should not place undue reliance on forward-looking statements since they involve known and unknown risks, uncertainties and other factors which are, in some cases, beyond our control and which could materially affect actual results, levels of activity, performance or achievements. Factors that may cause actual results to differ materially from current expectations, which we describe in more detail in this section titled “Risks,” include, but are not limited to:

Table of Contents

- unfavorable results of our product candidate development efforts;
- unfavorable results of our pre-clinical or clinical testing;
- delays in obtaining, or failure to obtain FDA approvals;
- increased regulation by the FDA and other agencies;
- the introduction of competitive products;
- impairment of license, patent or other proprietary rights;
- failure to achieve market acceptance of our products;
- the impact of present and future collaborative or partnering agreements or the lack thereof;
- failure to successfully implement our drug development strategy; and
- failure in the future to meet the requirements for continued listing on the NASDAQ Markets.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary significantly from what we projected. Any forward-looking statement you read in this Annual Report on Form 10-K reflects our current views with respect to future events and is subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, business strategy and liquidity. We assume no obligation to publicly update or revise these forward-looking statements for any reason, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

Risks Related to Our Business

We are a biopharmaceutical company with no revenue generating operations and high investment costs.

We expect to incur losses for a number of years as we expand our research and development projects. Our current level of funds is not sufficient to support all research expenses to achieve commercialization of any of our product candidates. On November 26, 2003, we sold all of our revenue generating operations. We are now focused on developing and testing the product candidates of AZX100 and Chrysalin and have allocated most of our resources to bringing these product candidates to the market, either through clinical trials or partnering efforts. We may invest in other peptide or small molecule-based therapeutics in the future, but there can be no assurance that opportunities of this nature will occur at acceptable terms, conditions or timing. We currently have no pharmaceutical products being sold or ready for sale and do not expect to be able to introduce any pharmaceutical products for at least several years. As a result of our significant research and development, clinical development, regulatory compliance and general and administrative expenses and the lack of any products to generate revenue, we expect to incur losses for at least the next several years and expect that our losses will increase if we expand our research and development activities and incur significant expenses for clinical trials. Our cash reserves are the primary source of our working capital. There can be no assurance that our cash resources will be sufficient to cover our future operating requirements, or should there be a need, other sources of cash will be available, or if available, at acceptable terms.

We may not receive any revenue from our product candidates until we receive regulatory approval and begin commercialization of our product candidates. We cannot predict when that will occur or if it will occur.

We caution that our future cash expenditure levels are difficult to forecast because the forecast is based on assumptions about the number of research projects we pursue, the pace at which we pursue them, the quality of the data collected and the requests of the FDA to expand, narrow or conduct additional clinical trials and analyze data. Changes in any of these assumptions can change significantly our estimated cash expenditure levels.

Table of Contents

Our product candidates have reached various stages of development but may not be successfully developed or commercialized.

If we fail to commercialize our product candidates, we will not be able to generate revenue. We currently do not sell any products. We have implemented a strategic shift in our development approach to our Chrysalin-based product candidates. We currently intend to pursue development partnering or licensing opportunities for our Chrysalin-based product candidates, a change from our previous development history of independently conducting human clinical trials necessary to advance our Chrysalin-based product candidates to market. Our product candidates have reached the following stages of development:

Chrysalin:

· Acceleration of Fracture Repair	Phase 3 / Phase 2b human clinical trials
· Diabetic Foot Ulcer Healing	Phase 1/2 human clinical trials
· Spine Fusion	Phase 1/2 human clinical trials
• Cartilage Defect Repair	Late stage pre-clinical trials
• Tendon Repair	Early stage pre-clinical trials
• Cardiovascular Repair	Pre-clinical trials
• Dental Bone Repair	Pre-clinical trials

AZX100:

• Scarring	IND filed in 2007, Phases 1 and 1b safety studies completed in 2008.

We are subject to the risk that:

- the FDA finds some or all of our product candidates ineffective or unsafe;
- we do not receive necessary regulatory approvals;
- we are unable to get some or all of our product candidates to market in a timely manner;
- we are not able to produce our product candidates in commercial quantities at reasonable costs;
- our products undergo post-market evaluations resulting in marketing restrictions or withdrawal of our products; or
- the patients, insurance and/or physician community does not accept our products.

In addition, our product development programs may be curtailed, redirected or eliminated at any time for many reasons, including:

- adverse or ambiguous results;
- undesirable side effects which delay or extend the trials;
- inability to locate, recruit, qualify and retain a sufficient number of patients for our trials;
- regulatory delays or other regulatory actions;
- difficulties in obtaining sufficient quantities of the particular product candidate or any other components needed for our pre-clinical testing or clinical trials;
- change in the focus of our development efforts; and
- re-evaluation of our clinical development strategy.

Table of Contents

We cannot predict whether we will successfully develop and commercialize any of our product candidates. If we fail to do so, we will not be able to generate revenue.

Our product candidates are all based on the same two chemical peptides, Chrysalin and AZX100. If one of our Chrysalin or AZX100 product candidates reveals safety or fundamental efficacy issues in clinical trials, it could impact the development path for our other current product candidates for that peptide.

Should the results of ongoing pre-clinical studies or human clinical trials show negative safety or efficacy data, it may impact the development of our AZX100 product candidates, or partnering opportunities for Chrysalin product candidates.

If we cannot protect the Chrysalin patents, the AZX100 patents, or our intellectual property generally, our ability to develop and commercialize our products will be severely limited.

Our success will depend in part on our ability to maintain and enforce patent protection for Chrysalin and AZX100 and each product resulting from Chrysalin or AZX100. Without patent protection, other companies could offer substantially identical products for sale without incurring the sizable discovery, development and licensing costs that we have incurred. Our ability to recover these expenditures and realize profits upon the sale of products would then be diminished.

Certain key Chrysalin methods of use patents have expired and other patents will expire during the development period of our Chrysalin product candidates. We believe our current patents covering formulations and specific indications are adequate to protect the value of the Chrysalin product candidates. However, if our current patents are not adequate, the value of our Chrysalin product candidates may be materially adversely impacted.

Chrysalin and AZX100 are patented and there have been no successful challenges to the patents. However, if there were to be a challenge to these patents or any of the patents for product candidates, a court may determine that the patents are invalid or unenforceable. Even if the validity or enforceability of a patent is upheld by a court, a court may not prevent alleged infringement on the grounds that such activity is not covered by the patent claims. Any litigation, whether to enforce our rights to use our or our licensors' patents or to defend against allegations that we infringe third party rights, will be costly, time consuming, and may distract management from other important tasks.

As is commonplace in the biotechnology and pharmaceutical industry, we employ individuals who were previously employed at other biotechnology or pharmaceutical companies, including our competitors or potential competitors. To the extent our employees are involved in research areas which are similar to those areas in which they were involved at their former employers, we may be subject to claims that such employees and/or we have inadvertently or otherwise used or disclosed the alleged trade secrets or other proprietary information of the former employers. Litigation may be necessary to defend against such claims, which could result in substantial costs and be a distraction to management and which may have a material adverse effect on us, even if we are successful in defending such claims.

We also rely in our business on trade secrets, know-how and other proprietary information. We seek to protect this information, in part, through the use of confidentiality agreements with employees, consultants, advisors and others. Nonetheless, we cannot assure that those agreements will provide adequate protection for our trade secrets, know-how or other proprietary information and prevent their unauthorized use or disclosure. The risk that other parties may breach confidentiality agreements or that our trade secrets become known or independently discovered by competitors, could adversely affect us by enabling our competitors, who may have greater experience and financial resources, to copy or use our trade secrets and other proprietary information in the advancement of their products, methods or technologies.

10

Table of Contents

Our success also depends on our ability to operate and commercialize products without infringing on the patents or proprietary rights of others.

Third parties may claim that we or our licensors or suppliers are infringing their patents or are misappropriating their proprietary information. In the event of a successful claim against us or our licensors or suppliers for infringement of the patents or proprietary rights of others, we may be required to, among other things:

- pay substantial damages;
- stop using our technologies;
- stop certain research and development efforts;
- develop non-infringing products or methods; and
- obtain one or more licenses from third parties.

A license required under any such patents or proprietary rights may not be available to us, or may not be available on acceptable terms. If we or our licensors or suppliers are sued for infringement, we could encounter substantial delays in, or be prohibited from, developing, manufacturing and commercializing our product candidates.

The loss of our key management and scientific personnel may hinder our ability to execute our business plan.

As a small company our success depends on the continuing contributions of our management team and scientific personnel, and maintaining relationships with the network of medical and academic centers in the United States that conduct our clinical trials. The resignation or retirement of members of senior management or scientific personnel could materially adversely affect our business prospects.

Reliance on Outside Suppliers and Consultants

We rely on outside suppliers and consultants for the manufacture of Chrysalin and AZX100 and technical assistance in our research and development efforts. The inability of our suppliers to meet our production quality requirements in a timely manner, or the lack of availability of experienced consultants to assist in our research and development efforts, could have a material effect on our ability to perform research or clinical trials.

We face an inherent risk of liability in the event that the use or misuse of our products results in personal injury or death.

The use of our product candidates in clinical trials may expose us to product liability claims, which could result in financial losses. Our clinical liability insurance coverage may not be sufficient to cover claims that may be made against us. In addition, we may not be able to maintain insurance coverage at a reasonable cost or in sufficient amounts or scope to protect us against losses. Any claims against us, regardless of their merit, could severely harm our financial condition, strain our management and other resources and adversely impact or eliminate the prospects for commercialization of the product which is the subject of any such claim.

Table of Contents

Risks of our Industry

We are in a highly regulated field with high investment costs and high risks.

Chrysalin has been in the human testing phase for three potential products and earlier pre-clinical testing phases for four other potential products. AZX100 has completed Phase 1 safety studies and Phase 2 dermal scarring efficacy studies are planned for early 2009. The FDA and comparable agencies in many foreign countries impose substantial limitations on the introduction of new pharmaceuticals through costly and time-consuming laboratory and clinical testing and other procedures. The process of obtaining FDA and other required regulatory approvals is lengthy, expensive and uncertain. Chrysalin and AZX100 are new drugs and are subject to the most stringent level of FDA review.

Even after we have invested substantial funds in the development of our Chrysalin and AZX100 products and even if the results of our future clinical trials are favorable, there can be no guarantee that the FDA will grant approval of Chrysalin and/or AZX100 for the indicated uses or that it will do so in a timely manner.

If we successfully bring one or more products to market, there is no assurance that we will be able to successfully manufacture or market the products or that potential customers will buy them if, for example, a competitive product has greater efficacy or is deemed more cost effective. In addition, the market in which we will sell any such products is dominated by a number of large corporations that have vastly greater resources than we have, which may impact our ability to successfully market our products or maintain any technological advantage we might develop. We also would be subject to changes in regulations governing the manufacture and marketing of our products, which could increase our costs, reduce any competitive advantage we may have and/or adversely affect our marketing effectiveness.

The pharmaceutical industry is subject to stringent regulation, and failure to obtain regulatory approval will prevent commercialization of our products.

Our research, development, pre-clinical and clinical trial activities and the manufacture and marketing of any products that we may successfully develop are subject to an extensive regulatory approval process by the FDA and other regulatory agencies in the United States and abroad. The process of obtaining required regulatory approvals for drugs is lengthy, expensive and uncertain, and any such regulatory approvals may entail limitations on the indicated usage of a drug, which may reduce the drug's market potential.

In order to obtain FDA approval to commercialize any product candidate, an NDA must be submitted to the FDA demonstrating, among other things, that the product candidate is safe and effective for use in humans for each target indication. Our regulatory submissions may be delayed, or we may cancel plans to make submissions for product candidates for a number of reasons, including:

- negative or ambiguous pre-clinical or clinical trial results;
- changes in regulations or the adoption of new regulations;
- unexpected technological developments; and
- developments by our competitors that are more effective than our product candidates.

Consequently, we cannot assure that we will make our submissions to the FDA in the timeframe that we have planned, or at all, or that our submissions will be approved by the FDA. Even if regulatory clearance is obtained, post-market evaluation of our products, if required, could result in restrictions on a product's marketing or withdrawal of a product from the market as well as possible civil and criminal sanctions.

12

Table of Contents

Clinical trials are subject to oversight by institutional review boards and the FDA to ensure compliance with the FDA's good clinical practice regulations, as well as other requirements for good clinical practices. We depend, in part, on third-party laboratories and medical institutions to conduct pre-clinical studies and clinical trials for our products and other third-party organizations to perform data collection and analysis, all of which must maintain both good laboratory and good clinical practices. If any such standards are not complied with in our clinical trials, the FDA may suspend or terminate such trial, which would severely delay and possibly end the development of a product candidate.

We also currently and in the future will depend upon third party manufacturers of our products, which are and will be required to comply with the applicable FDA Good Manufacturing Practice regulations. We cannot be certain that our present or future manufacturers and suppliers will comply with these regulations. The failure to comply with these regulations may result in restrictions in the sale of, or withdrawal of the products from the market. Compliance by third parties with these standards and practices are outside of our direct control.

In addition, we are subject to regulation under state and federal laws, including requirements regarding occupational safety, laboratory practices, environmental protection and hazardous substance control, and may be subject to other local, state, federal and foreign regulation. We cannot predict the impact of such regulations on us, although they could impose significant restrictions on our business and require us to incur additional expenses to comply.

If our competitors develop and market products that are more effective than ours, or obtain marketing approval before we do, our commercial opportunities will be reduced or eliminated.

Competition in the pharmaceutical and biotechnology industries is intense and is expected to increase. Several biotechnology and pharmaceutical companies, as well as academic laboratories, universities and other research institutions, are involved in research and/or product development for indications targeted for use by either Chrysalin or AZX100. Many of our competitors have significantly greater research and development capabilities, experience in obtaining regulatory approvals and manufacturing, marketing, financial and managerial resources than we have.

Our competitors may succeed in developing products that are more effective than the ones we have under development or that render our proposed products or technologies noncompetitive or obsolete. In addition, certain of such competitors may achieve product commercialization before we do. If any of our competitors develops a product that is more effective than one we are developing or plan to develop, or is able to obtain FDA approval for commercialization before we do, we may not be able to achieve significant market acceptance for certain products of ours, which would have a material adverse effect on our business.

For a summary of the competitive conditions relating to indications which we are currently considering for Chrysalin and AZX100, see Part I, Item 1 in this Report titled "Competition".

Our product candidates may not gain market acceptance among physicians, patients and the medical community, including insurance companies and other third party payors. If our product candidates fail to achieve market acceptance, our ability to generate revenue will be limited.

Even if we obtain regulatory approval for our products, market acceptance will depend on our ability to demonstrate to physicians and patients the benefits of our products in terms of safety, efficacy, and convenience, ease of administration and cost effectiveness. In addition, we believe market acceptance depends on the effectiveness of our marketing strategy, the pricing of our products and the reimbursement policies of government and third-party payors. Physicians may not prescribe our products, and patients may determine, for any reason, that our product is not useful to them. Insurance companies and other third party payors may determine not to reimburse for the cost of the therapy. If any of our product candidates fails to achieve market acceptance, our ability to generate revenue will be limited.

13

Table of Contents

Healthcare reform and restrictions on reimbursements may limit our financial returns.

Our ability to successfully commercialize our products may depend in part on the extent to which government health administration authorities, private health insurers and other third party payors will reimburse consumers for the cost of these products. Third party payors are increasingly challenging both the need for, and the price of, novel therapeutic drugs and uncertainty exists as to the reimbursement status of newly approved therapeutics. Adequate third party reimbursement may not be available for our drug products to enable us to maintain price levels sufficient to realize an appropriate return on our investments in research and product development, which could restrict our ability to commercialize a particular drug candidate.

Risks Related to Our Common Stock and Warrants

If we fail to meet the requirements for continued listing on the NASDAQ Stock Markets, our common stock could be delisted from trading, which would adversely affect the liquidity of our common stock and our ability to raise additional capital.

Our common stock is currently listed on the NASDAQ Global Market. We are required to meet specified financial requirements to maintain our listing on the NASDAQ Stock Markets. One such requirement is that we maintain a minimum bid price of at least $1.00 per share for our common stock. In 2008, our common stock closed at prices that are below the minimum bid price requirement and on August 11, 2008, we received a notice from NASDAQ, dated August 8, 2008, that the minimum bid price for our common stock had closed under $1.00 per share for over 30 business days, causing a violation of the continuing listing standard of the NASDAQ Global Market. If, after the periods provided by NASDAQ rules, our stock price remains below the minimum bid price, or if we fail to satisfy any other continued listing requirement of the NASDAQ Stock Markets in the future, our common stock could be delisted from the NASDAQ Stock Markets. A delisting of our common stock from the NASDAQ Stock Markets would make it more difficult for our shareholders to sell our stock in the public market and would likely result in decreased liquidity and increased volatility for our common stock. Our securities may also trade at a lower market price than they otherwise would.

If we fail to satisfy any of the NASDAQ Stock Markets' continued listing requirements, we cannot assure you that we would be successful in regaining compliance with those requirements in the future. In the event of delisting, trading, if any, could continue to be conducted on the over the counter market in the so called "pink sheets" or on the OTC Bulletin Board. Selling our common stock would be more difficult because, among other things, smaller quantities of shares would likely be bought and sold, transactions could be delayed, security analysts' coverage of us could be reduced and shareholders may find it more difficult to obtain accurate quotations as to the market value of our common stock. Also, a delisting (or a notice or other action indicating the possible future delisting of our common stock) could have a material adverse effect on the price for our shares and our ability to issue additional securities or to secure additional financing. In addition, delisting from the NASDAQ Stock Markets may subject our common stock to "penny stock" rules under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. These rules impose additional sales practice and other requirements on broker-dealers who sell and/or make a market in securities deemed penny stocks under SEC rules. Consequently, the delisting of our securities and the applicability of the penny stock rules may adversely affect the liquidity and price of our common stock.

Table of Contents

Our stock price is volatile and fluctuates due to a variety of factors.

Our stock price has varied significantly in the past (from a high of $9.32 to a low of $0.40 during the period of January 1, 2004 through December 31, 2008) and may vary in the future due to a number of factors, including:

- announcement of the results of, or delays in, preclinical and clinical studies;
- fluctuations in our operating results;
- developments in litigation to which we or a competitor is subject;
- announcements and timing of potential acquisitions, divestitures, capital raising activities or issuance of preferred stock;
- announcements of technological innovations or new products by us or our competitors;
- FDA and other regulatory actions;
- developments with respect to our or our competitors' patents or proprietary rights;
- public concern as to the safety of products developed by us or others;
- changes in stock market analyst recommendations regarding us, other drug development companies or the pharmaceutical industry generally; and
- failure in the future to meet the requirements for continued listing on the NASDAQ markets.

In addition, the stock market has from time to time experienced significant price and volume fluctuations that are unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the market price of our stock.

Additional authorized shares of our common stock available for issuance may have dilutive and other material effects on our stockholders.

We are authorized to issue 100,000,000 shares of common stock. As of December 31, 2008, there were 40,775,411 shares of common stock issued and outstanding. However, the total number of shares of our common stock issued and outstanding does not include shares reserved in anticipation of the exercise of options, warrants or additional investment rights. As of December 31, 2008, we had stock options outstanding to purchase approximately 2,990,304 shares of our common stock, the exercise price of which ranges between $1.02 per share to $7.83 per share, warrants outstanding to purchase 46,706 shares of our common stock with an exercise price of $6.39, warrants outstanding to purchase 357,423 shares of our common stock with an exercise price of $1.91, and we have reserved shares of our common stock for issuance in connection with the potential exercise thereof. To the extent additional options are granted and exercised or additional stock is issued, the holders of our common stock will experience further dilution. At December 31, 2008, 30,302 shares remain available to grant under the 2005 Equity Incentive Plan. In addition, in the event that any future financing or consideration for a future acquisition should be in the form of, be convertible into or exchangeable for, equity securities, investors will experience additional dilution.

Certain provisions of our amended and restated certificate of incorporation and bylaws will make it difficult for stockholders to change the composition of our board of directors and may discourage takeover attempts that some of our stockholders may consider beneficial.

Certain provisions of our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing changes in control if our board of directors determines that such changes in control are not in the best interests of the Company and our stockholders. These provisions include, among other things, the following:

Table of Contents

- a classified board of directors with three-year staggered terms;
- advance notice procedures for stockholder proposals to be considered at stockholders' meetings;
- the ability of our board of directors to fill vacancies on the board;
- a prohibition against stockholders taking action by written consent; and
- super majority voting requirements for the stockholders to modify or amend our bylaws and specified provisions of our amended and restated certificate of incorporation.

These provisions are not intended to prevent a takeover, but are intended to protect and maximize the value of our stockholders' interests. While these provisions have the effect of encouraging persons seeking to acquire control of our company to negotiate with our board of directors, they could enable our board of directors to prevent a transaction that some, or a majority, of our stockholders might believe to be in their best interests and, in that case, may prevent or discourage attempts to remove and replace incumbent directors. In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which prohibits business combinations with interested stockholders. Interested stockholders do not include stockholders whose acquisition of our securities is pre-approved by our board of directors under Section 203.

We may issue additional shares of preferred stock that have greater rights than our common stock and also have dilutive and anti-takeover effects.

We are permitted by our amended and restated certificate of incorporation to issue up to 2,000,000 shares of preferred stock. We can issue shares of our preferred stock in one or more series and can set the terms of the preferred stock without seeking any further approval from our common stockholders or other security holders. Any preferred stock that we issue may rank ahead of our common stock in terms of dividend priority or liquidation rights and may have greater voting rights than our common stock.

In connection with a Rights Agreement dated as of June 19, 2007 between us and the Bank of New York, (the "Rights Agreement"), our board approved the designation of 1,000,000 shares of Series A Preferred Stock. The Rights Agreement and the exercise of rights to purchase Series A Preferred Stock pursuant to the terms thereof may delay, defer or prevent a change in control because the terms of any issued Series A Preferred Stock would potentially prohibit our consummation of certain extraordinary corporate transactions without the approval of the Board. In addition to the anti-takeover effects of the rights granted under the Rights Agreement, the issuance of preferred stock, generally, could have a dilutive effect on our stockholders.

We have not previously paid dividends on our common stock and we do not anticipate doing so in the foreseeable future.

We have not in the past paid any dividends on our common stock and do not anticipate that we will pay any dividends on our common stock in the foreseeable future. Any future decision to pay a dividend on our common stock and the amount of any dividend paid, if permitted, will be made at the discretion of our board of directors.

Developments in any of these areas, which are more fully described elsewhere in "Item 1 - Business," and "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations" could cause our results to differ materially from results that have been or may be projected by us.

Table of Contents

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

During the years 1998 – 2007, we leased a facility in Tempe, Arizona, which is an approximately 100,000 square foot facility designed and constructed for industrial purposes and is located in an industrial district. It is the same facility we leased prior to our November 2003 divestiture of our bone growth stimulation device business. Following the divestiture, we occupied approximately 20% of the building capacity and subleased some portions of the building to other companies. This lease expired December 31, 2007. In July 2007, we entered into a new five-year lease for 17,000 square feet of space in the same Tempe facility, which became effective at the end of our current lease. We believe the facility is well-maintained and adequate for use through the end of our lease term.

Item 3. Legal Proceedings

None.

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

None.

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock commenced trading on NASDAQ on January 28, 1993 and is currently trading on the NASDAQ Global Market under the symbol "CAPS." The following table sets forth, for the fiscal periods indicated, the range of high and low sales prices of our common stock.

	2008		2007	
	High	Low	High	Low
First Quarter	$ 1.34	$ 0.79	$ 1.80	$ 1.35
Second Quarter	$ 1.09	$ 0.79	$ 1.64	$ 1.40
Third Quarter	$ 0.99	$ 0.72	$ 1.60	$ 1.35
Fourth Quarter	$ 0.95	$ 0.40	$ 1.59	$ 1.28

As of February 28, 2009, 40,775,411 shares of our common stock were outstanding and held by approximately 982 stockholders of record.

Dividends.

We have never paid a cash dividend on our common stock. We do not intend to pay any cash dividends on our common stock in the foreseeable future.

Table of Contents

Recent Sales of Unregistered Securities.

None.

Issuer Purchases of Equity Securities.

On March 5, 2008, we announced that our Board of Directors had approved a stock repurchase program for up to five percent of our then outstanding common shares. The shares may be repurchased from time to time in open market transactions or privately negotiated transactions at our discretion, subject to market conditions and other factors. There were approximately 41.8 million shares of common stock outstanding at March 5, 2008.

During the year ended December 31, 2008, we purchased a total of 1,131,622 shares at a total cost of $1,041,000.

The following table summarizes information regarding shares purchased during the three months ended December 31, 2008.

Month	Total Number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced program	Maximum number of shares that may yet be purchased under the program
November 1 - 30	18,804	$ 0.48	18,804	
December 1 - 31	30,022	$ 0.50	30,022	950,000

Item 6. Selected Financial Data

SELECTED FINANCIAL DATA

The selected financial data for each of the five years in the period ended December 31, 2008, is derived from our audited financial statements. The selected financial data should be read in conjunction with the financial statements, related notes to the financial statements and other financial information appearing elsewhere in this annual report on Form 10-K and particularly the discussion in “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” We sold our bone growth stimulation device business (“Bone Device Business”) on November 26, 2003. On August 5, 2004, we purchased substantially all the assets and the intellectual property of CBI. We became a development stage company commensurate with the CBI acquisition. On February 27, 2006, we purchased certain assets and assumed certain liabilities of AzERx. The financial data as presented in the following schedule reflects the gain on the sale of the bone growth stimulation device business as discontinued operations and reflects the purchased net assets of CBI and AzERx from the dates of those respective acquisitions.

Research and Development expenses in 2004, 2005 and 2006 include expenditures related to Phase 3 and Phase 2b Chrysalin clinical trials in distal radial fracture.

On March 15, 2006, we reported results of our Phase 3 fracture repair human clinical trial. For the primary endpoint, time to removal of immobilization, no statistically significant difference was observed between placebo and a single injection of Chrysalin.

18

Table of Contents

On August 29, 2006, we reported the results of interim analysis of data from our Phase 2b dose-ranging clinical trial of Chrysalin in unstable, displaced distal radius (wrist) fractures and termination of the Phase 2b study. In the dataset of 240 subjects as a group that were evaluable in the Phase 2b interim analysis, treatment with Chrysalin did not demonstrate benefit compared to placebo in the primary efficacy endpoint of time to removal of immobilization.

In 2006 we implemented a strategic shift in our development approach to our Chrysalin-based product candidates, to pursue development partnering or licensing opportunities for our Chrysalin-based product candidates, a change from our previous development history of independently conducting human clinical trials necessary to advance our Chrysalin-based product candidates to market.

Research and Development expenses in 2007 include regulatory required expenses related to the completion of the Phase 3 and Phase 2b distal radial fracture studies and expenses to file an IND in dermal scarring for AZX100. Research and Development expenses in 2008 include expenditures to complete Phase 1a and Phase 1b safety clinical trials in dermal scarring for AZX100.

Table of Contents

STATEMENTS OF OPERATIONS DATA
(A Development Stage Company)
(in thousands, except per share amounts)

	Years Ended December 31,				
	2008	2007	2006(1)	2005(2)	2004(3)
Operating expenses					
General and administrative	$ 2,991	$ 3,738	$ 6,558	$ 4,910	$ 3,306
Research and development	10,693	9,641	19,661	25,444	17,116
Purchased in-process research and development	-	-	8,471	-	25,840
Other	-	-	-	(250)	(347)
Total operating expenses	13,684	13,379	34,690	30,104	45,915
Interest and other income, net	(2,082)	(3,278)	(3,883)	(2,640)	(1,464)
Loss from continuing operations before taxes	11,602	10,101	30,807	27,464	44,451
Income taxes expense (benefit)	(363)		1,106	(108)	(642)
Loss from continuing operations	11,239	10,101	31,913	27,356	43,809
Discontinued operations					
Net gain on the sale of the bone device business net of taxes $0, $0, $0, $96, ($363) respectively	-	-	-	(154)	(2,048)
NET LOSS	$ 11,239	$ 10,101	$ 31,913	$ 27,202	$ 41,761
Per Share Information:					
Net loss from continuing operations basic and diluted	$ 0.27	$ 0.24	$ 0.78	$ 0.72	$ 1.22
Net (income) from discontinued operations basic and diluted	$ -	$ -	$ -	$ -	$ (0.06)
Net loss basic and diluted	$ 0.27	$ 0.24	$ 0.78	$ 0.72	$ 1.16
Basic and diluted shares outstanding	41,078	41,644	40,764	38,032	35,899

1. Research and development expenses in 2006 include recognition of a $2,100,000 Chrysalin patent cost impairment loss. Operating expenses in 2006 included $8,471,000 of purchased in-process research and development costs associated with the AzERx acquisition in February 2006. Income tax expenses in 2006 included the recording of a $1,106,000 valuation allowance for a deferred tax asset related to a Alternative Minimum Tax credit carryover.

2. Total operating expenses in 2005 were reduced by $250,000 as a result of a final settlement payment received from the buyer of the CPM business. A net gain of $154,000 was recognized on the sale of the Bone Device Business due to receipt of the entire escrow deposit outstanding.

3. On August 5, 2004, we completed the acquisition of CBI. OrthoLogic expensed in-process research and development and acquisition costs of $25.8 million.

A net gain of $2,048,000 was recognized on the sale of the Bone Device Business primarily due to a decrease in the risk related to the potential exposure of the representations and warranties provided in the governing asset purchase agreement.

Table of Contents

BALANCE SHEET DATA
(in thousands)

	December 31,				
	2008	2007	2006	2005	2004
Working capital	$ 44,865	$ 37,684	$ 52,533	$ 78,423	$ 88,955
Total assets	$ 49,514	$ 61,862	$ 72,589	$ 88,343	$ 115,184
Long term liabilities, less current maturities	$ -	$ -	$ -	$ 183	$ 137
Stockholders' equity	$ 47,522	$ 59,461	$ 69,148	$ 84,178	$ 110,930

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

OVERVIEW OF BUSINESS

Company History

Prior to November 26, 2003, we developed, manufactured and marketed proprietary, technologically advanced orthopedic products designed to promote the healing of musculoskeletal bone and tissue, with particular emphasis on fracture healing and spine repair. Our product lines included bone growth stimulation and fracture fixation devices including the OL1000 product line, SpinaLogic® and OrthoFrame/Mayo, which we sometimes refer to as our "Bone Device Business."

On November 26, 2003, we sold our Bone Device Business. Our principal business remains focused on tissue repair, although through biopharmaceutical approaches rather than through the use of medical devices.

On August 5, 2004, we purchased substantially all of the assets and intellectual property of Chrysalis Biotechnology, Inc. ("CBI"), including its exclusive worldwide license for Chrysalin for all medical indications. We became a development stage entity commensurate with the acquisition. Subsequently, all of our collective efforts were focused on research and development of our Chrysalin Product Platform, with the goal of commercializing our products. We currently own exclusive worldwide rights to Chrysalin.

On February 27, 2006 we purchased certain assets and assumed certain liabilities of AzERx, Inc. Under the terms of the transaction, we acquired an exclusive license for the core intellectual property relating to AZX100, a 24-amino acid synthetic peptide. We have an exclusive worldwide license to AZX100.

On October 1, 2008, OrthoLogic Corp. began doing business under the trade name of Capstone Therapeutics.

Chrysalin, Capstone Therapeutics and OrthoLogic are registered United States domestic trademarks of OrthoLogic Corp.

Our development activities for the Chrysalin and AZX100 represent a single operating segment as they share the same product development path and utilize the same Company resources. As a result, we have determined that it is appropriate to reflect our operations as one reportable segment. Through December 31, 2008, we have incurred $113 million in net losses as a development stage company.

Table of Contents

Description of the business

OrthoLogic is a biotechnology company committed to developing a pipeline of novel peptides and other molecules aimed at helping patients with under-served conditions. We are focused on the development and commercialization of two product platforms: Chrysalin® (TP508) and AZX100.

Chrysalin

Chrysalin (TP508), a novel synthetic 23-amino acid peptide, is believed to produce angiogenic and other tissue repair effects by activating or upregulating nitric oxide synthase (NOS) and the production of nitric oxide in endothelial cells, and if so, it may have potential therapeutic value in tissues and diseases exhibiting endothelial dysfunction. We have conducted clinical trials for two potential Chrysalin-based products, acceleration of fracture repair, and diabetic foot ulcer. We previously conducted a pilot study for spine fusion. We have conducted pre-clinical testing for cartilage defect repair, cardiovascular repair (including acute myocardial infarction and myocardial ischemia), dental bone repair and tendon repair.

The development of each of our potential Chrysalin-based product candidates is based on our collective knowledge and understanding of how Chrysalin contributes to the repair of tissue. While there are important differences in each of the product candidates in terms of purpose (acute myocardial infarction, myocardial ischemia, fracture repair, diabetic foot ulcer healing, etc.) each product candidate is focused on accelerating and enhancing tissue repair.

Chrysalin-based Product Candidates

- We believe that the results of our efforts to date support that Chrysalin may have potential therapeutic value in tissues and diseases exhibiting endothelial dysfunction.

- We are continuing pre-clinical experiments tying Chrysalin to potential modulation of the health of endothelial tissue in blood vessels and other mechanism-of-action studies.

- We are focusing our efforts on vascular product candidates and are not currently planning additional pre-clinical or clinical studies in fracture repair, wound healing, spine fusion, cartilage defect repair, dental bone repair or tendon repair.

- Although we do not currently plan to re-enter clinical trials with Chrysalin, we will perform pre-clinical and clinical studies which we believe would serve to strengthen our portfolio and partnering possibilities.

AZX100

AZX100, our second peptide, is a novel synthetic pre-clinical 24-amino acid peptide. AZX100 relaxes smooth muscle, which modulates blood pressure and the function of blood vessels, airways, sphincters, the gastrointestinal tract and the genitourinary tract. Sustained abnormal contraction of any of these muscles is called spasm. Any disorders known to be associated with excessive constriction or inadequate dilation of smooth muscle represent potential applications for AZX100.

AZX100 may also inhibit the fibrotic phenotype of fibroblasts and smooth muscle cells in a mechanism similar to that which causes vasorelaxation. Through phenotypic modulation of fibroblasts and smooth muscle cells, AZX100 may inhibit the scarring that results from wound healing and disease states in the dermis, blood vessels, lungs, liver and other organs.

22

Table of Contents

We are executing a development plan for this peptide which included the filing of an IND for a dermal indication in 2007, completion of Phase 1a and Phase 1b safety studies in 2008, and includes the commencement of Phase 2 efficacy studies in dermal scarring in the first quarter of 2009. The first safety study included 30 healthy subjects and was completed in mid 2008. Our second safety study for dermal scarring (Phase 1b), which included 40 subjects, was completed in the fourth quarter of 2008. The studies' Safety Committee reviewing all safety-related aspects of the clinical trials was satisfied with the profile of AZX100.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires that management make a number of assumptions and estimates that affect the reported amounts of assets, liabilities, and expenses in our financial statements and accompanying notes. Management bases its estimates on historical experience and various other assumptions believed to be reasonable. Although these estimates are based on management's best knowledge of current events and actions that may impact the Company in the future, actual results may differ from these estimates and assumptions. Our critical accounting policies are those that affect, or could affect, our financial statements materially and involve a significant level of judgment by management.

Income Taxes: SFAS No. 109 "Accounting for Income Taxes" requires that a valuation allowance be established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances from period to period are included in the tax provision in the period of change. In determining whether a valuation allowance is required, we take into account all evidence with regard to the utilization of a deferred tax asset included in past earnings history, expected future earnings, the character and jurisdiction of such earnings, unsettled circumstances that, if unfavorably resolved, would adversely affect utilization of a deferred tax asset, carryback and carryforward periods, and tax strategies that could potentially enhance the likelihood of realization of a deferred asset. We have evaluated the available evidence about future taxable income and other possible sources of realization of deferred tax assets and have established a valuation allowance for all of our deferred tax assets of approximately $45 million at December 31, 2008. The valuation allowance includes an allowance recorded in 2006 for a previously recorded deferred tax asset related to a Alternative Minimum Tax credit carryover of $1,106,000.

Patents: On November 2, 2006, we announced that we have no immediate plans to re-enter clinical trials for Chrysalin-based product candidates and a strategic shift in our development approach to our Chrysalin product platform. We currently intend to pursue development partnering or licensing opportunities for our Chrysalin-based product candidates, a change from its previous development history of independently conducting human clinical trials necessary to advance our Chrysalin-based product candidates to market. SFAS No. 142 requires an impairment loss be recognized for an amortizable intangible asset whenever the net cash in-flow to be generated from an asset is less than its carrying cost. We are unable to determine the timing or amount of net cash in-flow to be generated from Chrysalin-based product candidates. Accordingly, due to this uncertainty, we recognized an impairment loss for the amount of unamortized Chrysalin product platform patent costs of $2,100,000 in 2006. The impairment loss was included in research and development expenses in 2006.

Stock based compensation: Effective January 1, 2006, we adopted SFAS No. 123 (revised 2004), "Share-Based Payment", (SFAS 123(R)). SFAS 123(R) requires all share-based payments, including grants of stock options, restricted stock units and employee stock purchase rights, to be recognized in our financial statements based on their respective grant date fair values. Under this standard, the fair value of each employee stock option and employee stock purchase right is estimated on the date of grant using an option pricing model that meets certain requirements. We

currently use the Black-Scholes option pricing model to estimate the fair value of our share-based payments. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by our stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. We use the historical volatility adjusted for future expectations. The expected life of the stock options is based on historical data and future expectations. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our stock options and stock purchase rights. The dividend yield assumption is based on our history and expectation of dividend payouts. The fair value of our restricted stock units is based on the fair market value of our common stock on the date of grant. Stock-based compensation expense recognized in our financial statements in 2006 and thereafter is based on awards that are ultimately expected to vest. The amount of stock-based compensation expense in 2006 and thereafter will be reduced for estimated forfeitures. Forfeitures are required to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We will evaluate the assumptions used to value stock awards on a quarterly basis. If factors change and we employ different assumptions, stock-based compensation expense may differ significantly from what we have recorded in the past. To the extent that we grant additional equity securities to employees, our stock-based compensation expense will be increased by the additional compensation resulting from those additional grants.

Table of Contents

Results of Operations Comparing Years Ended December 31, 2008 and 2007

General and Administrative ("G&A") Expenses: G&A expenses related to our ongoing development operations decreased by $747,000 from $3,738,000 in 2007, to $2,991,000 in 2008. Our G&A expenses during 2008 were lower than 2007 primarily as a result of general cost containment efforts.

Research and Development Expenses: Research and development expenses were $10,693,000 for 2008 compared to $9,641,000 for 2007. Our research and development expenses increased by $1,052,000 in 2008, compared to 2007, primarily due to costs related to our Phase 1 clinical trials in dermal scarring and our previously announced completion of a pre-clinical study to assess the effects of Chrysalin in a model of acute myocardial infarction (heart attack), partially offset by a decline in AZX100 pre-clinical costs related to the filing of an IND in a dermal scarring indication, which was completed as of December 31, 2007. Given the overlapping nature of our research efforts it is not possible to clearly separate research expenditures between Chrysalin and AZX100; however, the substantial majority of our research and development expenses in 2008 and 2007 are directed towards AZX100 development efforts.

Interest and Other Income, Net: Interest and other income, net decreased from $3,278,000 in 2007 to $2,082,000 in 2008, due to the decrease in interest rates between the two periods and reduction in the amount available for investment.

Net Loss: We incurred a net loss in 2008 of $11.2 million compared to a net loss of $10.1 million in 2007. The increase in the net loss for 2008 compared to 2007 resulted primarily from costs related to our Phase 1 clinical trials in dermal scarring in 2008, reduced interest income, due to the decrease in interest rates between the two periods and reduction in the amount available for investment, partially offset by lower general and administrative expenses, due to general cost containment efforts, reduced AZX100 pre-clinical costs related to the filing of an IND for a dermal scarring indication, which was completed as of December 31, 2007, and reversal of a $363,000 income tax reserve in the fourth quarter of 2008.

Table of Contents

Results of Operations Comparing Years Ended December 31, 2007 and 2006.

General and Administrative ("G&A") Expenses: G&A expenses related to our ongoing development operations decreased by $2,820,000 to $3,738,000 in the year ended December 31, 2007 from $6,558,000 in 2006. Our administrative expenses during the year ended December 31, 2007 were lower than 2006, primarily as a result of a decrease of non-cash stock compensation expense of $1,433,000, reduced costs in 2007 reflecting management changes and staff reductions which occurred in the first half of 2006, and general cost containment efforts.

Research and Development Expenses: Research and development expenses were $9,641,000 for the year ended December 31, 2007 compared to $19,661,000 in 2006. Our research and development expenses decreased by $10,020,000 in the year ended December 31, 2007 compared to 2006, primarily due to a $5.5 million decline in clinical costs related to our fracture repair Phase 3 and Phase 2b clinical trials, which were substantially completed as of December 31, 2006 and a Chrysalin patent impairment loss of $2.1 million recorded in 2006.

Interest and Other Income, Net: Interest and other income net decreased from $3,883,000 in the year ended December 31, 2006 to $3,278,000 in 2007, due to a reduction in the cash and investments available for investment during 2007.

Net Loss: We incurred a net loss in 2007 of $10.1 million compared to a net loss of $31.9 million in 2006. The $21.8 million decrease in the net loss in the year ended December 31, 2007 compared to the same period in 2006, results primarily from $8.5 million of purchased in-process research and development costs in 2006, a decrease of $2.0 million in non-cash stock compensation expense, reduced costs in 2007 reflecting management changes and staff reductions which occurred in the first half of 2006, a $5.5 million decline in clinical costs related to our fracture repair Phase 3 and Phase 2b clinical trials, which were substantially completed as of December 31, 2006, a Chrysalin product platform patent impairment loss of $2.1 million recorded in 2006, and the recognition in 2006 of income tax expense related to the recording of a valuation allowance of $1.1 million for a deferred tax asset related to a Alternative Minimum Tax credit carryover.

Liquidity and Capital Resources

We have historically financed our operations through operating cash flows and the public and private sales of equity securities. However, with the sale of our Bone Device Business in November 2003, we sold all of our revenue producing operations. Since that time, we have relied on our cash and investments to finance all our operations, the focus of which was research and development of our Chrysalin and AZX100 product candidates. We received approximately $93.0 million in cash from the sale of our Bone Device Business. On December 1, 2005, we received the additional $7.2 million, including interest, from the escrow balance related to the sale of the Bone Device Business. On February 27, 2006, we entered into an agreement with Quintiles (see Note 15 to our Annual Report on Form 10-K filed with the Securities Exchange Commission on March 5, 2008), which provided an investment by Quintiles in our common stock, of which $2,000,000 was received on February 27, 2006 and $1,500,000 was received on July 3, 2006. We also received net proceeds of $4,612,000 from the exercise of stock options during our development stage period. At December 31, 2008, we had cash and cash equivalents of $23.1 million, short-term investments of $22.7 million and long-term investments of $2.2 million.

We announced that we have no immediate plans to re-enter clinical trials for Chrysalin-based product candidates and a strategic shift in our development approach for Chrysalin-based product candidates. We currently intend to pursue development partnering or licensing opportunities for our Chrysalin-based product candidates, a change from our previous development history of independently conducting human clinical trials necessary to advance our Chrysalin-based product candidates to market. We will continue to explore Chrysalin's therapeutic value in tissues and diseases exhibiting endothelial dysfunction as well as the science behind and potential of Chrysalin. We will also

continue research and development expenditures for further pre-clinical studies supporting multiple indications for AZX100 and plan to commence a Phase 2 human clinical trial for dermal scarring with AZX100 in the first quarter of 2009.

Table of Contents

Our future research and development expenses may vary significantly from prior periods depending on the Company's decisions on its future Chrysalin and AZX100 development plans. Our future interest and other income may vary significantly from prior periods based on changes in interest rates and amounts available for investment.

On March 5, 2008, we announced a stock repurchase program and at December 31, 2008, we had repurchased 1,131,622 shares of our common stock, at a total cost of $1,041,000, and had allocated approximately $1,000,000 to fund possible future stock repurchases.

We anticipate that our cash and short-term investments will be sufficient to meet our presently projected cash and working capital requirements for the next year. However, the timing and amounts of cash used will depend on many factors, including our ability to continue to control our expenditures related to our research and development programs, including our planned AZX100 dermal scarring clinical trials. If we decide to expand our clinical trials or if we consider other opportunities in the market, our expense levels may change, which could require us to seek other sources of capital. If additional funding is required, we would be required to seek new sources of funds, including raising capital through the sales of securities or licensing agreements. These sources of funds may not be available or could only be available at terms that would have a material adverse impact on our existing stockholders' interests.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

We had no debt and no derivative instruments at December 31, 2008. Our investment portfolio is used to preserve our capital until it is required to fund our operations. Our investment instruments are classified as held-to-maturity. We do not own derivative financial instruments in our investment portfolio. We maintain a non-trading investment portfolio of investment grade securities that limits the amount of non-US Government obligations credit exposure of any one issue, issuer or type of instrument. Due to the short duration and conservative nature of these instruments, we do not believe that we have a material exposure to interest rate risk.

Our long-term investment at December 31, 2008 is a U.S. Government obligation and matures in February 2010.

Item 8. Financial Statements and Supplementary Data

Balance sheets as of December 31, 2008 and December 31, 2007, statements of operations, stockholders' equity and cash flows for each of the years in the two-year period ended December 31, 2008, and the statements of operations and cash flow for the period of August 5, 2004 through December 31, 2008, together with the related notes and the reports of Ernst & Young, LLP, our independent registered public accounting firm, are set forth on the "F" pages of this Form 10-K.

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

None.

Table of Contents

Item 9A(T). Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rules 13a - 15(e) and 15d - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

Management's Annual Report on Internal Control Over Financial Reporting

The management of OrthoLogic Corp. (a development stage company) is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a - 15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in Internal Control - Integrated Framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2008.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities Exchange Commission that permit the Company to provide only management's report in this annual report.

Management's Annual Report on Changes in Internal Controls

There have not been any changes in our internal controls over financial reporting during the fiscal quarter ended December 31, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required herein is incorporated by reference pursuant to General Instruction G(3) of Form 10-K, since the Registrant will file its definitive proxy statement with the Securities and Exchange Commission for the 2009 Annual Meeting of Stockholders to be held on May 8, 2009, no later than 120 days after the close of its fiscal year ended December 31, 2008.

27

Table of Contents

Item 11. Executive Compensation

The information required herein is incorporated by reference pursuant to General Instruction G(3) of Form 10-K, since the Registrant will file its definitive proxy statement with the Securities and Exchange Commission for the 2009 Annual Meeting of Stockholders to be held on May 8, 2009, no later than 120 days after the close of its fiscal year ended December 31, 2008.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholders Matters

The information required herein is incorporated by reference pursuant to General Instruction G(3) of Form 10-K, since the Registrant will file its definitive proxy statement with the Securities and Exchange Commission for the 2009 Annual Meeting of Stockholders to be held on May 8, 2009, no later than 120 days after the close of its fiscal year ended December 31, 2008.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required herein is incorporated by reference pursuant to General Instruction G(3) of Form 10-K, since the Registrant will file its definitive proxy statement with the Securities and Exchange Commission for the 2009 Annual Meeting of Stockholders to be held on May 8, 2009, no later than 120 days after the close of its fiscal year ended December 31, 2008.

Item 14. Principal Accountant Fees and Services

The information required herein is incorporated by reference pursuant to General Instruction G(3) of Form 10-K, since the Registrant will file its definitive proxy statement with the Securities and Exchange Commission for the 2009 Annual Meeting of Stockholders to be held on May 8, 2009, no later than 120 days after the close of its fiscal year ended December 31, 2008.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this report:

1. Financial Statements.

The following financial statements of OrthoLogic Corp. and Report of Independent Registered Public Accounting Firm are presented in the “F” pages of this report:

Report of Independent Registered Public Accounting Firm.

Balance Sheets - December 31, 2008 and 2007.

Statements of Operations - Each of the years in the two-year period ended December 31, 2008 and for the period of August 5, 2004 through December 31, 2008.

Statements of Stockholders’ Equity - Each of the years in the two-year period ended December 31, 2008.

Statements of Cash Flows - Each of the years in the two-year period ended December 31, 2008 and for the period of August 5, 2004 through December 31, 2008.

Table of Contents

Notes to Financial Statements.

2. Financial Statement Schedules have been omitted since they are not applicable.

3. All management contracts and compensatory plans and arrangements are specifically identified on the attached Exhibit Index.

(b) Exhibits

See the Exhibit Index following the signature page of this report, which Index is incorporated herein by reference.

(c) Financial Statements and Schedules - See Item 15(a)(1) and Item 15(a)(2) above.

Table of Contents

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.

ORTHOLOGIC CORP.

Date: March 13, 2009

By /s/ John M. Holliman, III
John M. Holliman, III
Executive Chairman

Table of Contents

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/ John M. Holliman, III John M. Holliman, III	Executive Chairman (Principal Executive Officer) and Director	March 13, 2009
/s/ Fredric J. Feldman Fredric J. Feldman, Ph.D.	Director	March 13, 2009
/s/ Elwood D. Howse, Jr. Elwood D. Howse, Jr.	Director	March 13, 2009
/s/ William M. Wardell William M. Wardell, MD, Ph.D.	Director	March 13, 2009
/s/ Augustus A. White, III Augustus A. White III, MD.	Director	March 13, 2009
/s/ Randolph C. Steer Randolph C. Steer, MD, Ph.D.	President	March 13, 2009
/s/ Les M. Taeger Les M. Taeger	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 13, 2009

Table of Contents

OrthoLogic Corp.
Exhibit Index to Annual Report on Form 10-K
For the Year Ended December 31, 2008

Exhibit No.	Description	Incorporated by Reference To:	Filed Herewith
2.1	Asset Purchase Agreement and Plan of Reorganization by and between OrthoLogic Corp. and Chrysalis Biotechnology, dated April 28, 2004 (*)	Exhibit 2.1 to the Company's Registration Statement on Form S-4 filed with the SEC on June 3, 2004 ("June 2004 S-4")	
2.2	Amendment No. 1 to Asset Purchase Agreement and Plan of Reorganization by and between OrthoLogic Corp. and Chrysalis Biotechnology, dated June 1, 2004 (*)	Exhibit 2.2 to the Company's June 2004 S-4	
2.3	Amendment No. 2 to Asset Purchase Agreement and Plan of Reorganization between OrthoLogic Corp. and Chrysalis Biotechnology, Inc., dated August 5, 2004 (*)	Exhibit 2.1 to the Company's Current Report on Form 8-K filed on August 6, 2004	
2.4	Asset Purchase Agreement and Plan of Reorganization by and between OrthoLogic Corp. and AzERx, Inc., dated February 23, 2006 (*)	Exhibit 10.1 to the Company's Registration Statement on Form S-3 filed with the SEC on April 25, 2006	
3.1	Restated Certificate of Incorporation, executed April 15, 2005	Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, filed with the SEC on May 10, 2005 ("March 2005 10-Q")	
3.2	Amended and Restated Certificate of Designation of Series A Preferred Stock, executed June 19, 2007	Exhibit 3.1 to the Company's Current Report on Form 8-K filed with the SEC on June 25, 2007 ("June 25th 2007 8-K")	
3.3	Bylaws of the Company	Exhibit 3.4 to the Company's Amendment No. 2 to Registration Statement on Form S-1 (No. 33-47569) filed with the SEC on January 25, 1993 ("January 1993 S-1")	
4.1	Class A Warrant Agreement dated February 24, 2006, between OrthoLogic Corp. and PharmaBio Development Inc. (d/b/a NovaQuest)	Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the SEC on March 3, 2006	
4.2	Form of Additional Class A Warrant Agreement related to the Common Stock and Warrant Purchase Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc.	Exhibit 4.8 to the Company's Registration Statement on Form S-3 filed with the SEC on April 13, 2006 ("April 2006 S-3")	
4.3			

	Class A Warrant Agreement dated June 30, 2006 by and between OrthoLogic Corp. and PharmaBio Development, Inc	Exhibit 4.1 to the Company's Current Report on Form 8-K filed with the SEC on July 6, 2006
4.4	Amended and Restated Class B Warrant Agreement dated February 24, 2006, and amended and restated as of June 30, 2006, related to the Common Stock and Warrant Purchase Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc. (2)	Exhibit 4.5 to the Company's Amendment No. 1 to Registration Statement on Form S-3 filed with the SEC on September 22, 2006 ("September 2006 S-3/A")

Table of Contents

4.5	Amended and Restated Class C Warrant Agreement dated February 24, 2006, and amended and restated as of June 30, 2006, related to the Common Stock and Warrant Purchase Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc.	Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, filed with the SEC on May 7, 2007
4.6	Amended and Restated Class D Warrant Agreement dated February 24, 2006, and amended and restated as of June 30, 2006, related to the Common Stock and Warrant Purchase Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc.	Exhibit 4.6 to the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 5, 2008.
4.7	Rights Agreement, dated as of June 19, 2007, between OrthoLogic Corp. and the Bank of New York	Exhibit 4.1 to the June 25th 2007 8-K
10.1	Form of Indemnification Agreement(**)	Exhibit 10.16 to the Company's January 1993 S-1
10.2	1997 Stock Option Plan of the Company, as amended and approved by the stockholders (1)	Exhibit 4.3 to the Company's Registration Statement on Form S-8, filed with the SEC on March 2, 2005
10.3	Single-tenant Lease dated June 12, 1997, by and between the Company and Chamberlain Development, L.L.C.	Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997, filed with the SEC on November 14, 1997
10.4	Patent License Agreement between the Board of Regents of The University of Texas System through its component institution The University of Texas Medical Branch at Galveston and Chrysalis Biotechnology, Inc., dated April 27, 2004 and exhibits thereto (2)	Exhibit 10.1 to the Company's Amendment No. 1 to its Registration Statement on Form S-4, filed July 14, 2004
10.5	Form of Incentive Stock Option Grant Letter for use in connection with the Company's 1997 Stock Option Plan (***)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 4, 2005
10.6	Form of Non-qualified Stock Option Grant Letter for use in connection with the Company's 1997 Stock Option Plan (***)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 19, 2006
10.7	Patent Assignment Agreement dated June 28, 2005, between the Company and the University of Texas	Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2005, filed with the SEC on August 9, 2005 (the "June 2005 10-Q")
10.8	Director Compensation Plan, effective June 10, 2005 (1)	Exhibit 10.2 to the June 2005 10-Q
10.9	Letter of Stock Option Grant to Dr. James M. Pusey for 200,000 shares	Exhibit 10.3 to the March 4th, 2005 8-K

	of the Company's common stock, dated March 3, 2005 (1)	
10.10	Letter of Stock Option Grant to Dr. James M. Pusey for 300,000 shares of the Company's common stock, dated March 3, 2005 (1)	Exhibit 10.4 to the March 4th, 2005 8-K
10.11	Employment Agreement between the Company and Dana Shinbaum, dated October 17, 2005 (1)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on October 27, 2005
10.12	Employment Agreement dated January 10, 2006 between the Company and Les M. Taeger (1)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on January 11, 2006 (the "January 11th 8-K")

Table of Contents

10.13	Intellectual Property, Confidentiality and Non-Competition Agreement between the Company and Les M. Taeger dated January 10, 2006 (1)	Exhibit 10.2 to the January 11th 8-K
10.14	Separation Agreement and Release dated April 5, 2006 by and between OrthoLogic Corp. and James M. Pusey (1)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on April 11, 2006
10.15	Common Stock and Warrant Purchase Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc., dated February 24, 2006.	Exhibit 10.1 to the Company's April 2006 S-3
10.16	Registration Rights Agreement by and between OrthoLogic Corp. and PharmaBio Development, Inc., dated February 24, 2006	Exhibit 10.2 to the Company's April 2006 S-3
10.17	Registration Rights Agreement by and between OrthoLogic Corp., AzERx, Inc., and Certain Shareholders, dated February 27, 2006	Exhibit 10.3 to the Company's April 2006 S-3
10.18	Amended and Restated License Agreement dated February 23, 2006 by and between OrthoLogic Corp. and Arizona Science Technology Enterprises, LLC	Exhibit 10.5 to the Company's Registration Statement on Form S-3 filed with the SEC on April 25, 2006
10.19	2005 Equity Incentive Plan (2005 Plan) (1)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on May 18, 2006
10.20	Form of Incentive Stock Option Grant Letters for Grants under the 2005 Plan (***)	Exhibit 10.1 to the Company's Report on Form 10-Q for the quarterly period ended June 30, 2006, filed on August 8, 2006 ("June 2006 10-Q")
10.21	Form of Non-Qualified Stock Options Grant Letter for Grants under the 2005 Plan (***)	Exhibit 10.2 to the Company's June 2006 10-Q
10.22	Form of Restricted Stock Grant Letters for Grants under the 2005 Plan	Exhibit 10.4 to the Company's Current Report on Form 8-K filed with the SEC on May 18, 2006
10.23	Amendment to Employment Agreement dated January 10, 2006 between OrthoLogic Corp. and Les Taeger (1)	Exhibit 10.3 to the Company's June 2006 10-Q
10.24	Employment Agreement between Randolph C. Steer, MD, Ph.D., President, and OrthoLogic Corp., effective May 12, 2006 (1)	Exhibit 10.7 to the Company's June 2006 10-Q
10.25	Management Service Agreement between Valley Venture III, Management LLC, John M. Holliman, III, Executive Chairman and OrthoLogic	Exhibit 10.8 to the Company's June 2006 10-Q

	Corp., effective May 12, 2006 (1)	
10.26	Amendment No.1 to Registration Rights Agreement dated June 30, 2006 by and between PharmaBio Development, Inc., and OrthoLogic Corp.	Exhibit 10.4 to the Company's September 2006 S-3/A
10.27	Separation Agreement and Release dated November 17, 2006 by and between OrthoLogic Corp., and James T. Ryaby, Ph.D. (1)	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on November 24, 2006 ("November 24th 8-K")
10.28	Consulting Agreement dated November 17, 2006 by and between James T. Ryaby, Ph.D., and OrthoLogic Corp. (1)	Exhibit 10.2 to the Company's November 24th 8-K

Table of Contents

10.29	Lease Agreement dated July 19, 2007, by and between the Company and Phoenix Investors #13, L.L.C.	Exhibit 10.1 to the Company's Current Report on Form 8-K filed with the SEC on July 23, 2007	
10.30	Amendment #1 to Employment Agreement dated May 21, 2007, between Randolph C. Steer, MD, Ph.D., President, and OrthoLogic Corp.	Exhibit 10.30 to the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 5, 2008.	
10.31	Amendment #2 to Employment Agreement dated February 21, 2008, between Randolph C. Steer, MD, Ph.D., President, and OrthoLogic Corp.	Exhibit 10.31 to the Company's Annual Report on Form 10-K for the year ended December 31, 2007, filed with the SEC on March 5, 2008.	
10.32	Amendment No. 3, dated November 4, 2008, to the Management Services Agreement effective May 12, 2006 by and between AGP Management, LP, John M. Holliman, III, Executive Chairman, and OrthoLogic Corp. (1)	Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2008, filed with the SEC on November 6, 2008 (the "November 6, 2008 10-Q")	
10.33	Amendment No. 3, dated November 4, 2008, to the Employment Agreement effective May 12, 2006, between Randolph C. Steer, MD, Ph.D., President, and OrthoLogic Corp. (1)	Exhibit 10.2 to the Company's November 6, 2008 10-Q	
16.1	Letter from Deloitte and Touche, LLP, to the SEC dated June 19, 2006	Exhibit 16.1 to the Company's Current Report on Form 8-K filed with the SEC on June 20, 2006	
23.1	Consent of independent registered public accounting firm.		X
31.1	Certification of Principal Executive Officer Pursuant to Rule 13a -14(a) of the Securities Exchange Act of 1934, as amended		X
31.2	Certification of Principal Financial and Accounting Officer Pursuant to Rule 13a - 14(a) of the Securities Exchange Act of 1934, as amended		X
32.1	Certification of Principal Executive Officer and Principal Financial and Accounting Officer Pursuant to 18 U.S.C. Section 1350****		

(1) Management contract or compensatory plan or arrangement.

(2) Portions of this agreement have been redacted and filed under confidential treatment request with the Securities and Exchange Commission.

* Upon the request of the Securities and Exchange Commission, OrthoLogic Corp. agrees to furnish supplementally a copy of any schedule to the Asset Purchase Agreement and Plan of Reorganization between the Company and Chrysalis Biotechnology, Inc., dated as of April 28, 2004, as amended and the Asset Purchase Agreement and Plan of Reorganization by and between the Company and AzERx, Inc., dated February 23, 2006.

** OrthoLogic has entered into separate indemnification agreements with each of its current directors and executive officers that differ only in party names and dates. Pursuant to the instructions accompanying Item 601 of Regulation S-K, OrthoLogic has filed the form of such indemnification agreement.

*** OrthoLogic from time to time issues stock options to its employees, officers and directors pursuant to its 1997 and 2005 Stock Option Plan, as amended. The incentive stock option grant letters and non-qualified stock option grant letters that evidence these issuances differ only in such terms as the identity of the recipient, the grant date, the number of securities covered by the award, the price(s) at which the recipient may acquire the securities and the vesting schedule. Pursuant to the instructions accompanying Item 601 of Regulation S-K, OrthoLogic has filed the form of such incentive stock option grant letter and non-qualified stock option grant letter.

**** Furnished herewith.

Table of Contents

FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of OrthoLogic Corp. (dba Capstone Therapeutics)

We have audited the accompanying balance sheet of OrthoLogic Corp. (dba Capstone Therapeutics) (a development stage company) as of December 31, 2008 and 2007, and the related statements of operations, stockholders' equity, and cash flows for the years then ended, and for the period August 5, 2004 (inception) through December 31, 2008. 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. The financial statements for the period August 5, 2004 (inception) through December 31, 2005, were audited by other auditors whose report dated March 9, 2006 expressed an unqualified opinion on those statements. Our opinion on the statement of operations, stockholders' equity and cash flows for the period August 5, 2004 (inception) through December 31, 2008, insofar as it relates to the amounts for prior periods through December 31, 2005, is based solely on the report of other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 OrthoLogic Corp. (dba Capstone Therapeutics) (a development stage company) as of December 31, 2008 and 2007 and the results of their operations and their cash flows for the years then ended and the period from August 5, 2004 (inception) through December 31, 2008, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP
Phoenix, Arizona
March 10, 2009

Ernst & Young LLP

Table of Contents

ORTHOLOGIC CORP
(dba Capstone Therapeutics)
(A Development Stage Company)
BALANCE SHEETS
(in thousands, except share and per share data)

	December 31, 2008	December 31, 2007
ASSETS		
Current assets		
Cash and cash equivalents	$ 23,088	$ 20,943
Short-term investments	22,675	18,236
Prepaids and other current assets	1,094	906
Total current assets	46,857	40,085
Furniture and equipment, net	436	318
Long-term investments	2,221	21,459
Total assets	$ 49,514	$ 61,862
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 1,063	$ 702
Accrued compensation	648	824
Other accrued liabilities	281	875
Total current liabilities	1,992	2,401
Stockholders' Equity		
Common Stock $.0005 par value; 100,000,000 shares authorized; 40,775,411 shares in 2008 and 41,758,065 shares in 2007 issued and outstanding	20	21
Additional paid-in capital	188,314	189,013
Accumulated deficit	(140,812)	(129,573)
Total stockholders' equity	47,522	59,461
Total liabilities and stockholders' equity	$ 49,514	$ 61,862

See notes to financial statements

Table of Contents

ORTHOLOGIC CORP.
(dba Capstone Therapeutics)
(A Development Stage Company)
STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Years ended December 31,		As a Development Stage Company August 5, 2004-December 31,
	2008	2007	2008
OPERATING EXPENSES			
General and administrative	$ 2,991	$ 3,738	$ 20,075
Research and development	10,693	9,641	73,519
Purchased in-process research and development	-	-	34,311
Other	-	-	(375)
Total operating expenses	13,684	13,379	127,530
Interest and other income, net	(2,082)	(3,278)	(12,634)
Loss from continuing operations before taxes	11,602	10,101	114,896
Income tax benefit	(363)	-	(7)
Loss from continuing operations	11,239	10,101	114,889
Discontinued Operations			
Net gain on the sale of the bone device business, net of taxes of $267	-	-	(2,202)
NET LOSS	$ 11,239	$ 10,101	$ 112,687
Per Share Information:			
Net loss, basic and diluted	$ 0.27	$ 0.24	
Basic and diluted shares outstanding	41,078	41,644	

See notes to financial statements

Table of Contents

ORTHOLOGIC CORP.
(dba Capstone Therapeutics)
(A Development Stage Company)
STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional	Accumulated	
	Shares	Amount	Paid in Capital	Deficit	Total
Balance December 31, 2006	41,564	$ 21	$ 188,236	$ (119,109)	$ 69,148
Adoption of FIN 48	-	-	-	(363)	(363)
Stock option compensation cost	-	-	534	-	534
Compensation earned on stock awards	194	-	243	-	243
Net loss	-	-	-	(10,101)	(10,101)
Balance December 31, 2007	41,758	21	189,013	(129,573)	59,461
Stock option compensation cost	-	-	177	-	177
Compensation earned on stock awards	149	-	164	-	164
Common stock purchased and retired	(1,132)	(1)	(1,040)	-	(1,041)
Net loss	-	-	-	(11,239)	(11,239)
Balance December 31, 2008	40,775	$ 20	$ 188,314	$ (140,812)	$ 47,522

See notes to financial statements

Table of Contents

ORTHOLOGIC CORP.
(dba Capstone Therapeutics)
(A Development Stage Company)
STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		As a Development Stage Company August 5th 2004 - December 31,
	2008	2007	2008
OPERATING ACTIVITIES			
Net loss	$ (11,239)	$ (10,101)	$ (112,687)
Non cash items:			
Deferred tax expense	-	-	770
Depreciation and amortization	131	169	3,565
Non-cash stock compensation	341	777	4,061
Gain on sale of bone device business	-	-	(2,298)
In-process research and development	-	-	34,311
Change in other operating items:			
Prepaids and other current assets	(189)	1,044	614
Accounts payable	361	(919)	92
Accrued liabilities	(768)	(384)	(2,085)
Cash flows used in operating activities	(11,363)	(9,414)	(73,657)
INVESTING ACTIVITIES			
Expenditures for furniture and equipment, net	(250)	(178)	(943)
Proceeds from sale of assets	-	-	7,000
Cash paid for assets of AzERx/CBI	-	-	(4,058)
Cash paid for patent assignment rights	-	-	(650)
Purchases of investments	(29,757)	(51,395)	(227,046)
Maturities of investments	44,556	63,883	260,088
Cash flows provided by investing activities	14,549	12,310	34,391
FINANCING ACTIVITIES			
Net proceeds from stock option exercises	-	-	4,612
Net proceeds from sale of stock	-	-	3,376
Common stock purchases	(1,041)		(1,041)
Cash flows (used in) provided by financing activities	(1,041)	-	6,947
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	2,145	2,896	(32,319)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	20,943	18,047	55,407
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 23,088	$ 20,943	$ 23,088
Supplemental Disclosure of Non-Cash Investing Activities AzERx / CBI Acquisitions			
Current assets acquired	$ -	$ -	$ 29
Patents acquired	-	-	2,142
Liabilities acquired, and accrued acquisition costs	-	-	(457)
Original investment reversal	-	-	(750)

In-process research and development acquired	-	-	34,311
Common stock issued for acquisitions	-	-	(31,217)
Cash paid for acquisitions	$ -	$ -	$ 4,058

See notes to financial statements

F- 5

Table of Contents

ORTHOLOGIC CORP.
(dba Capstone Therapeutics)
(A Development Stage Company)
NOTES TO FINANCIAL STATEMENTS

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of the business

OrthoLogic is a biotechnology company committed to developing a pipeline of novel peptides and other molecules aimed at helping patients with under-served conditions. We are focused on the development and commercialization of two product platforms: AZX100 and Chrysalin® (TP508).

AZX100 is a novel synthetic pre-clinical 24-amino acid peptide and is believed to have smooth muscle relaxation and anti-fibrotic properties. AZX100 is currently being evaluated for medically and commercially significant applications, such as prevention of hypertrophic and keloid scarring, treatment of pulmonary disease and vascular intimal hyperplasia. We filed an IND for a dermal scarring indication in 2007 and completed Phase 1a and Phase 1b safety clinical trials in dermal scarring in 2008. OrthoLogic has an exclusive worldwide license to AZX100.

Chrysalin (TP508), a novel synthetic 23-amino acid peptide, is believed to produce angiogenic and other tissue repair effects in part by 1) activating or upregulating endothelial nitric oxide synthase (eNOS); 2) cytokine modulation resulting in an anti-inflammatory effect; 3) inhibiting apoptosis (programmed cell death); and 4) promoting angiogenesis and revascularization. It may have therapeutic value in diseases associated with endothelial dysfunction. We have primarily investigated Chrysalin in two indications, fracture repair and diabetic foot ulcer healing and we are currently studying other potential vascular indications. The Company owns exclusive worldwide rights to Chrysalin.

Company History

Prior to November 26, 2003, we developed, manufactured and marketed proprietary, technologically advanced orthopedic products designed to promote the healing of musculoskeletal bone and tissue, with particular emphasis on fracture healing and spine repair. Our product lines included bone growth stimulation and fracture fixation devices including the OL1000 product line, SpinaLogic® and OrthoFrame/Mayo, which we sometimes refer to as our “Bone Device Business.”

On November 26, 2003, we sold our Bone Device Business. Our principal business remains focused on tissue repair, although through biopharmaceutical approaches rather than through the use of medical devices.

On August 5, 2004, we purchased substantially all of the assets and intellectual property of Chrysalis Biotechnology, Inc. (“CBI”), including its exclusive worldwide license for Chrysalin for all medical indications. We became a development stage entity commensurate with the acquisition. Subsequently, our efforts were focused on research and development of Chrysalin with the goal of commercializing our product candidates.

On February 27, 2006, the Company purchased certain assets and assumed certain liabilities of AzERx, Inc. Under the terms of the transaction, OrthoLogic acquired an exclusive license for the core intellectual property relating to AZX100.

Table of Contents

Our development activities for Chrysalin and AZX100 represent a single operating segment as they share the same product development path and utilize the same Company resources. As a result, we have determined that it is appropriate to reflect our operations as one reportable segment. Through December 31, 2008, we have incurred $113 million in net losses as a development stage company.

OrthoLogic Corp. commenced doing business as Capstone Therapeutics on October 1, 2008.

In these notes, references to “we”, “our”, the “Company”, “Capstone Therapeutics” and “Capstone”, refer to OrthoLogic Corp. References to our Bone Device Business refer to our former business line of bone growth stimulation and fracture fixation devices, including the OL1000 product line, SpinaLogic®, OrthoFrame® and OrthoFrame/Mayo.

Use of estimates. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires that management make a number of assumptions and estimates that affect the reported amounts of assets, liabilities, and expenses in our financial statements and accompanying notes. Management bases its estimates on historical experience and various other assumptions believed to be reasonable. Although these estimates are based on management’s assumptions regarding current events and actions that may impact the Company in the future, actual results may differ from these estimates and assumptions.

The significant estimates include the Chrysalis Biotechnology, Inc. and AzERx purchase price allocations, valuation of intangibles, income taxes, contingencies and accounting for stock-based compensation.

Cash and cash equivalents. Cash and cash equivalents consist of cash on hand and cash deposited with financial institutions, including money market accounts, and investments purchased with a remaining maturity of three months or less when acquired.

Furniture and equipment. Furniture and equipment are stated at cost. Depreciation is calculated on a straight-line basis over the estimated useful lives of the various assets, which range from three to seven years. Leasehold improvements are amortized over the life of the asset or the period of the respective lease using the straight-line method, whichever is the shortest.

Patents. Patent costs relate to the acquisition of CBI and rights associated with Chrysalin were being amortized over the estimated life of the patents, 6 - 17 years. On November 2, 2006, the Company announced that it has no immediate plans to re-enter clinical trials for Chrysalin-based product candidates and a strategic shift in its development approach for Chrysalin. The Company currently intends to pursue development partnering or licensing opportunities for its Chrysalin-based product candidates, a change from its previous development history of independently conducting human clinical trials necessary to advance its Chrysalin-based product candidates to market. SFAS No. 142 requires an impairment loss be recognized for an amortizable intangible asset whenever the net cash in-flow to be generated from an asset is less that it’s carrying cost. The Company was unable to determine the timing or amount of net cash in-flow to be generated from Chrysalin-based product candidates. Accordingly, due to this uncertainty, the Company recognized an impairment loss for the amount of unamortized Chrysalin patent costs of $2,100,000 in 2006.

Research and development. Research and development represents both costs incurred internally for research and development activities, as well as costs incurred to fund the research activities with which we have contracted and certain payments regarding the continued clinical testing of Chrysalin and AZX100. All research and development costs are expensed when incurred.

Accrued Clinical. Accrued clinical represents the liability recorded on a per patient basis of the costs incurred for our human clinical trials. Total patient costs are based on the specified clinical trial protocol, recognized over the period

of time service is provided to the patient. We had no active clinical trials at December 31, 2008 or 2007. Our Phase 1a and Phase 1b clinical trials for AZX100 in dermal scarring were both commenced and completed during 2008.

Table of Contents

Stock-based compensation. At December 31, 2005, we had two stock-based employee compensation plans described more fully in Note 6. Prior to January 1, 2006, we accounted for those plans under the recognition and measurement principles of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Stock-based employee compensation cost was normally not recognized, as all options granted under our stock plans had an exercise price equal to the market value of the underlying common stock on the date of grant. For non-employees, this expense is recognized as the service is provided in accordance with guidance in Emerging Issues Task force (EITF) Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring or in Conjunction with Selling Goods or Services."

Effective January 1, 2006, we adopted SFAS No. 123 (revised 2004), "Share-Based Payment", (SFAS 123(R)). SFAS 123(R) requires all share-based payments, including grants of stock options, restricted stock units and employee stock purchase rights, to be recognized in our financial statements based on their respective grant date fair values. Under this standard, the fair value of each employee stock option and employee stock purchase right is estimated on the date of grant using an option pricing model that meets certain requirements. We currently use the Black-Scholes option pricing model to estimate the fair value of our share-based payments. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by our stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. We use the historical volatility adjusted for future expectations. The expected life of the stock options is based on historical data and future expectations. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of our stock options and stock purchase rights. The dividend yield assumption is based on our history and expectation of dividend payouts. The fair value of our restricted stock units is based on the fair market value of our common stock on the date of grant. Stock-based compensation expense recognized in our financial statements in 2006 and thereafter is based on awards that are ultimately expected to vest. We recognize compensation cost for an award with only service conditions that has a graded vesting schedule on a straight line basis over the requisite service period as if the award was, in-substance, a multiple award. However, the amount of compensation cost recognized at any date must at least equal the portion of grant-date fair value of the award that is vested at that date. The amount of stock-based compensation expense in 2006 and thereafter is reduced for estimated forfeitures. Forfeitures are required to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. We evaluate the assumptions used to value stock awards on a quarterly basis. If factors change and we employ different assumptions, stock-based compensation expense may differ significantly from what we have recorded in the past.

SFAS 123(R) requires the benefits associated with tax deductions that are realized in excess of recognized compensation cost to be reported as a financing cash flow rather than as an operating cash flow as previously required. Subsequent to the adoption of SFAS 123(R) on January 1, 2006, we have not recorded any excess tax benefit generated from option exercises, due to our net operating loss carryforwards, which cause such excess to be unrealized.

The Company recorded stock option based compensation of $341,000 in 2008 and $534,000 in 2007. Net loss for the years ended December 31, 2008 and 2007 increased by $341,000 and $534,000, respectively, and loss per weighted average basic and diluted shares outstanding increased by $0.01 per share in 2008 and $0.01 per share in 2007.

Table of Contents

Loss per common share. Loss per common share is computed on the weighted average number of common or common and equivalent shares outstanding during each year. Basic earnings per share is computed as net loss divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through stock options, warrants, and non-vested restricted stock when the effect would be dilutive. Because the average market price of the Company's Common Stock for the year ended December 31, 2008 was lower than the exercise prices of outstanding options and warrants, all outstanding options and warrants were anti-dilutive at December 31, 2008 and excluded from the calculation of earnings per share.

Discontinued operations. Under SFAS No. 144, "Accounting for the Impairment and Disposal of Long-Lived Assets," discontinued operations are reported if a component of the entity is held for sale or sold during the period. The Bone Device Business qualified as a component of the entity under the standard. Therefore, the gains on the sale of the Bone Device Business have been presented as discontinued operations in the financial statements.

Income Taxes. Under SFAS No. 109, "Accounting for Income Taxes," income taxes are recorded based on current year amounts payable or refundable, as well as the consequences of events that give rise to deferred tax assets and liabilities. We base our estimate of current and deferred taxes on the tax laws and rates that are estimated to be in effect in the periods in which deferred tax liabilities or assets are expected to be settled or realized. Pursuant to SFAS No. 109, we have determined that the deferred tax assets at December 31, 2008 require a full valuation allowance given that it is not "more likely than not" that the assets will be recovered.

We adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"), on January 1, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Based on our evaluation upon adoption of FIN 48 on January 1, 2007 and in accordance with FIN 48, the Company recognized a cumulative-effect adjustment of $363,000 at January 1, 2007, increasing its liability for unrecognized tax benefits, interest, and penalties and increasing accumulated deficit. For each period, we evaluated the tax years that remain open for assessment for federal and state tax purposes. This generally includes the years ended December 31, 2003 through 2008. However, during 2008, the 2003 statute of limitations expired in various states, other than Arizona. As a result, the FIN 48 reserve of $363,000 as of December 31, 2007 is no longer required as of December 31, 2008. This has been reflected as an income tax benefit in the Statements of Operations in 2008.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

	2008	2007
Balance at January 1	$ 1,001,000	$ 1,001,000
Additions based on tax positions related to the current year	-	-
Additions for tax positions of prior years	-	-
Reductions for tax positions of prior years	-	-
Settlements	-	-
Reductions due to lapse in statute of limitations	$ (363,000)	-
Balance at December 31	$ 638,000	$ 1,001,000

Table of Contents

Included in the gross amount of unrecognized tax benefits, as of December 31, 2007 and 2008, are $638,000 of unrecognized tax benefits that would not impact the effective tax rate.

We may, from time-to-time, be assessed interest or penalties by major tax jurisdictions, although any such assessments historically have been minimal and immaterial to our financial results. The Company recognizes accrued interest and penalties, if applicable, related to unrecognized tax benefits in income tax expense. During the years ended December 31, 2007 and 2008, the Company did not recognize a material amount in interest and penalties.

New Accounting Pronouncements

Effective January 1, 2008, the Company adopted the reporting requirements of FASB Statement No. 157 (SFAS 157), “Fair Value Measurements”, and No. 159, (SFAS 159) “Fair Value Option for Financial Assets and Liabilities”. SFAS 157 establishes a standard framework for measuring fair value in generally accepted accounting principles (GAAP), clarifies the definition of “fair value” within that framework, and expands disclosures about the use of fair value measurements. SFAS 159 allows entities to voluntarily choose, at specified election dates, to measure many financial assets and liabilities (as well as certain nonfinancial instruments that are similar to financial instruments) at fair value (the “value option”). The Company did not choose to voluntarily measure any financial assets or liabilities at fair value. The adoption of SFAS 157 and SFAS 159 did not have an effect on the Company’s results of operations or financial position.

In December 2007, the FASB ratified the consensuses reached in Emerging Issue Task Force, or EIFT, Issue No. 07-1, “Collaborative Arrangements”. EITF Issue No. 07-1 defines collaborative arrangements and establishes reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangements and third parties. Under EITF Issue No. 07-1, payments between participants pursuant to a collaborative arrangement that are within the scope of other authoritative accounting literature on income statement classification should be accounted for using the relevant provisions of that literature. If the payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authorize accounting literature or if there is no appropriate analogy, a reasonable, rational, and consistently applied accounting policy election. EITF Issue No. 07-1 also provides disclosure requirements and is effective for the Company on January 1, 2009. The effect of applying EITF Issue No. 07-1 will be reported as a change in accounting principle through retrospective applications to all prior periods presented for all collaborative arrangements existing as of the effective date, unless it is impracticable. The Company does not expect that the impact that the adoption of EITF Issue No. 07-1 will have a material impact on its consolidated financial statements.

2. ASSET ACQUISITION OF CHRYSALIS BIOTECHNOLOGY, INC

On August 5, 2004, we purchased substantially all of the assets and intellectual property of Chrysalis BioTechnology, Inc. (“CBI”), including its exclusive worldwide license for Chrysalin for all medical indications for $2.5 million in cash, excluding acquisition costs, and $25.0 million in OrthoLogic common stock. We issued 3,462,124 shares of OrthoLogic common stock to CBI for this transaction. Pursuant to the terms of the definitive agreement, we must issue an additional number of shares of OrthoLogic common stock valued at $7.0 million upon the occurrence of certain trigger events, which include the sale or other transactions that result in a change of control of OrthoLogic or the acceptance by the U.S. Food and Drug Administration of a new drug application for a product based on Chrysalin, if either such trigger occurs within five years of closing.

Table of Contents

3. INVESTMENTS AND FAIR VALUE DISCLOSURES

At December 31, 2008, investments consisted of U.S. Government obligations and corporate commercial paper or bonds and were classified as held-to-maturity securities. Such classification requires these securities to be reported at amortized cost unless they are deemed to be permanently impaired in value.

A summary of the fair market value and unrealized gains and losses on these securities is as follows (in thousands):

INVESTMENTS AND FAIR VALUE DISCLOSURES

Investments with maturities – Short-term	December 31,	
	2008	2007
Amortized cost	$ 22,675	$ 18,236
Unrealized gain	528	117
Fair value	$ 23,203	$ 18,353

Investments with maturities – Long term	December 31,	
	2008	2007
Amortized cost	$ 2,221	$ 21,459
Unrealized gain	104	610
Fair value	$ 2,325	$ 22,069

For our cash and cash equivalents and short-term investments, the carrying amount is assumed to approximate the fair market value because of the liquidity of these instruments. The carrying amount is assumed to be the fair value for other current assets, accounts payable and other accrued expenses because of their short maturity. Our long-term investment carries a market interest rate and the fair market value of the investment approximated the carrying value (as shown above) at December 31, 2008.

Our long-term investment at December 31, 2008 is a U.S. Government obligation and matures in February 2010.

4. FURNITURE AND EQUIPMENT

Furniture and equipment consisted of the following (in thousands):

	December 31,	
	2008	2007
Machinery and equipment	$ 1,116	$ 1,258
Furniture and fixtures	69	144
Leasehold improvements	36	-
	1,221	1,402
Less accumulated depreciation and amortization	(785)	(1,084)
Total	$ 436	$ 318

Depreciation expense for the years ended December 31, 2008 and 2007, and for the period of August 5, 2004 through December 31, 2008 was $126,000, $166,000 and $939,000, respectively.

Table of Contents

5. INCOME TAXES

The components of deferred income taxes at December 31 are as follows (in thousands):

	December 31,	
	2008	2007
Accruals and reserves	$ 82	$ 328
Valuation allowance	(82)	(328)
Total current	-	-
NOL, AMT and general business credit carryforwards	44,354	38,357
Difference in basis of fixed assets	79	93
Accruals and reserves	808	756
Difference in basis of intangibles	(37)	35
Valuation allowance	(45,204)	(39,241)
Total non current	-	-
Total deferred income taxes	$ -	$ -

The components of the income tax provision (benefit) are as follows (in thousands):

	Years Ended December 31		As a Development Stage Company August 5, 2004 -
	2008	2007	December 31, 2008
Provision (benefit) for income taxes			
Current	$ (363)	$ -	$ (1,113)
Deferred	-	-	1,106
Income tax provision (benefit)	$ (363)	$ -	$ (7)

SFAS No. 109 requires that a valuation allowance be established when it is more likely than not that all or a portion of a deferred tax asset will not be realized. Changes in valuation allowances from period to period are included in the tax provision in the period of change. In determining whether a valuation allowance is required, we take into account all evidence with regard to the utilization of a deferred tax asset including past earnings history, expected future earnings, the character and jurisdiction of such earnings, unsettled circumstances that, if unfavorably resolved, would adversely affect utilization of a deferred tax asset, carryback and carryforward periods, and tax strategies that could potentially enhance the likelihood of realization of a deferred tax asset. Management has evaluated the available evidence about future taxable income and other possible sources of realization of deferred tax assets and has established a valuation allowance of approximately $45 million at December 31, 2008. The valuation allowance includes approximately $6.7 million for net operating loss carry forwards that relate to stock option compensation expense for income tax reporting purposes. The results of the Company's Phase 3 Chrysalin fracture repair human clinical trial, which were received in 2006, resulted in a change in our planned clinical pathway and timeline for our Chrysalin fracture repair indication. This potential change, when factored with our current significant net operating loss carryovers and current period net loss, resulted in a revision of our estimate of the need for a valuation allowance for the previously recorded deferred tax asset related to a Alternative Minimum Tax credit carryover. Due to the uncertainty that the deferred tax asset will be realized, we recorded a valuation allowance for the full amount of the deferred tax asset ($1,106,000) in 2006. The valuation allowance reduces deferred tax assets to an amount that management believes will more likely than not be realized.

Table of Contents

We have accumulated approximately $101 million in federal and $89 million in state net operating loss carryforwards ("NOLs") and approximately $6 million of general business and alternative minimum tax credit carryforwards. The federal NOLs expire between 2023 and 2028. The Arizona state NOL's expire between 2009 and 2013. The availability of these NOL's to offset future taxable income could be limited in the event of a change in ownership, as defined in Section 382 of the Internal Revenue Code.

The AzERx and CBI acquisitions were treated as tax free reorganizations under Internal Revenue Code Section 368 and therefore resulted in a carryover basis and no income tax benefit for the related acquisition costs, including in-process research and development costs.

A reconciliation of the difference between the provision (benefit) for income taxes and income taxes at the statutory U.S. federal income tax rate is as follows for the years ended December 31, 2008 and 2007 and for the period of August 5, 2004 through December 31, 2008 (in thousands):

	Years Ended December 31,		As a Development Stage Company
	2008	2007	August 5, 2004 - December 31, 2008
Income tax provision (benefit) at statutory rate	$ (3,945)	$ (3,434)	$ (39,062)
State income taxes	(534)	(465)	(4,181)
Purchased in-process research and development	-	-	12,533
Research credits	(1,477)	(1,516)	(4,778)
Change in FIN 48 reserve	(363)	-	(363)
Other	156	(291)	1,180
Change in valuation allowance	5,800	5,706	34,664
Net provision (benefit)	$ (363)	$ -	$ (7)

6. STOCKHOLDERS' EQUITY

The number of common shares reserved for issuance under the OrthoLogic 1987 option plan was 4,160,000 shares. This plan expired during October 1997. In May 1997, the stockholders adopted a new stock option plan (the "1997 Plan"). The 1997 Plan reserved for issuance 1,040,000 shares of Common Stock. Subsequent to its original adoption, the Board of Directors and stockholders approved amendments to the 1997 Plan that increased the number of shares of common stock reserved for issuance to 4,190,000. The 1997 Plan expired in March 2007. In May 2006, the stockholders approved the 2005 Equity Incentive Plan (2005 Plan) and reserved 2,000,000 shares of our common stock for issuance. At December 31, 2008, 30,302 shares remained available to grant under the 2005 Plan. Two types of options may be granted under the Plans: options intended to qualify as incentive stock options under Section 422 of the Internal Revenue Code ("Code") and other options not specifically authorized or qualified for favorable income tax treatment by the Code. All eligible employees may receive more than one type of option. Any director or consultant who is not an employee of the Company shall be eligible to receive only nonqualified stock options under the Plans.

Table of Contents

The Plans provide that in the event of a takeover or merger of the Company in which 100% of the equity of the Company is purchased or a sale of all or substantially all of OrthoLogic's assets (an "Accelerating Event"), 75% of all unvested employee options will vest and the remaining 25% vest over the following twelve month period. If an employee or holder of stock options is terminated as a result of or subsequent to the acquisition, 100% of that individual's stock option will vest immediately upon employment termination.

2007 Stock Options

On January 1, 2007, the Board of Directors granted each Director a fully vested option to purchase 10,000 shares of the Company's common stock at an exercise price of $1.43. Additionally, during the three months ended March 31, 2007, the Company granted a fully vested option to purchase 13,889 shares of the Company's common stock to a consultant at an exercise price of $1.44 and an option to purchase 5,000 shares of common stock that vest over a four-year period, to an employee, at an exercise price of $1.45. On May 21, 2007, the Company granted an option to Dr. Steer to purchase 50,000 shares of the Company's common stock at $1.53, which vests pro-rata over a two-year period.

During the three months ended September 30, 2007, the Company granted options to purchase 86,000 shares of the Company's common stock to the members of its Scientific Advisory Board at an average exercise price of $1.43 per share. The options vested 25% on the date of grant, with the remaining options vesting pro-rata over a three year period. The cost of the options will be determined based upon the fair market value of the options by using the Black Scholes model, revalued at each Company reporting date until fully vested.

The Company used the Black-Scholes model with the following assumptions to determine the total fair value of $52,000 for options to purchase 78,889 shares of the Company's common stock issued during the three months ended March 31, 2007, the fair value of $33,000 for options to purchase 50,000 shares of the Company's common stock issued during the three months ended June 30, 2007, and the fair value of $87,000 for options to purchase 86,000 shares of the Company's common stock issued during the three months ended September 30, 2007.

	Three months ended March 31, 2007	Three months ended June 30, 2007	Three months ended September 30, 2007
Risk free interest rate	4.60%	4.87%	4.24%
Volatility	66%	61%	59%
Expected term from vesting	2.8 Years	2.8 Years	2.9 Years
Dividend yield	0%	0%	0%

2008 Stock Options

On January 1, 2008, the Board of Directors granted each Director a fully vested option to purchase 10,000 shares of the Company's common stock at an exercise price of $1.35. Additionally, during the three months ended March 31, 2008, the Company granted employees options to purchase 217,173 shares of the Company's common stock at an exercise price of $1.02. The employee options vest over a two to four year period.

The Company used the Black-Scholes model with the following assumptions to determine the total fair value of $147,000 for options to purchase 267,173 shares of the Company's common stock granted during the three months ended March 31, 2008:

Table of Contents

	Three months ended March 31, 2008
Risk free interest rate	2.4% - 3.4%
Volatility	57% - 58%
Expected term from vesting	3.7 Years
Dividend yield	0%

2007 Awards of Shares of Common Stock

On January 1, 2007, the Board of Directors of the Company awarded 104,898 shares of restricted stock (17,843 shares to each director), which vest on January 1, 2008. The total fair value of the grants, determined using the closing price of the Company's common stock on the date of grant, was $150,000, which included $25,000 (17,843 shares) that were subsequently forfeited due to Mr. Casey's decision to not seek re-election to the Board of Directors on May 10, 2007. The total fair value of the awards of $125,000 was recognized as compensation cost in the year ended December 31, 2007.

On May 10, 2007, the Board of Directors of the Company awarded total compensation of $115,000 to various executives, to be paid through the issuance of shares of the Company's common stock. The total number of shares of stock issued was 76,159.

2008 Stock Awards

On January 1, 2008, the Board of Directors of the Company awarded 92,595 shares of restricted stock (18,519 shares to each Director), which vest on January 1, 2009. The total fair value of the awards of $125,000, determined by using the closing price of the Company's common stock on the date of grant, has been recognized as compensation cost in the year ended December 31, 2008.

On February 21, 2008, the Company awarded 56,373 fully vested shares of the Company's common stock, having a fair value on the date of the awards of $57,500, to various employees.
The fair value of the awards was recognized as compensation cost in the year ended December 31, 2008.

Summary

Non-cash stock compensation cost for the year ended December 31, 2008, totaled $341,000. In the Statements of Operations for the year ended December 31, 2008, non-cash stock compensation expense of $263,000 was recorded as a general and administrative expense and $78,000 was recorded as a research and development expense.

Non-cash stock compensation cost for the year ended December 31, 2007, totaled $777,000. In the Statements of Operations for the year ended December 31, 2007, non-cash stock compensation expense of $513,000 was recorded as general and administrative expense and $264,000 was recorded as research and development expense.

No options were exercised in the years ended December 31, 2008 and 2007.

At December 31, 2008, the remaining unamortized non-cash stock compensation costs totaled approximately $69,000, which will be recognized ratably over the period ending December 31, 2011, with an estimated weighted average period of one year.

Table of Contents

A summary of option activity under our stock option plans for the years ended December 31, 2008 and 2007 is as follows:

	2008			2007	
	Number of Options	Weighted average exercise price	Weighted average remaining contractual term (years)	Number of Options	Weighted average exercise price
Options outstanding at the beginning of the year:	3,200,125	$ 3.43		3,438,126	$ 3.69
Granted	267,173	$ 1.08		214,889	$ 1.45
Exercised	-			-	
Forfeited	(476,994)	$ 4.96		(452,890)	$ 4.47
Outstanding at end of year	2,990,304	$ 2.98	6.13	3,200,125	$ 3.43
Options exercisable at year-end	2,681,292	$ 3.04	5.89	2,581,336	$ 3.54
Options vested and expected to vest at December 31, 2008	2,807,719	$ 2.99	6.01	2,942,863	$ 3.44

A summary of the status of the Company's unvested shares as of December 31, 2008 and 2007, and changes during the years ended December 31, 2008 and 2007, is presented below:

Unvested Shares	Number of Options	Weighted average Grant date Fair Value
Unvested shares at December 31, 2006		
Granted	181,057	$ 1.46
Vested	(163,574)	$ 1.47
Canceled/forfeited	(17,483)	$ 1.43
Unvested shares at December 31, 2007	-	
Granted	148,968	$ 1.23
Vested	(148,968)	$ 1.23
Canceled/forfeited	-	
Unvested shares at December 31, 2008	-	

It is the Company's policy to issue options from stockholder approved incentive plans. However, if the options are issued as an inducement for an individual to join the Company, the Company may issue stock options outside of stockholder approved plans. The options granted to employees under stockholder approved incentive plans have a ten-year term and vest over a two to four-year period of service. All options and stock purchase rights are granted

with an exercise price equal to the current market value on the date of grant and, accordingly, options or stock purchase rights have no intrinsic value on the date of grant. Based on the closing market price of the Company's common stock at December 31, 2008 of $0.42, stock options exercisable or expected to vest at December 31, 2008, have no intrinsic value.

Table of Contents

Warrants

At December 31, 2008, the Company has warrants outstanding to purchase 46,706 shares of the Company's common stock with an exercise price of $6.39 per share which expire in February 2016, and warrants outstanding to purchase 117,423 shares of the Company's common stock with an exercise price of $1.91 per share which expire in July 2016.

Performance based warrants to purchase 240,000 shares of the Company's common stock with an exercise price of $1.91, which expire in February 2016, are outstanding but unvested at December 31, 2008. The total cost of the performance based warrants will be charged to expense over the period of performance. The costs will be determined based on the fair market value of the warrants determined by using the Black-Scholes model, revalued at each Company reporting date until fully vested. The fair market value of the milestone warrants using the Black-Scholes model, 61% volatility, 0% dividend yield, expected term of 7.2 years, and 1.4 % interest rate was $90,000 at December 31, 2008. No costs were charged to expense at December 31, 2008 as it is not yet probable that any milestone warrants will vest.

7. COMMITMENTS

During 1998 through 2007, we were obligated under a non-cancelable operating lease agreement for a Tempe, Arizona office and research facility. Rent expense for the years ended December 31, 2008 and 2007, and for the period of August 5, 2004 through December 31, 2008 was $263,000, $999,000 and $4,042,000, respectively. We subleased portions of the Tempe facility to other tenants and approximately 45% of the Tempe facility was subleased through December 2007, which offset our lease expense. The Company recorded approximately $744,000 and $2,299,000 of sublease income for the year ended December 31, 2007 and for the period of August 5, 2004 through December 31, 2008, respectively. The Company had no sublease income in the year ended December 31, 2008.

On July 19, 2007, the Company entered into a new lease, which became effective upon the expiration of its previous lease, for 17,000 square feet of space in the same Tempe, Arizona facility. The new lease calls for monthly rental payments of $22,000, plus a proportionate share of building operating expenses and property taxes. The term of the new lease is sixty months from March 1, 2008, with an option to extend the lease for an additional twenty-four months with monthly rental payments set at $24,000, plus a proportionate share of building operating expenses and property taxes, during the extension period. The Company also has the right to terminate the new lease at the end of thirty-six months upon payment of an early termination fee of approximately $158,000. Total base rent for the initial sixty-month term is approximately $1,316,000, due approximately $263,000 per year for years 2008 through 2012 and $44,000 in year 2013.

8. 401(K) PLAN

We adopted a 401(k) plan (the "Plan") for our employees on July 1, 1993. We may make matching contributions to the Plan on behalf of all Plan participants, the amount of which is determined by the Board of Directors. We matched approximately $38,000 in 2008 and $40,000 in 2007.

9. AUTHORIZED PREFERRED STOCK

We have 2,000,000 shares of authorized preferred stock, the terms of which may be fixed by our Board of Directors. We presently have no outstanding shares of preferred stock. While we have no present plans to issue any additional shares of preferred stock, our Board of Directors has the authority, without stockholder approval, to create and issue one or more series of such preferred stock and to determine the voting, dividend and other rights of holders of such preferred stock. The issuance of any of such series of preferred stock may have an adverse effect on the holders of common stock.

Table of Contents

On June 19, 2007, the Company entered into a new Rights Agreement (the "New Rights Agreement") with the Bank of New York. In connection with the New Rights Agreement, we declared a dividend distribution of one Right for each outstanding share of our common stock to stockholders of record as of July 2, 2007 and designated 1,000,000 shares of preferred stock as Series A Preferred Stock. The Right, exercisable upon a Triggering Event as defined in the New Rights Agreement, allows the holder of each share of the Company's common stock to purchase 1/100 of a share of Series A Preferred Stock for $6.00. (Each 1/100 of a share of Series A Preferred Stock is convertible into $12 of the Company's common stock). The new rights replace similar rights that the Company issued under its previous Rights Agreement. The New Rights Agreement and the exercise of rights to purchase Series A Preferred Stock pursuant to the terms thereof may delay, defer or prevent a change in control because the terms of any issued Series A Preferred Stock would potentially prohibit our consummation of certain extraordinary corporate transactions without the approval of the Board of Directors. In addition to the anti-takeover effects of the rights granted under the New Rights Agreement, the issuance of preferred stock, generally, could have a dilutive effect on our stockholders. The New Rights Agreement will expire June 19, 2010.

10. AUTHORIZATION OF COMPANY BUY-BACK OF COMMON STOCK

On March 5, 2008, the Company announced that its Board of Directors approved a stock repurchase program for up to five percent of its then outstanding common shares. The shares may be repurchased from time to time in open market transactions or privately negotiated transactions at the Company's discretion, subject to market conditions and other factors. There were approximately 41.8 million shares of common stock outstanding on March 5, 2008. During the year ended December 31, 2008, the Company purchased and retired 1,131,622 shares at a total cost of $1,041,000.