ARBIOS SYSTEMS INC
Form 424B3
June 29, 2007

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Registration No. 333-143978

PROSPECTUS

ARBIOS SYSTEMS, INC.

15,533,539 Shares of Common Stock

This prospectus relates to the sale or other disposition of up to 7,478,462 shares of our currently outstanding shares of common stock that are owned by some of our stockholders, and 8,055,077 shares of our common stock issuable upon the exercise of currently outstanding common stock purchase warrants held by some of our stockholders. For a list of the selling stockholders, please refer to the "Selling Stockholders" section of this prospectus. We are not selling any shares of common stock in this offering and therefore will not receive any proceeds from this offering. We will, however, receive the exercise price of the warrants if and when those warrants are exercised by the selling stockholders. None of the warrants have been exercised as of the date of this prospectus. We will pay the expenses of registering these shares.

Our common stock is traded in the over-the-counter market and is quoted on the OTC Bulletin Board under the symbol ABOS. On June 28**,** 2007 the closing price of our common stock was $0.87, per share.

The shares included in this prospectus may be disposed of on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices. We will not control or determine the price at which a selling stockholder decides to sell or otherwise dispose of its shares. Brokers or dealers effecting transactions in these shares should confirm that the shares are registered under applicable state law or that an exemption from registration is available.

You should understand the risks associated with investing in our common stock. Before making an investment, please read the "Risk Factors" section of this prospectus, which begins on page 3.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of the prospectus. Any representation to the contrary is a criminal offense.

The date of this prospectus is June 29, 2007.

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PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus; it does not contain all of the information you should consider before investing in our common stock. Read the entire prospectus before making an investment decision.

Throughout this prospectus, the terms “we,” “us,” “our,” and “our company” refer to Arbios Systems, Inc., a Delaware corporation.

A glossary of certain terms used in this prospectus is contained on page 40 under “Glossary of Terms.”

Company Overview

Arbios Systems, Inc., or Arbios, is a Delaware corporation based in Waltham, Massachusetts and Los Angeles, California. We seek to develop, manufacture and market liver assist therapies to meet the urgent need for medical treatment of liver failure.

We are a medical device and cell-therapy company that is focusing on the development of products for the treatment of liver failure. Our lead products under development currently consist of a novel extracorporeal blood purification therapy called the SEPET™ Liver Assist Device and an extracorporeal, bioartificial liver therapy referred to as the HepatAssist™ Cell-Based Liver Support System that incorporate porcine pig liver cells. We currently own five issued U.S. patents and six issued foreign patents, and are the licensee of sixteen other issued U.S. patents, as well as the owner or licensee of eight patent applications and numerous related trade secrets.

In April 2005, we received permission from the United States Food and Drug Administration, or the FDA, to commence a 15 to 20 patient feasibility clinical study of our SEPET™ Liver Assist Device, targeted for the treatment of acute episodes of chronic liver disease. We have currently enrolled 15 patients and are thus in the final stages of completing the feasibility study. We are currently completing the monitoring and analysis of the data from the 15 enrolled patients. We are encouraged by the preliminary data and intend to submit it to the FDA in preparation for a pivotal trial for SEPET™. We further intend to use the data, once our analysis is complete, in support of gaining the CE Mark for SEPET™ in Europe.

Our HepatAssist™ Cell-Based Liver Support System is an enhanced version of a product system which we acquired in 2003 from another company, Circe Biomedical, Inc., which had tested HepatAssist™ in an unsuccessful Phase II/III pivotal clinical trial. We currently hold a Phase III investigational new drug application, or IND, for conducting an additional pivotal clinical trial of the HepatAssist™ system. Our current plan is to focus on reintroducing this important liver assist technology into clinical development in the U.S. and in Asia to the extent that we obtain additional funding for this program from a potential corporate marketing partner. We are currently seeking such a partnership.

Company History. Arbios Systems, Inc. was originally incorporated in February 1999 as Historical Autographs U.S.A., Inc., or HAUSA. Until October 2003, HAUSA was an e-commerce based company engaged in the business of acquiring and marketing historical documents. On October 30, 2003, HAUSA completed a reorganization (the “Reorganization”) in which HAUSA, through its wholly-owned subsidiary, acquired all of the outstanding shares of Arbios Technologies, Inc., or ATI, in exchange for 11,930,598 shares of HAUSA common stock. As a result of the Reorganization, ATI became the wholly-owned subsidiary of HAUSA. After the Reorganization, HAUSA changed its name to “Arbios Systems, Inc.,” replaced its officers and directors with those of ATI, closed its offices, ceased its e-commerce business, and moved its offices to Los Angeles, California. On July 25, 2005, Arbios Systems, Inc. completed its reincorporation as a Delaware corporation by merging with and into Arbios Systems, Inc., a Delaware corporation. The foregoing merger was approved by the Company’s stockholders at the annual meeting of stockholders held on July 7, 2005. In order to consolidate the functions and operations of Arbios and ATI, on July 26, 2005, ATI

merged into Arbios. As a result, Arbios now owns all of the assets of ATI and all of the operations of the two companies have been consolidated into Arbios.

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Our principal operations and executive offices are located at 1050 Winter Street, Suite 1000, Waltham, Massachusetts 02451 and our telephone number is (781) 839-7293. We also maintain corporate offices at 8797 Beverly Blvd., Suite 304, Los Angeles, California 90048 and our telephone number is (310) 657-4898. We also maintain a web site at www.arbios.com. The information on our web site is not, and you should not consider such information to be, a part of this filing.

Shares Being Offered

On April 23, 2007, we entered into a purchase agreement with several current and new accredited investors. Pursuant to the terms and subject to the conditions contained in the purchase agreement, we issued and sold to the investors in a private placement, 3,739,231 Units for an aggregate purchase price of $4,861,000. Each Unit was sold at a price of $1.30 per Unit. Each Unit consists of: (i) two shares of our common stock, (ii) one warrant to purchase one share of our common stock exercisable for a period of 2.5 years at an exercise price of $1.00 ("A Warrants") and (iii) one warrant to purchase one share of the Company's common stock exercisable for a period of 5 years at an exercise price of $1.40 ("B Warrants"), comprising a total of 7,478,462 shares of our common stock and warrants to purchase 7,478,462 shares of our common stock. The warrants have no provision for cashless exercise and, subject to certain requirements, may be called by us provided that our common stock trades above $1.50 for the A Warrants and above $2.80 for the B Warrants for a specified time period.

In addition to the shares of our common stock sold in the private placement and shares issuable upon exercise of warrants sold in the private placement, we are registering 346,615 shares of our common stock issuable upon exercise of warrants to David B. Musket and 230,000 shares of our common stock issuable upon exercise of warrants to Richard Wehby. Such warrants were issued to Mr. Musket and Mr. Wehby as compensation for the placement agent services provided by Musket Research Associates, Inc. in connection with the private placement.

The Offering

Common stock covered hereby	15,533,539 shares, consisting of 7,478,462 outstanding shares owned by selling stockholders and 8,055,077 shares issuable to selling stockholders upon exercise of outstanding warrants.
Common stock currently outstanding	25,144,086 shares (1)
Common stock to be outstanding assuming the sale of all shares covered hereby and assuming no exercise of the warrants for the shares covered by this prospectus	25,144,086 shares (1)
Common stock to be outstanding assuming the sale of all shares covered hereby and assuming the exercise of all warrants for the shares covered by this prospectus	33,199,163 shares (1)
OTC Bulletin Board Trading Symbol	ABOS
Risk Factors	An investment in our common stock involves significant risks. See "Risk Factors" beginning on page 3.

(1) In addition to these outstanding shares of common stock, as of May 31, 2007, there were outstanding (i) options to purchase 2,881,677 shares of our common stock (with exercise prices ranging from $0.15 per share to $3.40 per

share), and (ii) warrants (other than the warrants owned by the selling stockholders covered by this prospectus) to purchase 9,097,079 shares of our common stock (with exercise prices ranging from $0.65 per share to $3.50 per share).

RISK FACTORS

An investment in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information contained in this prospectus and in the documents incorporated by reference before deciding to invest in our company. If any of the following risks actually occur, our business, financial condition or operating results and the trading price or value of our securities could be materially adversely affected.

Risks Related to Our Business

We are an early-stage company subject to all of the risks and uncertainties of a new business, including the risk that we may never market any products or generate revenues.

We are an early-stage company that has not generated any operating revenues to date (our only revenues were from two government research grants). Accordingly, while we have been in existence for over five years, we should be evaluated as an early-stage company, subject to all of the risks and uncertainties normally associated with an early-stage company. As an early-stage company, we expect to incur significant operating losses for the foreseeable future, and there can be no assurance that we will be able to validate and market products in the future that will generate revenues or that any revenues generated will be sufficient for us to become profitable or thereafter maintain profitability.

We have had no product sales to date, and we can give no assurance that there will ever be any sales in the future.

All of our products are still in research or development, and no revenues have been generated to date from product sales. There is no guarantee that we will ever develop commercially viable products. To become profitable, we will have to successfully develop, obtain regulatory approval for, produce, market and sell our products. There can be no assurance that our product development efforts will be successfully completed, that we will be able to obtain all required regulatory approvals, that we will be able to manufacture our products at an acceptable cost and with acceptable quality, or that our products can be successfully marketed in the future. We currently do not expect to receive revenues from the sale of any of our products for at least one to two years.

Before we can market any of our products, we must obtain governmental approval for each of our products, the application and receipt of which is time-consuming, costly and uncertain.

The development, production and marketing of our products are subject to extensive regulation by government authorities in the United States and other countries. In the United States, our SEPET™ Liver Assist Device and our HepatAssist™ Cell-Based Liver Support System will require approval from the FDA prior to clinical testing and commercialization. The process for obtaining FDA approval to market therapeutic products is both time-consuming and costly, with no certainty of a successful outcome. This process includes the conduct of extensive pre-clinical and clinical testing, which may take longer or cost more than we currently anticipate due to numerous factors, including, without limitation, difficulty in securing centers to conduct trials, difficulty in enrolling patients in conformity with required protocols and/or projected timelines, unexpected adverse reactions by patients in the trials to our liver assist systems, temporary suspension and/or complete ban on trials of our products due to the risk of transmitting pathogens from the xenogeneic biologic component, and changes in the FDA's requirements for our testing during the course of that testing. We have not yet established with the FDA the nature and number of clinical trials that the FDA will require in connection with its review and approval of either SEPET™ or our HepatAssist™ products and these requirements may be more costly or time-consuming than we currently anticipate.

SEPET™ and HepatAssist™ are both novel in terms of their composition and function. Thus, we may encounter unexpected safety, efficacy or manufacturing issues as we seek to obtain marketing approval for products from the FDA, and there can be no assurance that we will be able to obtain approval from the FDA or any foreign

governmental agencies for marketing of any of our products. The failure to receive, or any significant delay in receiving, FDA approval, or the imposition of significant limitations on the indicated uses of our products, would have a material adverse effect on our business, operating results and financial condition. The health regulatory authorities of certain countries, including those of Japan, France and the United Kingdom, have previously objected, and other countries' regulatory authorities could potentially object, to the marketing of any therapy that uses pig liver cells (which our cell-based liver support systems are designed to utilize) due to safety concerns that pig cells may transmit viruses or diseases to humans. If the health regulatory agencies of other countries impose a ban on the use of therapies that incorporate pig cells, such as our HepatAssist™ Cell-Based Liver Support System, we would be prevented from marketing our products in those countries. If we are unable to obtain the approval of the health regulatory authorities in Japan, France, the United Kingdom or other countries, the potential market for our products will be reduced.

Because our products are at an early stage of development and have never been marketed, we do not know if any of our products will ever be approved for marketing, and any such approval will take several years to obtain.

Before obtaining regulatory approvals for the commercial sale of our products, significant and potentially very costly preclinical and clinical work will be necessary. There can be no assurance that we will be able to successfully complete all required testing of the SEPET™ liver assist device or our HepatAssist™ cell-based liver support system. While the time periods for testing our products and obtaining the FDA's approval are dependent upon many future variable and unpredictable events, we estimate that it could take between two to three years to obtain approval for the SEPET™ liver assist device and three to four years for the HepatAssist™ cell-based liver support system. We have not independently confirmed any of the third-party claims made with respect to patents, licenses or technologies we have acquired concerning the potential safety or efficacy of these products and technologies. Before we can begin clinical testing of our HepatAssist™ cell-based liver support system, we will need to amend our active Phase III IND to resume clinical testing, which application will have to be cleared by the FDA. The FDA may require significant revisions to our clinical testing plans or require us to demonstrate efficacy endpoints that are more time-consuming or difficult to achieve than what we currently anticipate. Because of the early stage of development of each of our products, we do not know if we will be able to generate clinical data that will support the filing of the FDA applications for these products or the FDA's approval of any product marketing approval application or IND that we do file.

The cost of conducting pivotal clinical studies for the SEPET™ liver assist device and HepatAssist™ cell-based liver support system exceeds our current financial resources. Accordingly, we will not be able to conduct such studies until we obtain additional funding.

If the feasibility clinical trial for the SEPET™ liver assist device is successful, we will have to obtain the FDA's approval to conduct a pivotal trial. We have not yet established with the FDA the nature and number of additional clinical trials that the FDA may require in connection with its review and approval of the SEPET™ liver assist device. Based on our internal projections of our operating costs and the costs normally associated with pivotal trials, we do not believe that we currently have sufficient funds to conduct any such pivotal trial(s) nor have we identified any sources for obtaining the required funds.

We have considered requesting FDA approval to commence a Phase III clinical trial of the HepatAssist™ cell-based liver support system. Such a request will require that we supplement and/or amend the existing Phase III clinical protocol that was approved by the FDA for the original HepatAssist system. The preparation of a modified or supplemented Phase III clinical protocol will be expensive and difficult to prepare. Although the cost of completing the Phase III clinical trial in the manner that we currently contemplate is uncertain and could vary significantly, if that Phase III clinical trial is authorized by the FDA, we currently estimate that the cost of conducting that study would approximately be between $10 million and $15 million, excluding the manufacturing infrastructure. We currently do not have sufficient funds to conduct this study and have not identified any sources for obtaining the required funds. In addition, no assurance can be given that the FDA will accept our proposed changes to the previously approved Phase III clinical protocol. The clinical tests that we would conduct under any FDA-approved protocol are very expensive and will cost much more than our current financial resources. Accordingly, even if the FDA approves the modified Phase III clinical protocol that we submit for HepatAssist™ cell-based liver support system, we will not be able to conduct any clinical trials until we raise substantial amounts of additional financing.

Our cell-based liver support system utilizes a biological component obtained from pigs that could prevent or restrict the release and use of those products.

Use of liver cells harvested from pig livers carries a risk of transmitting viruses harmless to pigs but potentially deadly to humans. For instance, all pig cells carry genetic material of the porcine endogenous retrovirus ("PERV"), but its ability to infect people is unknown. Repeated testing, including a 1999 study of 160 xenotransplantion (transplantation from animals to humans) patients and the Phase II/III testing of the HepatAssist™ cell-based liver support system by Circe Biomedical, Inc., has produced no sign of the transmission of PERV to humans. Still, no one can prove that PERV or another virus would not infect bioartificial liver-treated patients and cause potentially serious disease. This may result in the FDA or other health regulatory agencies not approving our HepatAssist™ cell-based liver support system or subsequently banning any further use of our product should health concerns arise after the product has been approved. At this time, it is unclear whether we will be able to obtain clinical and product liability insurance that covers the PERV risk.

In addition to the potential health risks associated with the use of pig liver cells, our use of xenotransplantation technologies may be opposed by individuals or organizations on health, religious or ethical grounds. Certain animal rights groups and other organizations are known to protest animal research and development programs or to boycott products resulting from such programs. Previously, some groups have objected to the use of pig liver cells by other companies, including Circe Biomedical, Inc., that were developing bioartificial liver support systems, and it is possible that such groups could object to our cell-based liver support system. Litigation instituted by any of these organizations, and negative publicity regarding our use of pig liver cells in a bioartificial liver device, could have a material adverse effect on our business, operating results and financial condition.

Because our products represent new approaches to treatment of liver disease, there are many uncertainties regarding the development, the market acceptance and the commercial potential of our products.

Our products will represent new therapeutic approaches for disease conditions. We may, as a result, encounter delays as compared to other products under development in reaching agreements with the FDA or other applicable governmental agencies as to the development plans and data that will be required to obtain marketing approvals from these agencies. There can be no assurance that these approaches will gain acceptance among doctors or patients or that governmental or third party medical reimbursement payers will be willing to provide reimbursement coverage for our products. Moreover, we do not have the marketing data resources possessed by the major pharmaceutical companies, and we have not independently verified the potential size of the commercial markets for any of our products. Since our products will represent new approaches to treating liver diseases, it may be difficult, in any event, to accurately estimate the potential revenues from our products, as there currently are no directly comparable products being marketed.

We need to obtain significant additional capital to complete the development of our liver assist devices, which additional funding may dilute our existing stockholders.

Based on our current proposed plans and assumptions, the Company estimates that it has cash to operate through the second quarter of calendar year 2008, and therefore will need to obtain significant additional funds during the first half of 2008. The clinical development expenses of our products will be very substantial. Based on our current assumptions, we estimate that the clinical cost of developing the SEPET™ liver assist device will be approximately $5 million to $10 million, and the clinical cost of developing the HepatAssist™ cell-based liver support system will be between $10 million and $15 million, in excess of the cost of basic operations of the Company. These amounts, which could vary substantially if our assumptions are not correct, are well in excess of the amount of cash that we currently have available to us. Accordingly, we will be required to (i) obtain additional debt or equity financing in order to fund the further development of our products and working capital needs, and/or (ii) enter into a strategic alliance with a larger pharmaceutical or biomedical company to provide its required funding. The amount of funding needed to

complete the development of one or both of our products will be very substantial and may be in excess of our ability to raise capital.

We have not identified the sources for the additional financing that we will require, and we do not have commitments from any third parties to provide this financing. There can be no assurance that sufficient funding will be available to us at acceptable terms or at all. If we are unable to obtain sufficient financing on a timely basis, the development of our products could be delayed and we could be forced to reduce the scope of our pre-clinical and clinical trials or otherwise limit or terminate our operations altogether. Any equity additional funding that we obtain will reduce the percentage ownership held by our existing security holders.

As a new small company that will be competing against numerous large, established companies that have substantially greater financial, technical, manufacturing, marketing, distribution and other resources than us, we will be at a competitive disadvantage.

The pharmaceutical, biopharmaceutical and biotechnology industry is characterized by intense competition and rapid and significant technological advancements. Many companies, research institutions and universities are working in a number of areas similar to our primary fields of interest to develop new products, some of which may be similar and/or competitive to our products. Furthermore, many companies are engaged in the development of medical devices or products that are or will be competitive with our proposed products. Most of the companies with which we compete have substantially greater financial, technical, manufacturing, marketing, distribution and other resources than us.

We will need to outsource and rely on third parties for the clinical development and manufacture and marketing of our products.

Our business model calls for the outsourcing of the clinical development, manufacturing and marketing of our products in order to reduce our capital and infrastructure costs as a means of potentially improving the profitability of these products for us. We have not yet entered into any strategic alliances or other licensing or contract manufacturing arrangements (except for the contractual manufacturing of LIVERAID™ modules by Spectrum Laboratories which we have indefinitely placed on hold) and there can be no assurance that we will be able to enter into satisfactory arrangements for these services or the manufacture or marketing of our products. We will be required to expend substantial amounts to retain and continue to utilize the services of one or more clinical research management organizations without any assurance that the products covered by the clinical trials conducted under their management ultimately will generate any revenues for the SEPET™ liver assist device and/or our HepatAssist™ cell-based liver support system. Consistent with our business model, we will seek to enter into strategic alliances with other larger companies to market and sell our products. In addition, we may need to utilize contract manufacturers to manufacture our products or even our commercial supplies, and we may contract with independent sales and marketing firms to use their pharmaceutical sales force on a contract basis.

To the extent that we rely on other companies or institutions to manage the conduct of our clinical trials and to manufacture or market our products, we will be dependent on the timeliness and effectiveness of their efforts. If the clinical research management organization that we utilize is unable to allocate sufficient qualified personnel to our studies or if the work performed by them does not fully satisfy the rigorous requirement of the FDA, we may encounter substantial delays and increased costs in completing our clinical trials. If the manufacturers of the raw material and finished product for our clinical trials are unable to meet our time schedules or cost parameters, the timing of our clinical trials and development of our products may be adversely affected. Any manufacturer that we select may encounter difficulties in scaling-up the manufacture of new products in commercial quantities, including problems involving product yields, product stability or shelf life, quality control, adequacy of control procedures and policies, compliance with FDA regulations and the need for further FDA approval of any new manufacturing processes and facilities. Should our manufacturing or marketing company encounter regulatory problems with the FDA, FDA approval of our products could be delayed or the marketing of our products could be suspended or otherwise adversely affected.

Because we are currently dependent on Spectrum Laboratories, Inc. as the manufacturer of our SEPET™ cartridges, any failure or delay by Spectrum Laboratories to manufacture the cartridges will negatively affect our future operations.

We have an exclusive manufacturing arrangement with Spectrum Laboratories for our fiber-within-fiber LIVERAID™ cartridges, the development of which we have placed on indefinite hold. Although we have no agreement with Spectrum Laboratories for the manufacture of the SEPET™ cartridges, Spectrum Laboratories has also been providing us with cartridges for prototypes of the SEPET™ liver assist device and has expressed an interest in manufacturing the HepatAssist™ cartridge. Although Spectrum Laboratories has agreed to transfer all of the know-how related to these products to any other manufacturer of our products if Spectrum Laboratories is unable to meet its contractual obligations to us, we may have difficulty in finding a replacement manufacturer if we are unable to effectively transfer the Spectrum Laboratories know-how to another manufacturer. We have no control over Spectrum Laboratories or its suppliers, and if Spectrum Laboratories is unable to produce SEPET™ cartridges on a timely basis, our business may be adversely affected.

We currently do not have a manufacturing arrangement for the cartridges used in the HepatAssist™ cell-based liver support system. While we believe there are several potential contract manufacturers who can produce these cartridges, there can be no assurance that we will be able to enter into such an arrangement on commercially favorable terms, or at all.

Because we are dependent on Medtronic, Inc. for the perfusion platform used in our HepatAssist™ cell-based liver support system, any failure or delay by Medtronic to make the perfusion platform commercially available will negatively affect our future operations.

We currently expect that a perfusion system known as the PERFORMER will become the platform for our HepatAssist™ cell-based liver support system. The PERFORMER has been equipped with proprietary software and our tubing in order to enable the machine to work with our HepatAssist™ cell-based liver support system. A limited number of the PERFORMER units have been manufactured to date. The PERFORMER is being manufactured by RanD, S.r.l. (Italy) and marketed by Medtronic, Inc. We currently do not have an agreement to purchase the PERFORMER from Medtronic or any other source. In the event that RanD and Medtronic are either unable or unwilling to manufacture the number of PERFORMERS needed to ensure that the HepatAssist™ cell-based liver support system is commercially viable, we would not have an alternate platform immediately available for use, and the development and sales of such a system would cease until an alternate platform is developed or found. We may have difficulty in finding a replacement platform and may be required to develop a new platform in collaboration with a third party contract manufacturer. While we believe there are several potential contract manufacturers who can develop and manufacture perfusion platforms meeting the HepatAssist™ cell-based liver support system functional and operational characteristics, there can be no assurance that we will be able to enter into such an arrangement on commercially favorable terms, or at all. In addition, we may encounter substantial delays and increased costs in completing our clinical trials if we have difficulty in finding a replacement platform or if we are required to develop a new platform for bioartificial liver use.

We may not have sufficient legal protection of our proprietary rights, which could result in the use of our intellectual properties by our competitors.

Our ability to compete successfully will depend, in part, on our ability to defend patents that have issued, obtain new patents, protect trade secrets and operate without infringing the proprietary rights of others. We currently own four U.S. and five foreign patents on our liver support products, have two patent applications pending, and are the licensee of twelve additional liver support patents. We have relied substantially on the patent legal work that was performed for our assignors and licensors with respect to all of these patents, application and licenses, and have not independently verified the validity or any other aspects of the patents or patent applications covering our products

with our own patent counsel. For example, we have recently received from the European Patent Office references to certain issued patents that may represent prior art in the field of large-pore hemofiltration. This prior art may prevent us from obtaining sufficient legal protection of our proprietary rights to our SEPET liver assist device.

Even when we have obtained patent protection for our products, there is no guarantee that the coverage of these patents will be sufficiently broad to protect us from competitors or that we will be able to enforce our patents against potential infringers. Patent litigation is expensive, and we may not be able to afford the costs. Third parties could also assert that our products infringe patents or other proprietary rights held by them.

We will attempt to protect our proprietary information as trade secrets through nondisclosure agreements with each of our employees, licensing partners, consultants, agents and other organizations to which we disclose our proprietary information. There can be no assurance, however, that these agreements will provide effective protection for our proprietary information in the event of unauthorized use of disclosure of such information.

The development of our products is dependent upon certain key persons, and the loss of one or more of these key persons would materially and adversely affect our business and prospects.

We are dependent upon our business and scientific personnel. We also depend upon the medical and scientific advisory services that we receive from the members of our Board of Directors and Scientific Advisory Board, many of whom have extensive backgrounds in the biomedical industry. We do not carry key man life insurance on any of these individuals.

As we expand the scope of our operations by preparing FDA submissions, conducting multiple clinical trials, and potentially acquiring related technologies, we will need to obtain the services of additional senior scientific and management personnel. Competition for these personnel is intense, and there can be no assurance that we will be able to attract or retain qualified senior personnel. As we retain senior personnel, our overhead expenses for salaries and related items will increase substantially from current levels.

The market success of our products will be dependent in part upon third-party reimbursement policies that have not yet been established.

Our ability to successfully penetrate the market for our products may depend significantly on the availability of reimbursement for our products from third-party payers, such as governmental programs, private insurance and private health plans. We have not yet established with Medicare or any third-party payers what level of reimbursement, if any, will be available for our products, and we cannot predict whether levels of reimbursement for our products, if any, will be high enough to allow us to charge a reasonable profit margin. Even with FDA approval, third-party payers may deny reimbursement if the payer determines that our particular new products are unnecessary, inappropriate or not cost effective. If patients are not entitled to receive reimbursement similar to reimbursement for competing products, they may be unwilling to use our products since they will have to pay for the unreimbursed amounts, which may well be substantial. The reimbursement status of newly approved health care products is highly uncertain. If levels of reimbursement are decreased in the future, the demand for our products could diminish or our ability to sell our products on a profitable basis could be adversely affected.

We may be subject to product liability claims that could have a material negative effect on our operations and on our financial condition.

The development, manufacture and sale of medical products expose us to the risk of significant damages from product liability claims. We have obtained clinical trial insurance for our SEPET™ trials. We plan to obtain and maintain product liability insurance for coverage of our clinical trial activities. However, there can be no assurance that we will be able to continue to secure such insurance for clinical trials for either of our two current products under development. We intend to obtain coverage for our products when they enter the marketplace (as well as requiring the manufacturers of our products to maintain insurance). We do not know if it will be available to us at acceptable costs. We may encounter difficulty in obtaining clinical trial or commercial product liability insurance for our bioartificial liver device that we develop since this therapy includes the use of pig liver cells and we are not aware of any therapy

using these cells that has sought or obtained such insurance. If the cost of insurance is too high or insurance is unavailable to us, we will have to self-insure. A successful claim in excess of product liability coverage could have a material adverse effect on our business, financial condition and results of operations. The costs for many forms of liability insurance have risen substantially during the past year, and such costs may continue to increase in the future, which could materially impact our costs for clinical or product liability insurance.

If we are not able to implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in a timely manner or with adequate compliance, we may be unable to provide the required financial information in a timely and reliable manner and may be subject to sanction by regulatory authorities.

We cannot be certain at this time that we will have the expertise and resources to be able to comply with all of our reporting obligations and successfully complete the procedures, certification and attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 by the time that we are required to do so. If we fail to comply with the requirements of Section 404, or if we or our independent registered public accounting firm identifies any material weaknesses, the accuracy and timeliness of the filing of our annual and quarterly reports may be negatively affected and could cause investors to lose confidence in our financial statements, impair our ability to obtain financing or result in regulatory sanctions. Remediating any material weakness could require additional management attention and increased compliance costs.

If we make any further acquisitions, we will incur a variety of costs and might never successfully integrate the acquired product or business into ours.

Following our acquisition of the HepatAssist™ cell-based liver support system from Circe Biomedical, Inc., we might attempt to acquire products or businesses that we believe are a strategic complement to our business model. We might encounter operating difficulties and expenditures relating to integrating the HepatAssist™ cell-based liver support system or any other acquired product or business. These acquisitions might require significant management attention that would otherwise be available for ongoing development of our business. In addition, we might never realize the anticipated benefits of any acquisition. We might also make dilutive issuances of equity securities, incur debt or experience a decrease in cash available for our operations, incur contingent liabilities and/or amortization expenses relating to goodwill and other intangible assets, or incur employee dissatisfaction in connection with future acquisitions.

If we are unable to comply with the terms of registration rights agreements to which we are a party, we may be obligated to pay liquidated damages to some of our stockholders and recharacterize outstanding warrants as debt.

We are a party to registration rights agreements with some of our stockholders. The registration rights agreements provide, among other things, that we register shares of our common stock held by those stockholders within a specified period of time and that we keep the registration statement associated with those shares continuously effective. If we are unable to comply with these provisions of the registration rights agreements, we may be obligated to pay those stockholders liquidated damages. Because of the potential operation of these provisions of our registration rights agreements, we have booked an estimated accrual of $180,000 to the balance sheet as of March 31, 2007 to estimate the contingent liability related to the probability of registration rights payments. These penalty provisions may also force us to re-characterize some of our other outstanding warrants from equity to debt. If we have to make this re-characterization, our liabilities would increase and our financial statements would be negatively impacted.

Our ability to continue as a going concern is dependent on future financing.

Our independent registered public accounting firm, has included an explanatory paragraph in its report on our financial statements for the fiscal year ended December 31, 2006, which expresses substantial doubt about our ability to continue as a going concern. The inclusion of a going concern explanatory paragraph in our accountant's report on our financial statements could have a detrimental effect on our stock price and our ability to raise additional capital.

Our financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. We have not made any adjustments to the financial statements as a result of the outcome of the uncertainty described above. Accordingly, the value of the Company in liquidation may be different from the amounts set forth in our financial statements.

Our continued success will depend on our ability to continue to raise capital in order to fund the development and commercialization of our products. Failure to raise additional capital may result in substantial adverse circumstances, including our inability to continue the development of our products and our liquidation.

Risks Related to Our Common Stock

Our stock is thinly traded, so you may be unable to sell at or near ask prices or at all if you need to sell your shares to raise money or otherwise desire to liquidate your shares.

The shares of our common stock are thinly-traded on the OTC Bulletin Board, meaning that the number of persons interested in purchasing our common shares at or near ask prices at any given time may be relatively small or non-existent. This situation is attributable to a number of factors, including the fact that we are a small company which is relatively unknown to stock analysts, stock brokers, institutional investors and others in the investment community that generate or influence sales volume, and that even if we came to the attention of such persons, they tend to be risk-averse and would be reluctant to follow an unproven, early stage company such as ours or purchase or recommend the purchase of our shares until such time as we became more seasoned and viable. As a consequence, there may be periods of several days or more when trading activity in our shares is minimal or non-existent, as compared to a seasoned issuer which has a large and steady volume of trading activity that will generally support continuous sales without an adverse effect on share price. We cannot give you any assurance that a broader or more active public trading market for our common shares will develop or be sustained, or that current trading levels will be sustained. Due to these conditions, we can give you no assurance that you will be able to sell your shares at or near ask prices or at all if you need money or otherwise desire to liquidate your shares.

If securities or independent industry analysts do not publish research reports about our business, our stock price and trading volume could decline.

Small, relatively unknown companies can achieve visibility in the trading market through research and reports that industry or securities analysts publish. However, to our knowledge, no independent analysts cover our company. The lack of published reports by independent securities analysts could limit the interest in our stock and negatively affect our stock price. We do not have any control over research and reports these analysts publish or whether they will be published at all. If any analyst who does cover us downgrades our stock, our stock price would likely decline. If any independent analyst ceases coverage of our company or fails to regularly publish reports on us, we could lose visibility in the financial markets, which in turn could cause our stock price or trading volume to decline.

You may have difficulty selling our shares because they are deemed "penny stocks."

Since our common stock is not listed on the NASDAQ Stock Market, if the trading price of our common stock is below $5.00 per share, trading in our common stock will be subject to the requirements of certain rules promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which require additional disclosure by broker-dealers in connection with any trades involving a stock defined as a penny stock (generally, any non-NASDAQ equity security that has a market price of less than $5.00 per share, subject to certain exceptions) and a two business day "cooling off period" before brokers and dealers can effect transactions in penny stocks. Such rules impose various sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors (generally defined as an investor with a net worth in excess of $1,000,000 or annual income exceeding $200,000 individually or $300,000 together with a spouse). For these types of transactions, the

broker-dealer must make a special suitability determination for the purchaser and have received the purchaser's written consent to the transaction prior to the sale. The broker-dealer also must disclose the commissions payable to the broker-dealer, current bid and offer quotations for the penny stock and, if the broker-dealer is the sole market-maker, the broker-dealer must disclose this fact and the broker-dealer's presumed control over the market. Such information must be provided to the customer orally or in writing before or with the written confirmation of trade sent to the customer. Monthly statements must be sent disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks. The additional burdens imposed upon broker-dealers by such requirements could discourage broker-dealers from effecting transactions in our common stock, which could severely limit the market liquidity of the common stock and the ability of holders of the common stock to sell their shares.

Anti-takeover provisions in our certificate of incorporation could affect the value of our stock.

Our certificate of incorporation contains certain provisions that could be an impediment to a non-negotiated change in control. In particular, without stockholder approval we can issue up to 5,000,000 shares of preferred stock with rights and preferences determined by the board of directors. These provisions could make a hostile takeover or other non-negotiated change in control difficult, so that stockholders would not be able to receive a premium for their common stock.

Potential issuance of additional common and preferred stock could dilute existing stockholders.

We are authorized to issue up to 60,000,000 shares of common stock. To the extent of such authorization, our board of directors has the ability, without seeking stockholder approval, to issue additional shares of common stock in the future for such consideration as the board of directors may consider sufficient. The issuance of additional common stock in the future will reduce the proportionate ownership and voting power of the common stock offered hereby. We are also authorized to issue up to 5,000,000 shares of preferred stock, the rights and preferences of which may be designated in series by the board of directors. Such designation of new series of preferred stock may be made without stockholder approval, and could create additional securities which would have dividend and liquidation preferences over the common stock offered hereby. Preferred stockholders could adversely affect the rights of holders of common stock by:

- exercising voting, redemption and conversion rights to the detriment of the holders of common stock;
- receiving preferences over the holders of common stock regarding or surplus funds in the event of our dissolution or liquidation;
- delaying, deferring or preventing a change in control of our company; and
- discouraging bids for our common stock.

Additionally, some of our outstanding warrants to purchase common stock have anti-dilution protection. This means that if we issue securities for a price less than the price at which the warrants are exercisable for shares of common stock, the warrants will become eligible to purchase more shares of common stock at a lower price, which will dilute the ownership of our common stockholders.

Substantial number of shares of common stock may be released onto the market at any time, and the sales of such additional shares of common stock could cause stock price to fall.

As of May 31, 2007, we had outstanding 25,144,086 shares of common stock. However, in the past year, the average daily trading volume of our shares has only been a few thousand shares, and there have been many days in which no shares were traded at all. As of June 2006, the resale of a total of 8,015,480 shares of our common stock issuable upon the exercise of outstanding warrants were registered on a registration statement on Form SB-2. Since June 2006, a warrant to purchase 40,000 shares of our common stock has been cancelled. This warrant was issued to our former director, Richard Bank, as compensation for fundraising on behalf of the Company and expired in January 2007. We have also registered an additional 746,602 shares of our common stock issuable upon exercise of outstanding warrants on the registration statement on From SB-2 filed with the SEC on June 1, 2007, and 8,055,077 shares of our common stock issuable upon exercise of outstanding warrants are being registered on the registration statement on Form SB-2 of which the prospectus forms a part. The shares underlying the warrants have not yet been issued and will not be issued until the warrants are exercised. Since the shares underlying these warrants have been registered, they can be sold immediately following the exercise. Accordingly, 16,777,159 additional shares could be released onto the trading market at any time. Because of the limited trading volume, the sudden release of 16,777,159 additional freely trading

shares onto the market, or the perception that such shares will come onto the market, could have an adverse affect on the trading price of the stock. In addition, there are currently 4,650,000 shares of unregistered, restricted stock that are currently eligible for public resale under Rule 144 promulgated under the Securities Act, some of which shares also may be offered and sold on the market from time to time and an additional 3,256,674 shares that are issuable upon the exercise of outstanding options and other warrants. No prediction can be made as to the effect, if any, that sales of the 16,777,159 registered warrant shares, or the sale of any of the 4,650,000 shares subject to Rule 144 sales or the 3,256,674 shares issuable upon the exercise of outstanding options and other warrants will have on the market prices prevailing from time to time. Nevertheless, the possibility that substantial amounts of common stock may be sold in the public market may adversely affect prevailing market prices for our common stock and could impair our ability to raise capital through the sale of our equity securities.

The market price of our stock may be adversely affected by market volatility.

The market price of our common stock is likely to be volatile and could fluctuate widely in response to many factors, including:

- announcements of the results of clinical trials by us or our competitors;
- developments with respect to patents or proprietary rights;
- announcements of technological innovations by us or our competitors;
- announcements of new products or new contracts by us or our competitors;
- actual or anticipated variations in our operating results due to the level of development expenses and other factors;
- changes in financial estimates by securities analysts and whether our earnings meet or exceed such estimates;
- conditions and trends in the pharmaceutical and other industries;
- new accounting standards; and
- general economic, political and market conditions and other factors, and the occurrence of any of the risks described in this prospectus.

FORWARD-LOOKING STATEMENTS

The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward-looking statements. This document contains forward-looking statements, which reflect the views of our management with respect to future events and financial performance. These forward-looking statements are subject to a number of uncertainties and other factors that could cause actual results to differ materially from such statements. Forward-looking statements are identified by words such as “anticipates,” “believes,” “estimates,” “expects,” “plans,” “projects,” “targets” and similar expressi Readers are cautioned not to place undue reliance on these forward-looking statements, which are based on the information available to management at this time and which speak only as of this date. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. For a discussion of some of the factors that may cause actual results to differ materially from those suggested by the forward-looking statements, please read carefully the information under “Risk Factors” beginning on page 3.

The identification in this document of factors that may affect future performance and the accuracy of forward-looking statements is meant to be illustrative and by no means exhaustive. All forward-looking statements should be evaluated with the understanding of their inherent uncertainty. You may rely only on the information contained in this prospectus.

We have not authorized anyone to provide information different from that contained in this prospectus. Neither the delivery of this prospectus nor the sale of common stock means that information contained in this prospectus is correct after the date of this prospectus. This prospectus is not an offer to sell or solicitation of an offer to buy these securities in any circumstances under which the offer or solicitation is unlawful.

USE OF PROCEEDS

We will not receive any proceeds from the sale or other disposition of the common stock covered hereby by the selling stockholders pursuant to this prospectus. However, we may receive the sale price of any common stock we sell to the selling stockholders upon exercise of the warrants. If all warrants included in this prospectus are exercised for cash (and not pursuant to the cashless exercise feature included in the warrants), the total amount of proceeds we would receive is $9,348,954. We expect to use the proceeds we receive from the exercise of warrants, if any, for general working capital purposes. We will pay the expenses of registration of these shares, including legal and accounting fees.

MARKET PRICE OF COMMON STOCK AND OTHER SHAREHOLDER MATTERS

Market Information

Our common stock has been traded on the OTC Bulletin Board over-the-counter market since March 18, 2004 under the symbol “ABOS.” From the Reorganization until March 18, 2004, our common stock was listed on the Pink Sheets over-the-counter electronic trading system under the symbol “ABOS.” Before the Reorganization on October 30, 2003, our common stock was listed on the Pink Sheets under the symbol “HIAU,” but there was virtually no trading in the common stock.

Our common stock will be offered in amounts, at prices, and on terms to be determined in light of market conditions at the time of sale. The shares may be sold directly by the selling stockholders in the open market at prevailing prices or in individually negotiated transactions, through agents, underwriters, or dealers. We will not control or determine the price at which the shares are sold.

The following table sets forth the high and low bid information for our common stock for each quarter within the last two fiscal years, as reported by Bloomberg L.P. The following price information reflects inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions:

Quarter Ending	High	Low
March 31, 2005	$ 1.66	$ 1.60
June 30, 2005	$ 2.20	$ 2.10
September 30, 2005	$ 1.90	$ 1.80
December 31, 2005	$ 1.80	$ 1.74
March 31, 2006	$ 1.85	$ 0.65
June 30, 2006	$ 1.25	$ 0.90
September 30, 2006	$ 0.92	$ 0.42
December 31, 2006	$ 0.79	$ 0.46
March 31, 2007	$ 0.65	$ 0.43

Holders

As of May 31, 2007, there were 125 listed shareholders of record of our common stock, although we believe there may be substantially more shareholders who hold our common stock in street name.

Dividends

We have not paid any dividends on our common stock to date and do not anticipate that we will be paying dividends in the foreseeable future. Any payment of cash dividends on our common stock in the future will be dependent upon the amount of funds legally available, our earnings, if any, our financial condition, our anticipated capital requirements and other factors that the Board of Directors may think are relevant. However, we currently intend for the foreseeable future to follow a policy of retaining all of our earnings, if any, to finance the development and expansion of our business and, therefore, do not expect to pay any dividends on our common stock in the foreseeable future.

Equity Compensation Plan Information

The following table summarizes as of December 31, 2006, the number of securities to be issued upon the exercise of outstanding derivative securities (options, warrants, and rights); the weighted-average exercise price of the outstanding derivative securities; and the number of securities remaining available for future issuance under our equity compensation plans.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders(1)	2,628,876	$ 1.50	1,371,124
Equity compensation plans not approved by security holders	637,000(2)	$ 2.41	-0-
Total	3,265,876(3)	$ 1.69	1,371,124

(1) These plans consist of our 2001 Stock Option Plan and 2005 Stock Incentive Plan.

(2) Represents warrants to purchase shares of our common stock issued to our consultants.

(3) Includes restricted stock grants totaling 172,199 shares of common stock.

MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Restatement of Financial Statements

In January 2005 and March 2006, we closed financing transactions that included the issuance of warrants and the grant of registration rights for securities issued in the transaction. We have been accounting for the warrants in accordance with Emerging Issues Task Force Issue No. EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, or EITF 0019. Beginning in the quarter ended March 31, 2006 for the warrants issued in the January 2005 financing and in the quarter ended September 30, 2006 for the warrants issued in the March 2006 financing, in accordance with EITF 00-19, we recorded the fair value of these warrants as an accrued warrant liability and reduced additional paid-in capital by the amount of the recorded liability. In the quarters ending June 30 and September 30, 2006, changes to the accrued liability were reported in our statement of operations. However, we have determined that we should have included in the calculation of the fair value of the warrant the value of the anti-dilution provisions contained in the warrant agreements. The calculations of the fair value of the warrants did not include the value of the anti-dilution provisions for the filed financial statements included in our Quarterly Reports on Form 10-QSB for the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006. Therefore, we restated our financial statements for these periods as follows: 1) for the three month period ended March 31, 2006, additional paid in capital is decreased by $271,000 with a corresponding increase in the accrued warrant liability, 2) for the three and six month periods ending June 30, 2006, other expense is increased by $63,000 with a corresponding increase in the accrued warrant liability, and 3) for the three month period ended September 30, 2006, additional paid in capital is decreased by $114,000 and other expense is increased by $49,000 with a corresponding increase in the accrued warrant liability of $163,000. For the nine month period ended September 30, 2006 additional paid-in capital is decreased by $385,000, other expense is increased by $112,000, and the accrued warrant liability is increased by $497,000. The following table shows the effect of the restatements on net loss, accrued warrant liability and additional paid-in-capital for the periods indicated.

	Three months ended March 31, 2006	Three months ended June 30, 2006	Six months ended June 30, 2006	Three months ended Sept. 30, 2006	Nine months ended Sept. 30, 2006
Net loss					
As originally reported	$ (1,069,468)	$ (837,202)	$ (1,906,670)	$ (1,081,410)	$ (2,988,080)
Adjustment	0	(63,000)	(63,000)	(49,000)	(112,000)
As adjusted	$ (1,069,468)	$ (900,202)	$ (1,969,670)	$ (1,130,410)	$ (3,100,080)
Accrued warrant liability					
As originally reported	$ 680,841		$ 407,717		$ 524,172
Adjustment	271,000		334,000		497,000
As adjusted	$ 951,841		$ 741,717		$ 1,021,172
Additional paid-in capital					
As originally reported	$ 14,190,980		$ 14,296,357		$ 14,307,052
Adjustment	(271,000)		(271,000)		(385,000)
As adjusted	$ 13,919,980		$ 14,025,357		$ 13,922,052

Overview

On October 30, 2003, we completed a reorganization (the "Reorganization") in which Arbios Technologies, Inc., or ATI, our operating company, became our wholly-owned subsidiary. At the time of the Reorganization, we had virtually no assets and virtually no liabilities (prior to the Reorganization we were an e-commerce based company engaged in the business of acquiring and marketing historical documents). Shortly after the Reorganization, we changed our name to "Arbios Systems, Inc." In the Reorganization, we also replaced our officers and directors with those of ATI. Following the Reorganization, we ceased our e-commerce business, closed our former offices, and moved our offices to Los Angeles, California. We currently do not plan to conduct any business other than the business of developing liver assist devices that Arbios Systems, Inc. has conducted since its organization. In July 2005, we merged ATI into the parent company, Arbios Systems, Inc.

Although we acquired ATI in the Reorganization, for accounting purposes, the Reorganization was accounted for as a reverse merger since the stockholders of ATI acquired a majority of the issued and outstanding shares of our common stock, and the directors and executive officers of ATI became our directors and executive officers. Accordingly, the financial statements contained in this prospectus, and the description of our results of operations and financial condition, reflect (i) the operations of ATI alone prior to the Reorganization, and (ii) the combined results of this company and ATI since the Reorganization. No goodwill was recorded as a result of the Reorganization.

Since the formation of ATI in 2000, our efforts have been principally devoted to research and development activities, raising capital, and recruiting additional scientific and management personnel and advisors. To date, we have not marketed or sold any product and have not generated any revenues from commercial activities, and we do not expect to generate any revenues from commercial activities during the next 12 months. Substantially all of the revenues that we have recognized to date have been Small Business Innovation Research grants (in an aggregate amount of $321,000) that we received from the United States Small Business Administration.

Our current plan of operations for the next 12 months primarily involves research and development activities, including additional clinical trials for SEPET™ both domestically and internationally, and the preparation and submission of applications to 1) a Notified Body in Europe to secure CE Mark approval to market our SEPET™ Liver Assist Device in CE countries and 2) the FDA to commence a pivotal trial of SEPET™ targeted for subsequent FDA approval of SEPET™ in the U.S. The actual amounts we may expend on research and development and related activities during the next 12 months may vary significantly depending on numerous factors, including the results of our clinical studies and the timing and cost of regulatory submissions. Based on our current estimates, we currently have sufficient cash to conduct our plan of operations for the next twelve months from the date of this prospectus; however, we are seeking additional investment from various investors, but currently have no agreements or commitments in this regard to fund future development of our products.

Our research offices and laboratories are located at Cedars-Sinai Medical Center ("Cedars-Sinai"), Los Angeles, California. Cedars-Sinai Medical Center is also one of the clinical testing sites for our SEPET™ clinical testing program. Under our lease agreement and other arrangements with Cedars-Sinai, we have access to their development resources of that leading medical center, including animal facilities, surgical facilities and clinical laboratories. The Hospital has informed us that they do not intend to renew the lease when it expires on June 30, 2007, and we intend to seek a new laboratory facility for testing our device. We are currently seeking to identify replacement laboratory space in eastern Massachusetts. We also lease administrative office space in Waltham, Massachusetts and Los Angeles, California.

In April 2004 we purchased certain assets of Circe Biomedical including a portfolio of patents, rights to a bioartificial liver (HepatAssist), a Phase III IND, selected equipment, clinical and marketing data, and over 400 standard operating procedures and clinical protocols that have previously been reviewed by the FDA. The purchase price paid for these

assets was $450,000, which amount has now been fully paid.

Critical Accounting Policies

Management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, impairment of long-lived assets, including finite lived intangible assets, accrued liabilities and certain expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

Our significant accounting policies are summarized in Note 1 to our audited financial statements for the year ended December 31, 2006. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our consolidated financial statements:

Development Stage Enterprise

We are a development stage enterprise as defined by the Financial Accounting Standards Board's, or FASB, Statement of Financial Accounting Standards, or SFAS, No. 7, *Accounting and Reporting by Development Stage Enterprises*. We are devoting substantially all of our present efforts to research and development. All losses accumulated since inception have been considered part of our development stage activities.

Short-Term Investments

Short-term investments generally mature between three and twelve months. Short-term investments consist of U.S. government agency notes purchased at a discount with interest accruing to the notes full value at maturity. All of our short-term investments are classified as available-for-sale and are carried at fair market value which approximates cost plus accrued interest.

Patents

In accordance with SFAS No. 2, *Accounting for Research and Development Costs*, the costs of intangibles purchased from others for use in research and development activities and that have alternative future uses are capitalized and amortized. We capitalize certain patent rights that are believed to have future economic benefit. The licensed capitalized patents costs were recorded based on the estimated value of the equity security issued by us to the licensor. The value ascribed to the equity security took into account, among other factors, our stage of development and the value of other companies developing extracorporeal bioartificial liver assist devices. These patent rights are amortized using the straight-line method over the remaining life of the patent. Certain patent rights received in conjunction with purchased research and development costs have been expensed. Legal costs incurred in obtaining, recording and defending patents are expensed as incurred.

Stock-Based Compensation

Commencing January 1, 2006, we adopted SFAS No. 123R, "Share Based Payment", or SFAS 123R, which requires all share based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on fair values.

Prior to adopting SFAS 123R, we accounted for stock-based employee compensation under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees,” as allowed by SFAS No. 123, “Accounting for Stock-Based Compensation.” We have applied the modified prospective method in adopting SFAS 123R. Accordingly, periods prior to adoption have not been restated.

New Accounting Pronouncements

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140*, or SFAS 156, which clarifies when servicing rights should be separately accounted for, requires companies to account for separately recognized servicing rights initially at fair value, and gives companies the option of subsequently accounting for those servicing rights at either fair value or under the amortization method. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The Company does not expect SFAS 156 to affect the Company's financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, or FIN48. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to SFAS No. 109, *Accounting for Income Taxes.* The interpretation clearly scopes out income tax positions related to SFAS No. 5, *Accounting for Contingencies.* We do not anticipate that the adoption of this statement will have a material effect on our financial position or results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, or SAB 108, to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements and related disclosures. SAB 108 is effective as of the end of our 2006 fiscal year, allowing a one-time transitional cumulative effect adjustment to retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB 108. We adopted provisions of SAB 108 in the quarter ended December 31, 2006 without any impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 with earlier application encouraged. We are evaluating the impact of adopting SFAS 157 on our financial statements.

In September 2006, the FASB issued SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans -- An Amendment of FASB Statements No. 87, 88, 106, and 132R*, or SFAS 158. SFAS 158 does not apply as the Company does not have a defined benefit pension or any other post retirement plan.

In December 2006, the FASB issued FASB Staff Position, or FSP, EITF 00-19-2, *Accounting for Registration Payment Arrangements*. This FSP addresses how to account for registration payment arrangements and clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. This accounting pronouncement further clarifies that a liability for liquidated damages resulting from registration statement obligations should be recorded in accordance with SFAS No. 5, *Accounting for Contingencies*, when the payment of liquidated damages becomes probable and can be reasonably estimated. This FSP shall be effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to the date of issuance of this FSP. For registration payment arrangements and financial instruments subject to those arrangements that were entered

into prior to the issuance of this FSP, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. The Company is currently assessing the impact that this FSP may have in its financial statements.

Results of Operations

Comparison of Fiscal Year ended December 31, 2006 to Fiscal Year ended December 31, 2005.

Since we are still developing our products and do not have any products available for sale, we have not yet generated any revenues from sales. Revenues from periods prior to 2005 represent revenues recognized from government research grants that we have received.

General and administrative expenses of $3,315,174 and $2,394,546 were incurred for the years ended December 31, 2006 and 2005, respectively. For the year ended December 31, 2006, the expenses include $662,000 in fees incurred to outside consultants, professionals and board member fees, $549,000 in payroll and payroll related costs, $1,076,000 in non-cash option and warrant charges, $239,000 in investor relation costs and other administrative expenses. For the year ended December 31, 2005, the expenses include $745,000 in fees incurred to outside consultants, professionals and board member fees, $509,000 in payroll and payroll related costs, $477,000 in non-cash option and warrant charges for grants awarded to consultants, $187,000 in investor relation costs and other administrative expenses. Professional fees decreased in 2006 due to a one time executive search recruitment fee incurred in 2005. The increase in non-cash option and warrant charges reflects the employee option grant charges recorded in the financial statements due to the adoption of SFAS 123(R) effective January 1, 2006 and the warrant charges incurred due to the warrant exercise term modifications granted to certain warrants expiring in 2006. The 2006 increase in payroll and payroll related expenses reflects, in part, the employment for the full year in 2006 as compared to nine months in 2005 of a Chief Executive Officer.

Research and development expenses of $1,822,614 and $1,554,507 were incurred for the years ended December 31, 2006 and 2005, respectively. Research and development expenses for 2006 consist primarily of $570,000 in payroll and payroll related expenses, $486,000 in SEPET™ development, manufacturing and clinical costs, $380,000 in consultant costs related to manufacturing, regulatory and product management, and $144,000 in HepatAssist™ facility costs. Research and development expenses for 2005 consist primarily of $414,000 in payroll and payroll related expenses, $362,000 in SEPET™ development, manufacturing and clinical costs, $226,000 in consultant costs related to manufacturing, regulatory and product management, $141,000 in employee costs from Cedars-Sinai and $108,000 in HepatAssist™ facility costs. Research and development costs increased by $268,107 from 2005 to 2006 and reflect increased expenditures for both the SEPET™ and HepatAssist™ programs. Payroll cost increases reflect 2006 full year salaries for employees that were hired in 2005, increased staff which replaced employee costs from Cedars-Sinai and the addition of new position for clinical research management. The increase in consulting costs reflects outsourced service costs incurred related to the SEPET™ Phase I trial.

The change in fair value of warrant liability reflects the net decline in the warrant liability valuation resulting in a non-cash benefit of $521,187.

Interest income of $154,697 and $125,286 was earned for the years ended December 31, 2006 and 2005 respectively. The increase in interest income of $29,411 results from the increase in short term interest offset, in part, by declining cash balances maintained in 2006.

Our net loss increased to $4,461,904 in 2006 from $3,823,903 in 2005. The increase in net loss is attributed to an increase in operating expenses incurred in the fiscal 2006 periods as compared to the same periods in 2005, without an increase in revenues.

Comparison of Quarter ended March 31, 2007 to Quarter ended March 31, 2006.

General and administrative expenses of $676,000 and $744,000 were incurred for the three months ended March 31, 2007 and 2006, respectively. General and administrative expenses for the three months ended March 31, 2007 and 2006 decreased by $68,000 over the prior year level. The decrease is primarily attributed to decreases in investor relation costs of $50,000, Board of Director costs of $33,000, non-cash option charges of $57,000 and a decline in other general and administrative expenses offset in part by $59,000 increase in warrant charges due to warrant extensions granted in connection with expiring warrants.

Research and development expenses of $1,031,000 and $366,000 were incurred for the three months ended March 31, 2007 and 2006, respectively. The research and development expenses for the three months ended March 31, 2007 increased by $665,000 over the comparable prior year levels primarily as a result of $425,000 in costs related to the patent portfolio acquisition in March 2007 and an increase of $241,000 in SEPET™ program costs which reflect the increased number of patients enrolled in the SEPET™ clinical trial.

An equity offerings contingency for $180,000 was accrued for potential subscription agreement obligations. Interest income of $18,000 and $41,000 was earned for the three months ended March 31, 2007 and 2006, respectively. The decrease in interest income primarily reflects declining cash and cash equivalent balances in 2007 from prior year levels.

Our net loss was $1,868,000 and $1,069,000 for the three months ended March 31, 2007 and 2006, respectively. The increase in net loss for the quarter ended March 31, 2007 compared to the comparable period in 2006 is attributable to the increase in research and development expenses and potential subscription agreement obligations.

Liquidity and Capital Resources

As of March 31, 2007, we had cash of $1,345,000 and $998,000 of current liabilities. We do not have any bank credit lines. To date, we have funded our operations from the sale of debt and equity securities and from government research grants.

On January 11, 2005, we completed a $6,611,905 private equity financing to a group of institutional investors and accredited investors. In the offering, we sold 2,991,812 shares of our common stock at a price of $2.21 per share to the investors and issued to them warrants to purchase an additional 1,495,906 shares of our common stock at an exercise price of $2.90 per share. The warrants are exercisable for five years and can be redeemed by us after January 11, 2007 if the average trading price of our common stock for 20 consecutive trading days is equal to or greater than $5.80 and the average trading volume of the common stock is at least 100,000 shares during those 20 days. We also issued warrants to purchase 114,404 shares of common stock to our placement agent in the offering.

On March 6, 2006, we completed a $1,350,000 private equity financing to a group of institutional investors and accredited investors. In the offering, we sold 1,227,272 shares of our common stock at a price of $1.10 per share to the investors and issued to them warrants to purchase an additional 613,634 shares of our common stock at an exercise price of $1.50 per share. The warrants are exercisable for a period of five years.

On April 23, 2007, we completed a $4,861,000 private equity financing to a group of current and new accredited investors. In the offering, we sold 3,739,231 Units. Each Unit was sold at a price of $1.30 per Unit. Each Unit consists of: i) two shares of our common stock, ii) one warrant to purchase one share of our common stock exercisable for a period of 2.5 years at an exercise price of $1.00 (“A Warrants”) and iii) one warrant to purchase one share of our common stock exercisable for a period of 5 years at an exercise price of $1.40 (“B Warrants”), comprising a total of 7,478,462 shares of our common stock and warrants to purchase 7,478,462 shares of our common stock. The warrants have no provision for cashless exercise and, subject to certain requirements, may be called by us provided that our

common stock trades above $1.50 for the A Warrants and above $2.80 for the B Warrants for a specified time period. We also issued warrants to purchase 576,615 shares of our common stock to persons affiliated with our placement agent.

Based on our current plan and the above private placement, we believe that our current cash balances will be sufficient to fund our operations through for the next twelve months from the date of this report.

We do not currently anticipate that we will derive any revenues from either product sales or from governmental research grants during the current fiscal year.

The cost of completing the development of our products and of obtaining all required regulatory approvals to market our products is substantially greater than the amount of funds we currently have available and substantially greater than the amount we could possibly receive under any governmental grant program. As a result, we will have to obtain significant additional funds during the next 12-15 months. We currently expect to attempt to obtain additional financing through the sale of additional equity and possibly through strategic alliances with larger pharmaceutical or biomedical companies. We cannot be sure that we will be able to obtain additional funding from either of these sources, or that the terms under which we obtain such funding will be beneficial to this company.

The following is a summary of our contractual cash obligations for the following fiscal years:

Contractual Obligations	**Total**	**2007**	**2008**	**2009**	**2010**
Long-Term Leases	$ 41,000	$ 41,000	$ -	$ -	$ -
License Agreement	300,000		50,000	100,000	150,000
Total	$ 341,000	$ 41,000	$ 50,000	$ 100,000	$ 150,000

We do not believe that inflation has had a material impact on our business or operations.

We do not engage in trading activities involving non-exchange traded contracts. In addition, we have no financial guarantees, debt or lease agreements or other arrangements that could trigger a requirement for an early payment or that could change the value of our assets.

Off- Balance Sheet Arrangements

We are not a party to any off-balance sheet arrangements.

BUSINESS

Products Overview

We currently have one product under active development; a novel extracorporeal blood purification therapy called the SEPET™ Liver Assist Device. We also have an additional product which is an extracorporeal, bioartificial liver therapy referred to as the HepatAssist™ Cell-Based Liver Support System that incorporates pig liver cells, or porcine hepatocytes. We have postponed further clinical development of our HepatAssist™ program until we are able to secure additional funding for this project from a potential corporate partner.

SEPET™ is a single-use disposable plastic cartridge that contains specially designed microporous tubes called hollow fibers. When a patient's blood is pumped through these hollow fibers, substances normally metabolized by the liver and accumulated in the blood during liver failure are transported convectively across the porous fiber wall and are discarded. As a result of this blood purification, or detoxification, process, we believe that the levels of pathological blood components will move toward normal ranges, leading to amelioration of liver failure and stabilization or improved function of a patient's liver. Our belief is based on the encouraging preliminary results of the SEPET™ feasibility clinical trial, which is being conducted at prominent liver disease treatment hospitals in the U.S. The data, which remains subject to monitoring and analysis, is preliminary and reflects numerous apparent responses of hepatic encephalopathy associated with acute-on-chronic liver failure to SEPET™ treatment as well as a favorable safety profile to date. These results, if demonstrated by the final data from this study, will need to be statistically proven in a further, randomized, controlled clinical trial and reviewed by the FDA and other regulatory agencies. SEPET™ is designed for use with commercially available kidney hemodialysis systems and/or blood plasma apheresis systems that utilize hollow-fiber cartridges for dialysis and related hemoperfusion procedures.

In April 2004, we acquired from Circe Biomedical, Inc., an unaffiliated biomedical company, the rights to a bioartificial liver, known as the HepatAssist™ Cell-Based Liver Support System. Certain technologies included in the HepatAssist™ bioartificial liver were designed and tested in pre-clinical and early clinical studies by Drs. A. A. Demetriou and J. Rozga, who later founded Arbios Systems, Inc. Our HepatAssist™ Cell-Based Liver Support System utilizes a single-use cartridge that contains pig liver cells plus columns that contain certain chemical particles referred to as sorbents. When a patient's blood is pumped through the cell-based liver support system, substances normally metabolized by the liver and accumulated in the blood during liver failure move across the porous fiber walls into two sequential plasma compartments; one compartment is filled with pig liver cells and the other compartment incorporates columns that contain sorbents. The exposure of the viable pig liver cells to patient plasma causes toxic substances contained in the plasma to be metabolized, thereby reducing their concentration level. At the same time, substances produced by pig liver cells move in reverse across the porous wall back into the blood compartment. In addition, the sorbents lower the level of other pathological blood components, such as ammonia. As a result of these two processes (provision of whole liver functions by the pig liver cells and removal of toxins by the sorbents) we believe the levels of pathological and normal blood components will move toward normal ranges in the patient's body. Our belief is supported by the results of tests performed during clinical trials using the HepatAssist™ system.

Our HepatAssist™ Cell-Based Liver Support System is similar to the earlier HepatAssist™ system, and we have subsequently enhanced it by employing a larger quantity of pig cells, a change which has been authorized by the U.S. FDA for use in a new pivotal clinical trial. We do not anticipate that HepatAssist™ will use the Circe-designed proprietary perfusion platform, which is a machine through which the patient's blood is circulated, that was originally developed for the HepatAssist™ system. Instead, we have validated a perfusion platform known as the PERFORMER for use as the platform to provide bioartificial liver therapy. The PERFORMER is a multi-function integrated system capable of supporting extracorporeal blood/plasma/fluid circulation therapies that is manufactured by RanD S.r.l. (Italy) and distributed world-wide by Medtronic, Inc. The PERFORMER has been equipped with proprietary software

and a specialized tubing set for use with our HepatAssist™ Cell-Based Liver Support System.

Both SEPET™ and HepatAssist™ rely on single-use disposable cartridges that are placed on a blood perfusion apparatus that is attached to the patient's blood circulation system. Following treatments with any of our products, the disposable cartridges are discarded, and new cartridges are used for the next therapy.

Background of our Company

Arbios Technologies, Inc., our former operating subsidiary, was formed in August of 2000 by Drs. Achilles A. Demetriou and Jacek Rozga, two leaders in the field of artificial liver therapy, to develop extracorporeal therapies for the treatment of liver failure. As former employees of Cedars-Sinai Medical Center, Drs. Demetriou and Rozga previously were involved in the development of a first generation bioartificial liver known as HepatAssist™ that was licensed by Cedars-Sinai Medical Center in 1994 to W.R. Grace & Co. and then subsequently transferred to Circe Biomedical, Inc. The prior owners of this technology spent millions of dollars on the research and development of the original HepatAssist™ system, the perfusion platform and on the related technologies and operating procedures necessary to bring the product to market. The original HepatAssist™ system was tested in Phase II/III clinical trials approved by the FDA in patients with fulminant and subfulminant liver failure and primary non-function following liver transplantation. These trials of the original HepatAssist® system were the first large (171 patients) prospective, randomized, controlled multi-center trial demonstrating a survival advantage for an extracorporeal liver assist system utilizing pig liver cells. Although treated fulminant/subfulminant hepatic failure patients with viral and drug-induced liver injury retrospectively demonstrated improved survival compared to controls when adjusted for the effect of confounding factors (such as liver transplantation), the prospective primary clinical end point in the overall study population (survival at 30 days post-transplantation) was not achieved. Accordingly, the HepatAssist™ system was not approved for marketing, and the FDA requested that a new Phase III clinical study be performed. A new Phase III protocol was prepared and reviewed by the FDA. However in 2003, before these new studies could be undertaken, Circe Biomedical ceased its operations. In April 2004, we purchased the remaining assets of Circe Biomedical that related to its bioartificial liver operations, including rights to the original HepatAssist™ system, the new Phase III protocol that had been reviewed by the FDA, and over 400 manufacturing and quality control and quality assurance standard operation protocols previously reviewed by FDA. In July 2005, we merged Arbios Technologies, Inc. into the parent company, Arbios Systems, Inc.

To date, we have funded our operations from the gross proceeds of funds we raised from the sale of over $18,000,000 of our equity securities and $321,000 of Small Business Innovation Research, or SBIR, grants that have been awarded by the United States Small Business Administration. We intend to apply for additional SBIR grants to fund a portion of our research expenditures. However, whether or not we receive additional SBIR grants, we will have to raise substantial additional proceeds to fund our future clinical development expenses and our on-going working capital needs.

Our research offices and laboratories are located at Cedars-Sinai Medical Center ("Cedars-Sinai"), Los Angeles, California. Cedars-Sinai Medical Center is also one of the clinical testing sites for our SEPET™ clinical testing program. Under our lease agreement and other arrangements with Cedars-Sinai, we have access to their development resources of that leading medical center, including animal facilities, surgical facilities and clinical laboratories. The Hospital has informed us that they do not intend to renew the lease when it expires on June 30, 2007, and we intend to seek a new laboratory facility for testing our device. We are currently seeking to identify replacement laboratory space in eastern Massachusetts. We also lease administrative office space in Waltham, Massachusetts and Los Angeles, California.

Two members of our management team, Dr. Ulrich Baurmeister, Ph.D., Chief Technology Officer, and Prof. Jan Stange, M.D., Senior Clinical Advisor, are engaged under consulting agreements and are based in Germany (Wuppertal and Rostock, respectively). Their work is divided between their homes, clinical sites and product development sites under contract with the Company.

We have also entered into various agreements with Spectrum Laboratories, Inc., including research and development agreements and manufacturing agreements. Spectrum Laboratories is a company that specializes in the development and manufacture of innovative molecular separation products for the research community and is a supplier of dialysis and ultrafiltration membranes used for biomedical research, molecular biology and clinical diagnostics throughout the world.

Strategy

We believe that the clinical testing and regulatory approval periods for the SEPET™ Liver Assist Device will be shorter than our HepatAssist™ Cell-Based Liver Support System because SEPET™ may be evaluated as a medical device that does not contain biological components such as the pig cells that are an integral part of our HepatAssist™ product. Accordingly, because of the shorter regulatory period and the ability of SEPET™ to operate through the use of a standard, currently available kidney dialysis instrument, we expect that the development of SEPET™ will be completed before the development of HepatAssist™ is completed.

We have already performed *in vitro* and *in vivo* testing of the SEPET™ prototype device and commenced clinical testing of SEPET™ in late 2005. To date, 15 patients suffering from acute-on-chronic liver failure with hepatic encephalopathy have been enrolled in the U.S. clinical feasibility trial of SEPET™. Our strategy for realizing sales revenue for the Company is to seek the first commercialization of SEPET™ under the CE Mark in Europe, which we believe may be possible by 2008. It may also be possible to commercialize SEPET™ in Asia in that same timeframe, although we do not yet have assurance of regulatory pathways in that region. Commercialization of SEPET™ in the US may follow completion of a pivotal clinical trial of SEPET™ intended for U.S. FDA market approval of the product. Our ability to successfully market SEPET™ in these various regions will depend on a number of factors including regulatory approvals, marketing and sales partnerships, and patents protection which is not yet issued outside the United States.

We are currently evaluating the possibility of conducting clinical studies of the HepatAssist™ system under a modified version of the FDA-reviewed Phase III IND protocol that we acquired in March 2004 from Circe Biomedical. Since we are still currently developing our clinical and regulatory strategies for the HepatAssist™ Cell-Based Liver Support System, and since our continual development of this product depends on our securing a corporate collaboration and associated funding, we cannot estimate when an application requesting marketing approval of that system will be filed.

The April 2004 acquisition of the assets of Circe Biomedical has provided us with new potential opportunities for the development of a bioartificial liver. The Circe Biomedical bioartificial liver device that we acquired consisted of the following four distinct components that we believe may be useful to the development of our bioartificial liver products:

(1) *FDA-approved standard operating procedures*. These are standard operating procedures for production of porcine cells including harvesting, freezing, storing, shipping and processing by the end user (thawing, washing) of the cells. These procedures and protocols have been reviewed by the FDA.

(2) *The cartridge used in the Phase III trial of HepatAssist™*. We intend to use the existing, FDA-approved cartridge, and intend to seek the FDA's approval to increase the number of porcine cells that the cartridge could contain, which increase we believe will improve the functionality of the system.

(3) *An FDA reviewed Phase III protocol acquired from Circe Biomedical*. We will likely further modify this protocol, according to the retrospective analysis of the original Phase II-III clinical trial published in the *Annals of Surgery* in 2004 (by A.A. Demetriou et al), and submit the modified protocol to the FDA for approval.

(4) *The HepatAssist™ perfusion platform.* The HepatAssist perfusion platform is Circe Biomedical's specially designed machine that pumped the patient's plasma through the HepatAssist cartridge. This machine was used in the Phase II/III trial of HepatAssist™.

Rather than using Circe Biomedical's specially designed machine, we intend to use the PERFORMER, a commercially available machine that is distributed by Medtronic, Inc. We believe that the PERFORMER may become the platform for our HepatAssist™ Cell-Based Liver Support System.

We are currently in the process of designing further clinical trials to demonstrate the safety and tolerability of SEPET™ in treating patients with acute exacerbation of chronic liver failure. In April 2005 we received permission from the FDA to commence a 15 to 20 patient clinical feasibility study for SEPET™. We have enrolled 15 patients in our SEPET™ feasibility clinical trial and are currently monitoring and analyzing the trial results for these first 15 patients. Based on our current analysis of the data in preliminary form, we plan to submit the fully monitored and analyzed data to the FDA in the next several months along with a protocol summary for a proposed, randomized, controlled pivotal trial to further test the efficacy of the device for purposes of product approval in the U.S. Based on our current assumptions regarding clinical trial sizes and other factors, we estimate that the future clinical cost of developing SEPET™ will be approximately $5 million to $10 million and the future clinical cost of developing HepatAssist™ will be between $15 million and $20 million. These amounts, which could vary substantially if our assumptions are not correct, are well in excess of the amount of cash that we currently have available to us. See "Management's Discussion and Analysis or Plan of Operation - Factors that May Affect Future Results and Market Price of Our Stock."

Liver Function Background

The liver controls, or affects, almost every aspect of metabolism and most physiologic regulatory processes, including protein synthesis, sugar and fat metabolism, blood clotting, the immune system, detoxification of alcohol, chemical toxins, and drugs, and waste removal. Loss of liver function is a devastating and life threatening condition. Liver failure affects all age groups and may be due to many causes, including viral infection, hepatitis, ingestion of common medications, alcohol, and surgical liver removal for trauma and cancer.

Currently, there is no direct treatment for liver failure, except a successful liver transplant. There is, however, a current scarcity of donor livers, and approximately two thousand patients on the waiting list for donor livers die annually before receiving liver transplants. Our management believes that treatments with currently available technologies such as blood detoxification methods are short-term measures, and none of them has achieved wide clinical use or ability to arrest or reverse liver failure and improve survival. As a consequence, liver failure patients must still either undergo liver transplantation or endure the probability of prolonged hospitalization with a low probability of survival. In addition, many patients do not qualify for transplantation or live in regions of the world where transplantation is not readily available. Still others do not recover after transplantation because of irreversible brain damage or other organ damage caused by liver failure. Although the liver has a remarkable capacity for regeneration, the repair process after massive liver damage is markedly impaired by the continued presence of toxins, inflammatory cytokines and other inhibitors of organ regeneration still present in the blood of patients.

In liver failure patients, there is a need for an effective blood purification therapy that will clear the blood of toxins, mediators of inflammation and inhibitors of hepatic growth. SEPET™ is a novel form of such therapy developed by us in which the plasma fraction containing substances that are toxic to the brain, the liver and other internal organs and tissues are removed from patient blood and replaced with normal human plasma. We have demonstrated an extension of survival in large animal model testing of SEPET™, which results have led to the initiation of a clinical feasibility trial in human patients.

There is a further need to develop artificial means of liver replacement with the aim of either supporting patients with borderline functional liver cell mass until their liver regenerates or until a donor liver becomes available for

transplantation. Such an “artificial liver” should also support patients during recovery after transplantation with marginal livers and after extended liver resections for trauma or cancer. To achieve these effects, effective liver support systems should be able to lower blood levels of substances toxic to the brain and liver and to provide whole liver functions, which are impaired or lost.

The founders of this company as well as investigators not associated with this company have demonstrated *in vitro* and in animal models of liver failure that cell-based bioartificial livers using viable isolated liver cells, or hepatocytes, can provide whole liver functions. However, only a few bioartificial livers have been tested in humans and it remains to be seen whether systems utilizing hepatocytes as the only means of liver support are effective. We believe that in order to provide the maximum support for the failing liver, porcine hepatocyte therapy should be combined with blood purification or detoxification.

Our cell-based liver support system, the HepatAssist™ Cell-Based Liver Support System, was designed to become an advanced effective application of the basic bioartificial liver concept. In the Cell-Based Liver Support System, liver cell therapy in the form of porcine hepatocytes, is combined with blood detoxification, in the form of sorbent based plasma therapy. Depending on the cause of liver disease, severity of illness and deficiency of specific liver functions, the bioartificial liver mode of therapy can be provided individually, simultaneously or sequentially. Because of these features, we believe our bioartificial liver technology is well suited to treat patients with liver failure of all causes and severity, including those requiring maximum liver support. While the HepatAssist™'s predecessor HepatAssist Phase II/III clinical trial demonstrated an increase in patient survival in patients with viral and drug-induced fulminant/subfulminant hepatic failure, a new Phase III clinical trial will be needed before our HepatAssist™ system, which is an enhanced version of the original HepatAssist system, can be used by human patients. Pre-clinical data for our HepatAssist™ Cell-Based Liver Support System indicates that this system can improve heart rate and blood pressure and provide clearance of ammonia and indocyanine green (ICG), which is a liver function test.

The Products We Are Developing

We currently are developing novel treatments for acute and chronic liver failure. We believe that our SEPET™ Liver Assist Device and our HepatAssist™ Cell-Based Liver Support System may:

- help keep liver failure patients alive and neurologically intact before, during and immediately after transplantation;
- allow other patients to recover liver functionality and to survive without a transplant (a "bridge" to liver regeneration);
- support patients during periods of functional recovery and regeneration after extensive removal due to liver trauma and/or cancer;
- accelerate recovery from acute exacerbation of chronic liver disease;
- shorten length of stay in intensive care units;
- shorten hospital stay;
- reduce the cost of care; and
- reduce intractable itching associated with severe jaundice.

We believe that our SEPET™ Liver Assist Device and HepatAssist Cell-Based Liver Support System can achieve these effects because they can lower blood levels of substances that are toxic to both the brain and liver. However, final proof of clinical benefit in patients is lacking at this time, and the clinical utility of these products still needs to be demonstrated in patients with acute liver failure.

We own certain technologies and rights related to our products, and have licensed certain other technologies. See "-Patents and Proprietary Rights" below for a description of the rights that we own and have licensed.

SEPET™

We are developing the SEPET™ Liver Assist Device as a blood purification measure to provide temporary liver support during acute liver failure and acute exacerbation of chronic liver disease. SEPET™ therapy will be provided through the sale of our single-use, disposable cartridge that contains a bundle of hollow fibers made of bio- and hemo-compatible material capable of sieving substances with molecular weight of up to 100 kilodaltons, or kDa. The importance of using fibers with this sieving characteristic, which is larger than for conventional renal dialysis cartridges, is that most hepatic failure toxins as well as mediators of inflammation and inhibitors of hepatic regeneration have a molecular weight that is less than 100 kDa, while "good" blood components, for the most part, have molecular weight greater than 100 kDa. At present, Spectrum Laboratories is the manufacturer of these disposable cartridges. See "— Manufacturing" below. The SEPET™ system is designed for use with any commercially available kidney dialysis unit or other similar machines that utilize hollow-fiber cartridges. Accordingly, no specialized apparatus needs to be developed or manufactured for SEPET™. Accessory components for the SEPET™ system such as disposable tubings and connectors will mostly consist of standard components that are currently used in renal dialysis and provided by manufacturers of those systems. We expect that any new accessory components that may be required will be manufactured for us by third-party vendors.

During SEPET™ therapy, an ultrafiltrate containing toxins, inhibitors of hepatic growth and mediators of inflammation with molecular weight of 100 kDa or less will be removed from the patient's blood stream by exiting from the side port of the cartridge, while at the same time, intravenous electrolyte solutions, albumin solution, fresh frozen plasma, or a combination thereof will be administered to the patient. We believe that as a result of these two processes, the levels of pathological and normal blood components present in the patient's circulation will move toward normal ranges, thereby facilitating recovery from liver failure. Based on published medical literature, rapid and efficient blood detoxification is expected to protect the liver, brain and other organs against further injury, accelerate healing of the native liver and improve its residual functions. Preliminary results of the SEPET™ U.S. feasibility clinical trial encourage us that these expectations may be realized in human therapy using SEPET™, but these results need to be further monitored, analyzed and finalized, and then will be acquired in a further, randomized, controlled pivotal trial.

HepatAssist™ Cell-Based Liver Support System

Our current cell-based liver support system under development is the HepatAssist™ Cell-Based Liver Support System. We have designed our HepatAssist™ Cell-Based Liver Support System to provide temporary liver support during acute liver failure and acute exacerbation of chronic liver disease. The HepatAssist™ Cell-Based Liver Support System incorporates several proprietary components and technologies into an integrated liver assist system, including a hollow fiber cartridge with porcine hepatocytes and a plasma re-circulation circuit that incorporates a cell cartridge and sorbents. The HepatAssist™ Cell-Based Liver Support System is designed to (i) provide liver cell functions by utilizing viable pig liver cells that are housed in specially designed cartridges and (ii) detoxify blood. Since it has been scientifically established that pig liver cells perform liver functions when maintained in specially designed cartridges outside of the human body, our bioartificial liver cartridge is designed to bring human plasma into contact with viable pig liver cells in a manner similar to that observed in the normal human liver inside the body in order to provide liver functions to the patient. In addition, our Cell-Based Liver Support System is designed to lower the levels of pathological blood components (through activated charcoal or other purification sorbents).

Critical to the HepatAssist™ technology is (i) the source and method of procurement of liver cells, (ii) the cryopreservation, or freezing, of the liver cells, (iii) the storage of the liver cells, (iv) the proprietary plasma re-circulation loop incorporating the cell cartridge and sorbents, and (v) the standard operating procedure protocols and quality control and programs related to the foregoing. We currently own or have licensed numerous proprietary

technologies and methods for sourcing and using hepatocytes, which technologies and methods apply to our HepatAssist-2™ system. The following addresses our current plans and procedures regarding viable liver cells (hepatocytes).

Hepatocyte donors. Ideally, human hepatocytes should be used in a bioartificial liver. However, there is a shortage of organ donors and published data demonstrating that pig liver cells can outperform other animal and human liver cell lines, including those derived from liver cancers. In addition, use of human cancer-derived cells raises safety concerns. At this time, we intend to utilize pig liver cells.

Hepatocyte harvest. The founders of Arbios and Circe Biomedical developed certain semi-automated methods for large-scale harvest of pig hepatocytes. The methods of harvesting and collecting liver cells are covered by four patents, which patents we either have acquired from Circe Biomedical and now own or have licensed from Cedars-Sinai Medical Center.

Hepatocyte storage. Hepatocyte storage, quality control and shipment of cells to treatment sites are best achieved by use of cell freezing, or cryopreservation. Cryopreservation also provides greater protection from bacterial and viral contamination because frozen cells can be stored until microbiologic testing is completed and cells are then released for clinical use. Prior to use, cells are rapidly thawed and their viability is tested. The patented hepatocyte cryopreservation technology is now owned by us and by Cedars-Sinai Medical Center, which has licensed this technology to us.

The pig liver cells are expected to be harvested from young purpose-bred, pathogen-free, vaccinated pigs raised in the United States Department of Agriculture, or the USDA, certified facility specifically for biomedical research purposes. Each batch of cryopreserved pig liver cells will be released for clinical use only after proper verification of biosafety and viability/functionality of the cells. We acquired all of the required laboratory and quality assurance protocols from Circe Biomedical, which protocols were previously reviewed by the FDA and deemed to be in compliance with FDA requirements. We are currently leasing facilities in which we will be able to house and maintains pigs and surgically acquire their livers. The facilities, which are still under development, would be used to monitor the health of these pigs and to assure that the pigs and cells remain free from infection and meet specific FDA requirements and to harvest the pig livers. We believe that once suitable modifications and FDA approved leasehold improvements are implemented and completed, these facilities will be suitable to meet our near-term goals for maintaining and harvesting the number of pig livers that we expect to need until the commercial viability of our products is established.

HepatAssist™ is designed to be used in the same manner as any other plasma therapy device. In a typical clinical procedure, the operator will install bioartificial liver components consisting of the cell cartridge, oxygenator, sorbent detoxification column(s), and tubing kit, into the blood/plasmaperfusion platform. Approximately 15 billion viable pig hepatocytes will be seeded into the extra-fiber space through the cartridge side ports. At the start of treatment, the platform will be attached to the patient and the cell-based liver support system will be perfused with the patient’s oxygenated plasma. At the end of treatment, the disposables will be discarded in the normal manner that all other biohazardous waste products (such as syringes and bandages) are handled and disposed. No special governmental regulations have been required, or are expected, to dispose of the used cartridges and disposable products.

We expect to demonstrate that during HepatAssist™ therapy, substances normally metabolized by the liver and accumulated in the blood during liver failure will diffuse freely across the porous membrane into the compartment containing pig liver cells. At the same time, products of pig liver cell metabolism will diffuse back into the plasma compartment and then into the blood circuit. It is anticipated that as a result of these two processes, the levels of pathological and normal blood components present in the patient’s circulation will move toward normal ranges, thereby facilitating recovery from liver failure. Additional therapeutic benefits may be provided by blood purification, or detoxification, therapy. In this mode of therapy, small and large protein-bound toxins, which accumulate in the blood during liver failure, are expected to be removed by sorbents. Blood detoxification is believed to protect the liver, brain and other organs against further injury, accelerate healing of the native liver and improve its residual functions. Decreased blood toxicity is also expected to prolong the life and metabolic activity of pig hepatocytes in the bioartificial liver modules.

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Product Advantages

We believe that SEPET™ as a blood purification therapy will be more effective than sorbent-based devices such as charcoal, resin and silica, and more effective than whole plasma exchange therapy, because only the plasma fraction containing known toxins of hepatic failure is being removed and discarded during SEPET™ therapy. In contrast, sorbent-based blood purification is not toxin-specific, and in the case of charcoal sorption it is limited because of the protective coating of the charcoal particles. It also fails to remove most mediators of inflammation and protein bound toxins from the blood which have been associated with liver failure. Subject to the successful completion of clinical trials and FDA or other regulatory approval, we believe that SEPET™ will be able to be used with currently available hospital kidney dialysis systems, which may offer the following advantages:

- Ease of use. The systems bring user friendliness (e.g., pump integration, automation and an intuitive user interface) to traditionally complex liver support procedures.

- Simplicity. Kidney dialysis systems are routinely used in hospitals and outpatient clinics and, therefore, there may be a reduced need for extensive personnel training for use of these similar systems with SEPET™. They are commonly available in intensive care units and related settings where SEPET™ may be initially used for treating acute episodes of chronic liver failure.

- Reduced cost. The cost of therapy is expected to be lower than with other liver assist devices that are currently under development because the machine to which the SEPET™ cartridge can be attached is a standard machine (such as a kidney dialysis machine) with commercially available tubing. Therefore, unlike other devices, no special equipment is required.

- No Intensive Care Unit needed to provide treatment. SEPET™ may become available for treatment of patients with a lower degree of liver failure outside of the intensive care unit setting. We do not believe that any changes will have to be made to SEPET™ or the dialysis system in order for SEPET™ to become available outside of intensive care unit settings. However further (e.g. Phase IV) clinical trials will likely be necessary to fully develop these additional indications for SEPET™.

We believe that HepatAssist™ is the only liver assist device under development that is capable of providing both liver cell functions and blood purification either simultaneously or sequentially in a versatile and customized manner depending on the cause and severity of liver failure. Drs. Demetriou and Rozga, the founders of Arbios and the major stockholders of the company, have previously demonstrated that cryopreserved pig hepatocytes can remain alive (e.g. >80% viability) after freezing and thawing using carefully developed, patented procedures. Moreover, the hepatocytes quickly aggregate, forming liver-like 3-dimensional cellular units, and resume basic functions (e.g., drug metabolism) at levels comparable to those seen in intact livers. Drs. Demetriou and Rozga have also reported that treatment of animals and patients with fulminant hepatic failure with a bioartificial liver loaded with freshly thawed pig hepatocytes prolonged life, alleviated intracranial hypertension and improved blood chemistry. In addition, in experimental animals, bioartificial liver therapy improved native liver function and triggered mechanisms regulating liver regeneration. In addition, because porcine hepatocytes can be stored frozen at a clinical site, treatment with our cell-based liver support system can be commenced within two to three hours of patient consent and product preparation, thereby making this bioartificial liver therapy available on demand. In instances of liver failure, this rapid availability of therapy should be a critical competitive advantage. In contrast, we believe other liver assist devices under development require longer time for preparation prior to patient treatment (up to several days in some instances, including cumbersome means of shipment to the clinical site).

While these projected advantages appear supported by the clinical trial data evidence to date, some of these product functions may need to be tested in head-to-head trials with competitive approaches.

Clinical Utility

Our SEPET™ Liver Assist Device is currently undergoing human testing in an IDE clinical feasibility trial in the US, with patients suffering acute exacerbation of chronic liver failure with hepatic encephalopathy. This 15 to 20 patient clinical trial was authorized by the FDA in 2005, and we have currently enrolled 15 patients in the trial. Based upon our preliminary review of data in the first ten patients enrolled in the trial, a favorable safety profile was established and a majority of patients accomplished a two stage grade improvement in hepatic encephalopathy severity, the clinical effectiveness endpoint of the trial. We have recently announced preliminary results with 15 patients enrolled in the clinical trial, which further bear out these earlier published results. We further plan to request a meeting with the FDA to review the data and to propose a design for a randomized, controlled, pivotal clinical trial of SEPET™ intended to be sufficient for FDA allowance of a future pre-market approval application by the Company and to confirm and prove what we believe to be encouraging results of the current single arm, uncontrolled feasibility clinical trial.

Our HepatAssist™ Cell-Based Liver Support System is an enhanced version of the original HepatAssist™ system. Overall, we believe that the animal and human clinical data generated and published to date on the original HepatAssist™ system indicate that the basic concept of a bioartificial liver utilizing cryopreserved pig liver cells and blood detoxification is valid and that repeated six-hour bioartificial liver treatments are safe and yield measurable therapeutic benefits. Accordingly, we believe that our novel, next-generation products will represent improvements and/or enhancements over earlier technologies.

The safety and efficacy of the original HepatAssist™ system were evaluated in a prospective, randomized, controlled, multi-center FDA-approved clinical trial. A total of 171 patients, 86 in the control group, and 85 in the bioartificial liver group, were enrolled. Patients with fulminant and subfulminant hepatic failure and primary non-function following liver transplantation were included. Data were analyzed with and without accounting for the following confounding factors: liver transplantation during the survival endpoint period, time to liver transplant, cause of the disease or condition, disease severity, and treatment site. For the entire patient population, survival at 30 days was 71% for bioartificial liver compared to 62% for the control group. When survival was analyzed accounting for confounding factors such as liver transplantation and survival prior to transplantation, across the entire patient population, there was thus a trend towards improved survival but not a statistically significant difference between the two groups. However, survival in the 147 fulminant and subfulminant hepatic failure patients (i.e. excluding the primary non-function patients) was significantly higher in the HepatAssist™ Cell-Based Liver Support System group compared to the control group. Furthermore, HepatAssist™ therapy reduced the risk of pre-transplant death by 67% in patients with drug and chemical toxicity ($p<0.0140$) and by 47% in patients with rapid onset of fulminant hepatic failure ($n=121$; $p<0.0428$) To our knowledge, this was the first prospective, randomized, controlled trial of an extracorporeal liver support system that demonstrated safety and improved survival in patients with fulminant and subfulminant hepatic failure.

Market Opportunity

Based on the number of patients with liver diseases and lack of alternative direct therapy other than liver transplantation, we believe that there is an urgent need for artificial means of liver replacement and/or assistance to facilitate recovery from liver failure without a transplant. Effective liver support therapies could also help maintain liver failure patients' lives until an organ becomes available for transplantation. The SEPET™ Liver Assist Device and HepatAssist™ Cell-Based Liver Support System are designed to treat patients with liver failure across a wide range of causes and severity, including acute exacerbation of chronic liver disease as well as acute liver failure in patients without history of chronic disease.

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Arbios believes that the patient and market opportunity is substantial and underserved. According to the American Liver Foundation, 25,000,000 persons in the United States, nearly one in every ten persons, are or have been suffering from liver and biliary diseases. According to the National Center for Health Statistics data published for 2004, there were over 500,000 hospital discharges for patients with chronic liver disease and/or cirrhosis plus additional patients categorized as suffering from other forms of liver failure. Liver failure is reported as the tenth leading cause of death in the U.S., and fourth leading cause of death in persons aged 45 - 54 years) because no donor liver was found or because they had contraindications to transplantation.

The mounting crisis of viral hepatitis B and hepatitis C is projected to continue to propel numbers of liver failure episodes as patients age and increasingly suffer hepatic decompensation. Approximately 4 million Americans are chronically infected with the hepatitis C virus, and an estimated 25,000 people each year are newly infected in the United States each year with the hepatitis C virus. At the same time, 10,000 - 12,000 deaths have occurred annually in the United States due to hepatitis C virus infection, and the number is likely rising. Hepatic decompensation, as a result of chronic hepatitis C virus infection, is now the leading cause of liver transplantation in the United States. Despite improved rates of organ donation, increased utilization of deceased donor livers and a resurgence in living donor transplants, the number of liver transplants performed yearly is now approximately 5,500. At the same time, in 2004 alone there were more than 10,000 new waitlist registrations for liver replacement. As of March 6, 2006, the liver transplant waiting list contained 17,650 individuals. Hepatitis B is less prevalent in the U.S. than hepatitis C - a situation that is dramatically reversed in other parts of the world where chronic hepatitis B infection is endemic or pandemic; however, according to National Institutes of Health and the American Association for the Study of Liver Diseases, 5,000 deaths occur annually as a consequence of hepatitis B virus infection.

Worldwide, hepatitis B is the leading cause of liver failure. Of the 2 billion people who have been infected with the hepatitis B virus, more than 350 million are estimated to have chronic, or lifelong, infections. These chronically infected persons are at high risk of death from cirrhosis of the liver and liver cancer. The World Health Organization estimates very large numbers of deaths worldwide from hepatitis B virus infection -- an estimated 880,000 per year from liver failure and another 320,000 per year from liver cancer (some of whom may require liver support therapy before and/or after surgical resection of the cancer). Infection is most common in Asia, Africa and the Middle East. Hepatitis C is also a major cause of liver failure worldwide. According to the World Health Organization, globally, an estimated 170 million persons are chronically infected with the hepatitis C virus. At the same time, an estimated 3 to 4 million persons are newly infected each year. Liver failure has recently been cast, worldwide, as the third leading cause of death. In China and other Asian countries, liver disease represents a pressing health problem and the need for an effective liver support therapy is most urgent. Although epidemiological data on hepatitis C virus and hepatitis B virus infection in China are not publicly available, we believe there are approximately 200 million carriers of the hepatitis virus B or C in China, and primary liver cancer is a common malignancy.

At present, no direct dependable treatment for liver failure is available and such patients must receive a liver transplant or endure prolonged hospitalization with significant mortality. Moreover, no prognostic test is available that would help predict which liver failure patient is likely to survive on medical therapy alone. Due to the critical nature of liver failure and the resulting adverse effects on other organs, the hospitalization costs can be as high as $20,000 per day. While liver transplants have significantly increased the chances of survival for patients with liver failure, due to a severe shortage of donor livers, far less than 10% of liver failure patients received a transplant. Further, many liver failure patients were excluded from the waiting list because of alcohol or drug abuse, cancer, cardiovascular disease or inadequate post-operative support by family or others.

At this time, based on the preliminary information available to us, we estimate that the cost to the provider of a single treatment with the SEPET™ therapy could be within a $2,000 - $4,000 range and that the respective cost of HepatAssist™ therapy could be approximately $15,000 to $20,000 in the United States. Pricing in other world regions will likely vary. We anticipate that SEPET™ and/or HepatAssist™ therapy may have to be repeated up to an average of three to five times before a satisfactory clinical outcome is obtained, although fewer treatments per patient may be sufficient

depending on the severity of disease. Based on these estimates and the above mentioned projections, the potential U.S. market for SEPET™ and HepatAssist™ is significant, with similar or possibly larger opportunities in some regions outside North America. However, we have not confirmed the potential size of these markets through an independent marketing study.

If we are successful in demonstrating the clinical utility of one or both of our products, liver failure patients treated with our products may be spared liver transplantation and the need for life-long immune-suppression. In addition, these patients can be treated outside of the intensive care unit and could be discharged from the hospital after shorter stays, all of which would reduce costs for healthcare providers and generate a demand for the use of these products.

Sales, Marketing and Distribution

We currently do not have any agreements in place to market any of our products if and when those products are commercially released, and we do not currently expect to establish an in-house marketing and sales program to distribute our products in all regions of the world. We currently expect to outsource at least a portion of the sales, marketing and distribution of our products to third parties who specialize in the sales, marketing and distribution of medical products. Alternatively, we may enter into strategic alliances with larger medical companies or license the rights to our products to such larger companies. Our direct marketing and sales operations may, in these cases, eventually be directed towards supporting sales and distribution activities of any future partner. We currently expect that our products will be marketed in at least North America and Europe, and possibly in Asia. We are currently seeking a commercialization partner for HepatAssist™ and plan to do the same for SEPET™, for some world regions, in the next two years.

Manufacturing

We currently do not have a finalized manufacturing arrangement for the cartridges used in the HepatAssist™ system, although our plan is to hopefully establish such relationship(s) in the near future. The HepatAssist™ cartridge is based on a conventional single-bundle hollow-fiber technology and a number of third party manufacturers could produce these cartridges for us under contract.

With respect to cartridges that we expect will be needed for SEPET™, we anticipate that such cartridges will be commercially manufactured by either Spectrum Laboratories or a manufacturer of clinical hemodialyzers, which are cartridges containing porous membranes used to filter blood. Spectrum Laboratories, Inc. is a provider of hemodialysis products and is based in Los Angeles, California. Additional disposable components, such as tubing kits, may also be manufactured by third party subcontractors.

The kidney dialysis systems that will be used as a platform for SEPET™ therapy are not expected to require any technical adjustments. Since pressure monitors and hemoglobin detectors are standard in kidney dialysis systems, additional safety features are not likely to be required. Since the existing kidney dialysis instruments will not be affected, only the kidney dialysis cartridge will be replaced by a SEPET™ cartridge, we do not anticipate that consents will have to be obtained from the manufacturers of those units, and no additional insurance is expected to be required to use those units. Nevertheless, manufacturers of such instruments may in the future have incentives to form partnerships with us for marketing and distribution of disposables, either as stand-alone products or as integrated systems of disposables for use on their instruments.

The platform we currently expect to use for the HepatAssist™ bioartificial liver therapy is a perfusion platform known as the PERFORMER. The PERFORMER is a multi-function integrated system capable of supporting extracorporeal blood/plasma/fluid circulation therapies that is manufactured by RanD S.r.l. (Italy) and distributed by Medtronic, Inc. The PERFORMER may be equipped with proprietary software, which has already been developed by RanD for Arbios, and a tubing set for use with our HepatAssist™ system.

The pig liver cells will be harvested from young purpose-bred, pathogen-free, vaccinated pigs raised in a USDA certified facility specifically designed for biomedical research purposes. The liver cells will be harvested and cryopreserved under aseptic conditions using our proprietary technology as well as commercially available equipment.

With regard to cell procurement and cryopreservation for bioartificial liver use, we do not yet own or lease our own specialized and certified bio-secure porcine liver cell manufacturing plant. Prior to Phase III clinical testing of HepatAssist™, we will determine whether to build a cell procurement facility to meet the expected requirements for commercial sales, which will likely require a substantial lease obligation and/or capital investment. This decision will be based on technical evaluation of the project as well as an economic evaluation of company performance.

Patents and Proprietary Rights

Liver Assist Device Rights. Our intellectual property rights relating to the SEPET™ Liver Assist Device consist of a U.S. patent application plus pending foreign counterpart applications, a family of in-licensed U.S. patents plus foreign counterparts and pending patent applications, and certain related trade secrets.

Our U.S. patent application and foreign counterparts regarding our selective plasma filtration therapy (SEPET™) technology was filed in August 2002 with the United States Patent and Trademark Office and European Patent Office and subsequently in other countries and is currently under review for possible issuance. The applications contain claims for the use of various hemofiltration apparatus to treat liver failure and related diseases, as well as claims covering the hemofiltration apparatus itself.

In March 2007, we in-licensed a family of issued U.S. patents and various U.S. and foreign patent applications which include broad claims for methods of treating liver failure, multi-organ failure, multi-organ dysfunction syndrome, sepsis, septic shock, systemic inflammatory response syndrome, and related inflammatory disorders by selective blood filtration. The patents and applications relate to the use of blood filtration devices which remove, from the blood of patients with the above disease conditions, a broad spectrum of inflammatory and other disease mediators ranging from small molecules through intermediate size blood proteins with molecular weights up to the size of beneficial immunoglobulins. Such devices are capable of removing known “bad actor” compounds associated with liver failure, multi-organ failure and sepsis while preserving critical immunogloblins, clotting factors, lipids, and other beneficial large proteins in the circulating blood of afflicted patients. The patents and/or applications also relate to the combined use of replacement fluids including human serum albumin or combined uses of secondary selective plasma adsorption devices and/or certain classes of anti-inflammatory therapeutic drugs, and to apparatus suitable for the above uses.

Included in this in-licensed family are five issued U.S. patents, four pending U.S. patents, and two pending European patents. We will owe royalties on net sales of products which are covered by the license, including potentially the SEPET™ Liver Assist Device. We will also owe maintenance fees and certain other minimum spending obligations under the license and may owe contingent milestone fees. Our fixed obligations under the license will total less than $500,000 over the next 4 years, a portion of which includes spending on future product development possibly leading to future sales revenues for Arbios. Our contingent obligations under the license will total less than $500,000 over approximately the same period (however dependent on the pace of potential future patent issuances).

Bioartificial Liver Rights. We originally obtained exclusive, worldwide rights from Cedars-Sinai Medical Center and Spectrum Laboratories to seven issued U.S. patents protecting our bioartificial liver technology and accompanying cell procurement/cryopreservation technologies. One of the patents we licensed from Spectrum Laboratories, Inc., patent #5,015,585 “Method and Apparatus for Culturing and Diffusively Oxygenating Cells on Isotropic Membranes” has expired.

The founders of Arbios, Drs. Rozga and Demetriou, are co-inventors of both the semi-automated methods for large-scale production of isolated pig/human hepatocytes and cryopreservation of isolated pig/human hepatocytes. Currently, the key proprietary bioartificial liver technologies that we intend to use include the following licensed patents:

(1) A cell-based liver support system in which liver cell therapy and blood detoxification are integrated in a single fiber-in-fiber module (US Patent # 6,582,955 B2 for "Bioreactor With Application as Blood Therapy Device" issued in June 2003). We have licensed this patent from Spectrum Laboratories.

(2) Semi-automated large-scale liver cell procurement technology (US Patent #5,888,409 for "Methods for Cell Isolation and Collection" issued on March 30, 1999). We licensed this patent from Cedars-Sinai Medical Center.

(3) Liver cell procurement technology (US Patent #5,968,356 for "System for Hepatocyte Cell Isolation and Collection" issued on October 19, 1999, and related European Patent #0 830 099 for "Apparatus and Method for Cell Isolation and Collection"). We licensed this patent from Cedars-Sinai Medical Center.

(4) Liver cell cryopreservation technology (US Patent #6,140,123 for "Method for Conditioning and Cryopreserving Cells" issued on October 31, 2000). We licensed this patent from Cedars-Sinai Medical Center.

Cedars-Sinai Medical Center Licenses. On June 19, 2001, Arbios entered into an agreement with Cedars-Sinai Medical Center pursuant to which Cedars-Sinai granted to Arbios exclusive and worldwide rights to patents (2)-(4) above and to certain other technical information. These rights are and remain exclusive over the legal life of the various patents and include, subject to limitations, the right to sublicense the patent rights to third parties. In order to maintain its rights under the license, Arbios is required to expend an aggregate amount of $1,760,000 in research and development expenses toward the development and promotion of products derived from the patents. As of the end of the fiscal year ended December 31, 2004, we had expended more than the minimum required $1,760,000 and have, therefore, fully satisfied the research and development expenditure requirement of this license. Cedars-Sinai Medical Center will have nonexclusive rights to any products derived from the patents. We will have to initially pay Cedars-Sinai Medical Center royalty fees equal to 1.5% of the gross sales price of royalty bearing products. From the third to tenth years of the license, the royalty fee percent will phase out evenly to 0%. Cedars-Sinai Medical Center is also a stockholder of this company. See Note 7, "Junior Preferred Stock" of the financial statements.

Circe Biomedical Properties. In April 2004, we acquired from Circe Biomedical a portfolio of intellectual properties, including certain U.S. and foreign patents applicable to the HepatAssist™ bioartificial liver that Circe Biomedical was developing, including various patents related to the harvesting and handling of cells to be used in the bioartificial liver. We also acquired a number of other patents and rights related to Circe Biomedical's bioartificial liver program that we will not be using, as well as patents on other technologies that we do not intend to pursue (such as patents to Circe Biomedical's artificial pancreas system and three patents for cholesterol removal membranes). The following is a list of U.S. patents and patent applications that we acquired from Circe Biomedical and that we expect to maintain and use with our cell-based liver support system:

(1) Apparatus for Bioprocessing a Circulating Fluid. US Patent #5643794 (issued on July 1, 1997).

(2) Cryopreserved Hepatocytes and High Viability and Metabolic Activity. US Patent #5795711 (issued on August 18, 1998).

(3) Closed System for Processing Cells. US Patent #5858642 (issued on January 12, 1999).

(4) Cell Innoculation Device. US Patent #5,891,713 (issued on April 6, 1999).

(5) Method of Thawing Cryopreserved Cells. US Patent #5895745 (issued on April 20, 1999).

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(6) High Flow Technique for Harvesting Mammalian Cells. US Patent #5912163 (issued on June 15, 1999).

(7) Removal of Agent From Cell Suspension. US Patent #6068775 (issued on May 30, 2000).

(8) Method for Cryopreserving Hepatocytes. US Patent #6136525 (issued on October 24, 2000).

Many of these issued U.S. patents have issued foreign counterparts including in Europe and in Japan.

Pending Patent Applications

Patent No.	Country	Title of Patent Application
515326/97	JP	Cryopreserved Hepatocytes & High Viability and Metabolic Activity

In addition to the foregoing Circe Biomedical patents, we acquired other rights to Circe Biomedical's HepatAssist™ bioartificial liver and related technologies, such as clinical and marketing data and over 400 manufacturing and quality assurance/control standard operation protocols that the FDA had previously reviewed. The Phase I-III clinical data that we acquired is expected to be useful in the preparation of future FDA submissions, since the data is based on pig liver cells from the same source. We also acquired an FDA Phase III IND for an enhanced version of the HepatAssist™ system. We are currently evaluating the possibility of conducting clinical studies of the HepatAssist™ system under a modified version of the FDA-approved Phase III IND protocol that we acquired, but must raise additional funds for this project. In connection with our acquisition of the foregoing patents, we also assumed Circe Biomedical's obligations to make the following royalty payments:

(a) We assumed the obligation to pay a royalty of 2% of "net sales" of any product that utilizes or incorporates the bioartificial liver patents, technology, inventions, and technical or scientific data that Circe Biomedical acquired from W.R. Grace & Co. pursuant to that certain Royalty Agreement, dated as of January 29, 1999, between Circe Biomedical (as a wholly-owned subsidiary of W.R. Grace & Co.) and Circe Acquisition Corp., Since the assets that we acquired from Circe Biomedical are expected to be used in the HepatAssist™ system, it is likely that we will have to pay this royalty with respect of sales of those parts of our HepatAssist™ Cell-Based Liver Support System that incorporate the W.R. Grace & Co. technology. Net sales include revenues received from our licensees and sublicensees from third parties. The obligation to pay royalties on the net sales of certain parts of our cell-based liver support systems will continue for at least ten years after the date on which we have obtained all required regulatory approvals and have received $100,000 of net sales.

(b) We are obligated to make royalty payments equal to 1% of the "net sales" price for that portion of a liver assist system sold by us or any of our sublicensees that comprises or incorporates a cartridge having a combination of porcine hepatocytes with hollow fiber membranes pursuant to that certain Restated License Agreement dated as of August 1, 1999 between Circe Biomedical and Cedars-Sinai Medical Center. Since our HepatAssist™ Cell-Based Liver Support System may utilize this type of cartridge, we will have to pay this royalty with respect of sales of all cartridges used in our cell-based liver support system. Our obligation to pay these royalties will begin with the first commercial sale of a bioartificial liver and continue thereafter for ten years.

Under U.S. law, utility patents filed before June 8, 1995 are valid for 20 years from the filing date, or 17 years from date of issuance, whichever period is longer. Patents filed on or after June 8, 1995 are good for 20 years from the date of filing.

We have filed for trademark protection for our product names, SEPET™ and HepatAssist™, which marks may become registered only upon commercialization of products.

Research and Development

We spent a total of $1,823,000 on research and development during the fiscal year ended December 31, 2006, $1,555,000 on research and development during the fiscal year ended December 31, 2005 and $1,426,000 on research and development during the fiscal year ended December 31, 2004. In addition, pursuant to our research agreement with Spectrum Laboratories, Spectrum Laboratories provided research and development services valued at $17,260 in 2003 for our liver assist systems. See, "Certain Relationships and Related Transactions."

Competition

Our products will compete with numerous other products and technologies that are currently used or are being developed by companies, academic medical centers and research institutions. These competitors consist of both large established companies as well as small, single product development stage companies. We expect substantial competition from these companies as they develop different and/or novel approaches to the treatment of liver disease. Some of these approaches may directly compete with the products that we are currently developing.

Other therapies currently available include whole plasma exchange therapy, a procedure involving massive plasma transfusions that is being used primarily for correction of coagulopathy in patients with severe acute liver failure. In addition, two extracorporeal blood detoxification systems are currently available in the United States for treatment of liver failure: (1) the Adsorba column (Gambro, Hechingen, Germany) which contains activated charcoal and (2) the BioLogic-DT system (HemoCleanse, West Lafayette, Indiana) utilizing a mixture of charcoal, silica and exchange resins**.** Published data indicate that in limited, uncontrolled clinical trials utilizing these systems, only a transient improvement in neurological status was observed with no effect on patients' survival.

Other technologies offered by competing companies include the following:

Gambro's MARS system (molecular adsorbents recirculating system) combines the specific removal of the toxins of liver failure (albumin bound toxins) using a hollow-fiber cartridge impregnated with albumin, and sorbent columns placed in a dialysis circuit filled with 20% albumin solution. Albumin in the dialysate is "regenerated" during continuous recirculation in the closed loop system through sorbent columns (charcoal, resin). In addition, standard hemodialysis is performed during MARS treatment. In Europe, initial results in patients with acute liver failure were encouraging. In November 2004, Gambro announced that in a recently completed Phase II controlled study, which was conducted in 79 patients with acute exacerbation of chronic liver disease, MARS treatment improved hepatic encephalopathy and lowered blood levels of certain toxins implicated in the pathophysiology of liver failure.

Fresenius' PROMETHEUS system is a variant of the MARS system and also combines albumin dialysis with sorbent based blood detoxification and dialysis. In Europe, initial results in a small group of patients with acute exacerbation of chronic liver failure appeared encouraging. Controlled clinical trials are needed to establish if the technology has any therapeutic value and also needed for registration of the product in the United States.

Vital Therapies, Inc. uses technology developed by predecessor companies Hepatix and VitaGen, Inc. Its bioartificial liver ELAD® utilizes a cell line derived from human liver cancer tissue and a conventional hollow fiber bioreactor. A Phase I clinical study of the newest ELAD® version was reported at the annual meeting of the American Association for the Study of Liver Disease in November 2004 in Boston. In patients with acute liver failure, treatment with ELAD® had no effect on survival when compared to patients receiving standard therapy. In January 2006, Vital Therapies, Inc. announced that it had received guidance from the FDA to allow it to begin shipment of its ELAD® cartridges to China in anticipation of pivotal clinical trials scheduled to begin in China in early 2006. This trial has

been reported to be initiated with no results yet formally reported, although the company has issued favorable press releases regarding progress and preliminary results of the trial.

Several other technologies could potentially compete with our cell-based liver support systems. These include xenotransplantation, which is the use of pig or other animal organs in humans, transplantation of isolated hepatocytes and *ex vivo* whole liver perfusions. While major progress has been made in the area of xenotransplantation and transgenic pigs are now available, attempts at xenotransplantation have resulted only in short-term survival of grafted organs. *Ex vivo* whole liver perfusion is impractical because it is cumbersome and requires maintenance of multiple pathogen-free pig colonies due to direct cell-cell contact between pig liver and human blood cells. Although transplantation of hepatocytes showed great promise in animal models of liver failure, there is no adequate supply source of human cells due to shortage of organ donors.

Government Regulation

In order to clinically test, manufacture, and market products for therapeutic use, we will have to satisfy mandatory procedures and safety and effectiveness standards established by various regulatory bodies. In the United States, the Public Health Service Act and the Federal Food, Drug, and Cosmetic Act, as amended, and the regulations promulgated thereunder, and other federal and state statutes and regulations govern, among other things, the testing, manufacture, labeling, storage, record keeping, approval, advertising, and promotion of our products. Product development and approval within this regulatory framework take a number of years and involve the expenditure of substantial resources. After laboratory analysis and preclinical testing in animals, an IDE (in the case of a medical device such as SEPET™) or an IND (in the case of a drug or a combination product such as HepatAssist™) is filed with the FDA to begin human testing. Typically, a two-phase (for devices) or a three-phase (for drugs) clinical testing program is then undertaken. In phase 1 or feasibility phase, small clinical trials are conducted to determine the safety of the product. In phase 2 (typically not required for devices), clinical trials are conducted to assess safety and gain preliminary evidence of the efficacy of the product. In phase 3 or pivotal phase, clinical trials are conducted to provide sufficient data for the statistically valid proof of safety and efficacy. Variations on these paths can also occur, and repetition of particular phases may be required.

The time and expense required to perform this clinical testing can vary and be very substantial. No action can be taken to market any new device, drug or combination product in the United States until an appropriate marketing application has been approved by the FDA. Even after initial FDA approval has been obtained, further clinical trials may be required to provide additional data on safety and effectiveness and are required to gain clearance for the use of a product as a treatment for indications other than those initially approved. In addition, side effects or adverse events that are reported during clinical trials can delay, impede, or prevent marketing approval. Similarly, adverse events that are reported after marketing approval can result in additional limitations being placed on the product's use and, potentially, withdrawal of the product from the market. Any adverse event, either before or after marketing approval, can result in product liability claims against us.

In addition to regulating and auditing clinical trials, the FDA regulates and usually inspects equipment, facilities, and processes used in the manufacturing and testing of such products prior to providing approval to market a product. If, after receiving clearance from the FDA, a material change is made in manufacturing equipment, location, or process, additional regulatory review may be required. We will also have to adhere to current Good Manufacturing Practice and product-specific regulations enforced by the FDA through its facilities inspection program. The FDA also conducts regular, periodic visits to re-inspect equipment, facilities, laboratories, and processes following the initial approval. If, as a result of these inspections, the FDA determines that any equipment, facilities, laboratories, or processes do not comply with applicable FDA regulations and conditions of product approval, the FDA may seek civil, criminal, or administrative sanctions and/or remedies against us, including the suspension of the manufacturing operations.

The FDA has separate review procedures for medical devices before such products may be commercially marketed in the United States. There are two basic review procedures for medical devices in the United States. Certain products may qualify for a Section 510(k) procedure, under which the manufacturer gives the FDA a Pre-Market Notification,

or 510(k) Notification, of the manufacturer's intention to commence marketing of the product at least 90 days before the product will be introduced into interstate commerce. The manufacturer must obtain written clearance from the FDA before it can commence marketing the product. Among other requirements, the manufacturer must establish in the 510(k) Notification that the product to be marketed is "substantially equivalent" to another legally-marketed, previously existing product. If a device does not qualify for the 510(k) Notification procedure, the manufacturer must file a Pre-Market Approval Application. The Pre-Market Approval (PMA) Application requires more extensive pre-filing testing than the 510(k) Notification procedure and involves a significantly longer FDA review process, although the process is typically less than for a new drug or combination product (in part because of the two-phase vs. three-phase clinical trial process described above).

SEPET™ may be regulated in the U.S. as a Class III medical device requiring a PMA review process, similar to medical devices for conducting plasma exchange; however, the FDA may classify it as a Class II device suitable for Section 510(k) approval (described above). We are currently in the process of designing a clinical trial to demonstrate the safety and efficacy of SEPET™ in treating patients with chronic liver failure, which we believe will be required for FDA approval of SEPET™ in case of either a PMA or a 510(k) review process. Accordingly, it is likely to be subject to a two-step approval process starting with a submission of an IDE and subsequent amendments to conduct human studies, followed by the submission of an application for Product Marketing Approval (PMA). The steps required before a product such as SEPET™ is likely to be approved by the FDA for marketing in the United States generally include (i) preclinical laboratory and animal tests; (ii) the submission to the FDA of an IDE for human clinical testing, which must become effective before human clinical trials may commence; (iii) adequate and well-controlled human clinical trials to establish the safety and efficacy of the product; and (iv) the submission to the FDA of a product application. Preclinical tests include laboratory evaluation of the product, as well as animal studies to assess the potential safety and efficacy of the product. The results of the preclinical tests, together with analytical data, are submitted to the FDA as part of an IDE, which must become effective before human clinical trials may commence. The sponsor and the FDA must resolve any outstanding concerns before clinical trials can proceed. Human clinical trials typically involve two sequential phases. Each trial must be reviewed and approved by the FDA before it can begin. The feasibility phase involves the initial introduction of the experimental product into human subjects to evaluate its safety and, if possible, to gain early indications of efficacy. The pivotal phase typically involves further evaluation of clinical efficacy and testing of product safety of a product in final form within an expanded patient population. The results of preclinical testing and clinical trials, together with detailed information on the manufacture and composition of the product, are submitted to the FDA in the form of an application requesting approval to market the product.

HepatAssist™ is classified by the FDA as a combination product comprising a biological therapeutic and a Class III medical device. Accordingly, it is subject to a two-step approval process starting with a submission of an IND to conduct human studies followed by the submission of applications for Product Marketing Approval (PMA) and Biologic License Approval (BLA). The steps required before a product such as HepatAssist™ may be approved by the FDA for marketing in the United States generally include (i) preclinical laboratory and animal tests; (ii) the submission to the FDA of an IND for human clinical testing, which must become effective before human clinical trials may commence; (iii) adequate and well-controlled human clinical trials to establish the safety and efficacy of the product; and (iv) the submission to the FDA of a product application. Preclinical tests include laboratory evaluation of the product, as well as animal studies to assess the potential safety and efficacy of the product. The results of the preclinical tests, together with analytical data, are submitted to the FDA as part of an IND, which must become effective before human clinical trials may commence. The sponsor and the FDA must resolve any outstanding concerns before clinical trials can proceed. Human clinical trials typically involve three sequential phases. Each trial must be reviewed and approved by the FDA before it can begin. Phase I involves the initial introduction of the experimental product into human subjects to evaluate its safety and, if possible, to gain early indications of efficacy. Phase II usually involves a trial in a limited patient population to (i) evaluate preliminarily the efficacy of the product for specific, targeted indications; (ii) determine dosage tolerance and optimal dosage; and (iii) identify possible adverse effects and safety risks. Phase III typically involves further evaluation of clinical efficacy and testing of product safety of a product in final form within an expanded patient population. The results of preclinical testing and clinical trials, together with detailed information on the manufacture and composition of the product, are submitted to the FDA in the form of an application requesting approval to market the product. In the case of HepatAssist™, the product may be available for Phase III testing once the new platform to provide therapy (which we currently believe will be the PERFORMER) is found to be equivalent as a plasma perfusion apparatus to the original platform used in previous Phase I/II/III studies, and the FDA agrees to amend the previous IND to use the PERFORMER in a new Phase III clinical study. No assurance can be given that the results of the equivalency studies will show that the PERFORMER is a suitable platform for the HepatAssist™ Cell-Based Liver Support System. Finally, we will also have to re-establish an approved cell manufacturing capability or engage an approved third party provider of pig cells.

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In addition to obtaining FDA approval, we will have to obtain the approval of the various foreign health regulatory agencies of the foreign countries in which we may wish to market our products. In Europe, we plan on seeking approval to market SEPET™ under the CE Mark and related device regulations which often require less clinical testing than comparable approval processes in the U.S. Label claims for medical devices marketed under the CE Mark are restricted to what has been proven in clinical trials, so initial efficacy claims are typically limited vs. those in the U.S. This can have an adverse impact on marketability of products.

Certain health regulatory authority (including those of Japan, France and the United Kingdom) have objected, and other countries regulatory authorities could potentially object, to the marketing of any therapy that uses pig liver cells (which our cell-based liver support system is expected to utilize) due to safety concerns relating to porcine endogenous viruses. If we are unable to obtain the approval of the health regulatory authorities in any country, the potential market for our products will be reduced.

Employees

As of May 31, 2007, we employed seven full-time employees. We have also engaged seven independent contractors under consulting agreements who provide services to us on a substantial part-time basis. Of the foregoing employees and contractors, four are primarily engaged in administration or management, and the remaining ten persons are involved in scientific research, product development, clinical development, manufacturing development and/or regulatory compliance matters. Our employees are not represented by a labor organization or covered by a collective bargaining agreement. We have not experienced work stoppages and we believe that our relationship with our employees is good.

Glossary of Terms

"Dialysate" is a cleansing liquid used in the two forms of dialysis—hemodialysis and peritoneal dialysis.

"Dialysis" is the process of cleaning wastes from the blood artificially. This job is normally done by the kidney and liver.

"Extracorporeal" means situated or occurring outside the body.

"Ex vivo" pertains to a biological process or reaction taking place outside of a living cell or organism.

"Fulminant" means occurring suddenly, rapidly, and with great severity or intensity.

"Hemodialysis" pertains to the use of a machine to clean wastes from blood after the kidneys have failed. The blood flows through a device called a dialyzer, which removes the wastes. The cleaned blood then flows back into the body.

"Hemofiltration/ Hemofiltrate" Hemofiltration is a continuous dialysis therapy in which blood is pumped through a hollow-fiber cartridge and the liquid portion of blood containing substances are removed into the sink compartment. The liquid portion of the blood ("hemofiltrate") is discarded.

"Hepatitis" is an inflammation of the liver caused by infectious or toxic agents.

"Hepatocytes" are the organ tissue cells of the liver.

"kDa" is a measure of molecular weight using "Daltons" (abbreviated as "Da"). One "Da" is 1/12 of the weight of an atom carbon ^{12}C. "kDa" is a kilodalton, or a 1,000 Daltons.

"IND" means Investigational New Drug application.

"In vitro" pertains to a biochemical process or reaction taking place in a test-tube (or more broadly, in a laboratory) as opposed to taking place in a living cell or organism.

"In vivo" pertains to a biological process or reaction taking place in a living cell or organism.

"PERV" means the porcine endogenous retrovirus.

"Plasma" is the clear, yellowish fluid portion of blood. Plasma differs from serum in that it contains fibrin and other soluble clotting elements.

"Porcine" means of or pertaining to swine; characteristic of the hog.

"Regeneration" means regrowth of lost or destroyed parts or organs.

"Sorbent" means to take in and adsorb or absorb.

Property

We currently maintain our laboratory at Cedars-Sinai Medical Center in Los Angeles, California, which facilities we lease under a three-year lease that expires on June 30, 2007. We currently pay rent of $4,059 per month for the 628 square foot facility under the lease; however we have been informed by Cedars-Sinai Medical Center that they do not intend to renew the lease when it expires in June 2007, and we will need to find a new laboratory facility. We currently intend to replace this laboratory space with similar space in eastern Massachusetts and plan to relocate certain personnel to manage that new facility. Cedars-Sinai Medical Center is a stockholder of our company and was one of the initial stockholders of Arbios. See "Certain Relationships and Related Transactions."

Since April 1, 2004, we have been leasing 1,700 square feet of administrative office space in a building across the street from our laboratories that are located at Cedars-Sinai Medical Center. Our office is located at 8797 Beverly Blvd., Suite 304, Los Angeles, California 90048. On September 1, 2005, we re-signed the lease for an additional two years. The office lease requires us to pay rent of $5,777 per month. Since December 5, 2005, we have been leasing approximately 600 square feet of administrative office space in Waltham, Massachusetts where our corporate headquarters and some of our executive management are located. The office lease, located at 1050 Winter Street, Suite 1000, Waltham, Massachusetts 02154, required us to pay a total of $18,040 for a period of seven months through June 30, 2006. The lease was extended in October 2006 at a rate of $5,102 per month, and is on a month to month basis.

Legal Proceedings

We are not a party to any material legal proceedings.

We may occasionally become subject to legal proceedings and claims that arise in the ordinary course of our business. It is impossible for us to predict with any certainty the outcome of pending disputes, and we cannot predict whether

any liability arising from pending claims and litigation will be material in relation to our consolidated financial position or results of operations.

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

Directors and Executive Officers of Arbios Systems, Inc.

The following table sets forth the name, age and position held by each of our directors and executive officers as of April 30, 2007. Directors are elected at each annual meeting and thereafter serve until the next annual meeting (currently expected to be held during the third calendar quarter of 2007) at which their successors are duly elected by the stockholders. Pursuant to the stock purchase agreement signed by the Company and investors in connection with the March 6, 2006 financing, it was agreed upon that no more than nine director nominees shall be elected at the next annual shareholders meeting.

Name	Age	Position
Walter C. Ogier	50	Director, President and Chief Executive Officer
John M. Vierling, M.D. [2][4]	61	Director, Chairman of the Board
Dennis Kogod [2][3][4]	47	Director
Thomas C. Seoh [1][3][4]	49	Director
Jack E. Stover [1][4]	54	Director
Thomas M. Tully [1][2][3][4]	61	Director
Shawn P. Cain	40	Vice President of Operations
Scott L. Hayashi	35	Vice President of Administration, Chief Financial Officer and Secretary
Jacek Rozga, M.D., Ph.D.	58	Chief Scientific Officer
David J. Zeffren	50	Vice President of Product Development

(1) Member of Audit Committee.

(2) Member of Compensation Committee

(3) Member of Nominating and Corporate Governance Committee.

(4) Independent director. Independence has been determined by our Board of Directors based on the definition promulgated by the NASDAQ Stock Market.

Business Experience and Directorships

The following describes the backgrounds of the members of the management team and current directors.

Walter C. Ogier Mr. Ogier was appointed President and Chief Executive Officer and a director of Arbios in November 2005 and has two decades of experience in the healthcare and biotechnology industries. Prior to joining Arbios, Mr. Ogier was President and Chief Executive Officer of Genetix Pharmaceuticals Inc., which is developing gene therapies for major genetic diseases and was affiliated with Johnson & Johnson, from December 2001 until November 2005. Prior to that, Mr. Ogier was President and Chief Executive Officer of Eligix, Inc., a Harvard University-affiliated company engaged in monoclonal antibody-based therapies for stem cell transplantation and cell therapies for cancer, from October 1997 through November 2001. Mr. Ogier was also previously Vice President of Marketing for Aastrom Biosciences and held various positions in marketing and business development within Baxter Healthcare Corporation and its Blood Therapy Group and was an industrial economist with SRI International (formerly Stanford Research Institute).

John M. Vierling, M.D., FACP Dr. Vierling has served as a director since February 2002. In April 2005, Dr. Vierling assumed the position of Professor of Medicine and Surgery, Director of Baylor Liver Health and Chief of Hepatology at the Baylor College of Medicine and Director, Advanced Liver Therapies at St. Luke's Episcopal Hospital in Houston, Texas. Dr. Vierling had been a Professor of Medicine at the David Geffen School of Medicine at UCLA from 1996 to 2005 and was the Director of Hepatology and Medical Director of Multi-Organ Transplantation Program at Cedars-Sinai Medical Center from 1990 until 2004. Dr. Vierling is also currently the President of the American Association for the Study of Liver Diseases. Dr. Vierling was the Chairman of the Board of the American Liver Foundation from 1994 to 2000, and the President of the Southern California Society for Gastroenterology from 1994 to 1995. Dr. Vierling has also been a member of numerous National Institutes of Health study sections and advisory committees, including the NIDDK Liver Tissue Procurement and Distribution Program. He is currently Chairman of the Data Safety Monitoring Board for the National Institute of Health, NIDDK ViraHep C Multicenter Trial. Dr. Vierling's research has focused on the immunological mechanisms of liver injury caused by hepatitis B and C viruses and autoimmune and alloimmune diseases.

Dennis Kogod Mr. Kogod has served as a director since May 2005. Mr. Kogod is Division President, Western Group for Davita, Inc., a leading provider of dialysis services for patients suffering from chronic kidney failure. Mr. Kogod joined Davita when that company acquired Gambro Healthcare in October 2005. Prior to the acquisition, Mr. Kogod was President and Chief Operating Officer of the West Division of Gambro Healthcare USA, which he joined in July 2000. Before that, Mr. Kogod spent 13 years with Teleflex Corporation, a NYSE-traded company. While there, he served as Division President of the Teleflex Medical Group from December 1999 to July 2000.

Thomas C. Seoh Mr. Seoh has served as a director since March 2005. Since February 2006, Mr. Seoh has served as Chief Executive Officer of Faust Pharmaceuticals S.A., a clinical stage product company focused on drugs for neurological diseases and conditions. From 2005 to 2006, Mr. Seoh was Managing Director of Beyond Complexity Ventures, LLC, engaged in life science start-up and business development consulting activities. From 1995 to 2005, Mr. Seoh was Senior Vice President, Corporate and Commercial Development, and previously Vice President, General Counsel and Secretary, with NASDAQ-listed Guilford Pharmaceuticals Inc., engaged in research, development and commercialization of CNS, oncology and cardiovascular products. Previous positions included Vice President and Associate General Counsel of ICN Pharmaceuticals, Inc., General Counsel and Secretary of Consolidated Press U.S., Inc. and corporate attorney in the New York City and London offices of Lord Day & Lord, Barrett Smith.

Jack E. Stover Mr. Stover has served as a director since November 2004. Mr. Stover is also a director of PDI, Inc. and Antares Pharma, Inc. Mr. Stover was elected the President and Chief Operating Officer of Antares Pharma, Inc., (a public specialty pharmaceutical company) in July 2004. In September 2004, he was named President, CEO and was appointed as a director of that company. Prior thereto, for approximately two years Mr. Stover was Executive Vice President, Chief Financial Officer and Treasurer of SICOR, Inc., a NASDAQ traded injectable pharmaceutical company that was acquired by Teva Pharmaceutical Inc. Prior to that, Mr. Stover was Executive Vice President and Director for Gynetics, Inc., a private women's drug company, and the Senior Vice President, Chief Financial Officer, Chief Information Officer and Director for B. Braun Medical, Inc., a private global medical device and pharmaceutical company. For over 16 years, Mr. Stover was an employee and then a partner with PricewaterhouseCoopers, working in their bioscience industry division. Mr. Stover is also a CPA.

Thomas M. Tully Mr. Tully has served as a director since May 2005. Since January 2006, Mr. Tully has served as Chairman and Chief Executive Officer of IDev Technologies, a medical device company focused on the development and marketing of innovative minimally invasive devices for the treatment of peripheral vascular disease. From August 2000 until April 2005, Mr. Tully was the President and Chief Executive Officer of Neothermia Corporation, a medical device company. Prior thereto, from June 1995 to April 2000, Mr. Tully was the President and Chief Executive Officer of Nitinol Medical Technologies, Inc., a medical device company. Mr. Tully was the President of Organogenesis Inc., from 1991 to 1994, and the President of Schnieder (USA) Inc. from 1988 to 1991. From 1980

through 1988, he held various positions with Johnson & Johnson, including President, Johnson & Johnson Interventional Systems and Vice President Marketing and Sales at the Johnson & Johnson Cardiovascular division.

Shawn P. Cain Mr. Cain joined the company as its Vice President of Operations in April 2005 and was previously employed by us as a part-time consultant from December 2003 to March 2005. From June 2003 to March 2005, Mr. Cain was employed at Becton Dickinson's Discovery Labware, Biologics Business, where he was responsible for the operation of two manufacturing facilities that produced over 900 biologics products. From January 1997 through May 2003, Mr. Cain was the Vice President of Operations for Circe Biomedical, Inc., where he was instrumental in the early development of the bioartificial liver technology, including development the company's HepatAssist™ product.

Scott L. Hayashi Mr. Hayashi joined the company as its Chief Administrative Officer in February 2004, became the Secretary of the company in July 2004 and was appointed as the Vice President of Administration in November 2004. In March 2005, Mr. Hayashi assumed the role as our Chief Financial Officer. Prior to joining Arbios, Mr. Hayashi was a Manager of Overseas Development for Cardinal Health, Inc. from July 2000 to April 2002, Mr. Hayashi worked in finance, mergers and acquisitions for Northrop Grumman Corporation from March 1997 to July 2000 and Honeywell, Inc. from July 1994 to December 1996.

Jacek Rozga, M.D., Ph.D. Dr. Rozga is a co-founder of Arbios and has been Chief Scientific Officer of Arbios since its organization in August 2000. Dr. Rozga served as President of Arbios from August 2000 until November 2005. From October 2003 until March 2005, Dr. Rozga also acted as our Chief Financial Officer. Dr. Rozga is Chairman and Chief Executive Officer of OncoTx, Inc., a private California corporation since October 2005. Since 1992, Dr. Rozga has been a professor of Surgery at UCLA School of Medicine. Dr. Rozga was previously a research scientist at Cedars-Sinai Medical Center from 1992 to 2005.

David J. Zeffren Mr. Zeffren was first employed by us as a consultant in February 2004, before being appointed Vice President of Operations in November 2004, after which he became Vice President of Product Development in March 2005. Prior to joining Arbios, Mr. Zeffren had been the Chief Operating Officer of Skilled Health Systems, L.C., a healthcare technology and clinical research organization from 1999 to 2004. Mr. Zeffren was also Chief Operating Officer of Physician Care Management from 1996 to 1999. Mr. Zeffren was a Corporate Director, Business Development & Division Manager at INFUSX, Inc., a subsidiary of Salick Health Care, Inc. from 1993-1996. Mr. Zeffren has over 20 years of experience working in the healthcare and medical device industries.

There are no family relationships between any of the executive officers and directors.

Key Employees and Consultants

Ulrich Baurmeister, Ph.D. Dr. Baurmeister has been Chief Technology Officer of Arbios since November, 2006. He is an expert in the field of semi-permeable polymer membrane development. From 1982 until 2000, Dr. Baurmeister served in various senior research and development, marketing and business development roles at Membrana GmbH, a leading supplier of semi-permeable membranes for dialysis and water purification, and its parent companies, Akzo Nobel and Acordis AG. He was most recently Managing Director, Business Development, overseeing Membrana's extension into new areas of business and technology. From 2000 to 2004, he continued at Membrana while also serving as Chief Executive Officer of MAT Adsorption Technologies GmbH & Co. KG, a Membrana spin-off venture that developed selective adsorption membrane technology. Dr. Baurmeister serves Arbios on a half-time contractor basis, alongside his role as Advisor and Senior Visiting Scientist at the University Hospital Charite in Berlin, Germany. He also serves on the boards of the Society of Artificial Organs, the International Society of Blood Purification, and the International Society for Apheresis, and he participates in various working groups in the fields of biocompatibility of materials and organ failure. Dr. Baurmeister works for Arbios on a part-time consulting basis.

Jan Stange, M.D. Prof. Stange has been Senior Clinical Advisor to Arbios since early 2006 and he is currently overseeing the Company's clinical development program. He is an expert in the clinical development of products for the treatment of liver failure, having managed pivotal phase, multi-center clinical trials for various liver failure indications in both the U.S. and Europe. From 2000 to 2005, he was a founder and the Medical Director of Teraklin

GmbH, where he directed clinical trials of that company's MARS Liver Assist system, currently owned by Gambro AS. Since 1992, Dr. Stange has held academic, clinical and research positions at the University of Rostock, Germany and the University of California, San Diego and has founded other medical products companies in addition to Teraklin. He is currently Professor of Bioartificial Therapies at the University of Rostock. He serves on the board of directors of Forum Liver Dialysis. Dr. Stange serves Arbios on a part-time contractor basis.

Audit, Compensation and Nominating Committees

In February 2004, our Board of Directors established an Audit Committee. The Board of Directors has instructed the Audit Committee to meet periodically with the company's management and independent accountants to, among other things, review the results of the annual audit and quarterly reviews and discuss the financial statements, recommend to the Board the independent accountants to be retained, and receive and consider the accountants' comments as to controls, adequacy of staff and management performance and procedures in connection with audit and financial controls. The Audit Committee is also authorized to review related party transactions for potential conflicts of interest. The Audit Committee consists of three persons and is currently composed of Mr. Stover, Mr. Seoh and Mr. Tully. Each of these individuals is a non-employee director and, in the opinion of our Board, is independent as defined under the NASDAQ Stock Market's listing standards. Mr. Stover is our "audit committee financial expert" as defined under Item 401(e) of Regulation S-B of the Securities Exchange Act of 1934, as amended. The Audit Committee operates under a formal charter that governs its duties and conduct. In November 2004, we established a Compensation Committee and a Nomination Committee. The Compensation Committee is authorized to review and make recommendations to the full Board of Directors relating to the annual salaries and bonuses of our senior executive officers. The Nomination Committee assists the Board in identifying qualified candidates, selecting nominees for election as directors at meetings of stockholders and selecting candidates to fill vacancies on our Board, and developing criteria to be used in making such recommendations.

EXECUTIVE AND DIRECTOR COMPENSATION

Summary Compensation Table

The following table sets forth certain information concerning the annual and long-term compensation for services rendered to us in all capacities for the fiscal years ended December 31, 2006, 2005, and 2004 of (i) all persons who served as the Chief Executive Officer of this company during the fiscal year ended December 31, 2006 and (ii) each other person who was an executive officer on December 31, 2006 and whose total annual salary and bonus during the fiscal year ended December 31, 2006 exceeded $100,000. (The Chief Executive Officer and the other named officers are collectively referred to as the "Named Executive Officers.") The information set forth below includes all compensation paid to the Named Executive Officers by ATI before the Reorganization by ATI, and all compensation paid to such individual by both Arbios and ATI since the Reorganization.

Name and Principal Position	Year	Salary	Bonus	Option Awards	Non-Equity Incentive Plan Compensation	All Other Compensation[6]	Total
Walter C. Ogier,[1]							
President and Chief	2006	$ 300,000	-	-	-	$ 7,980	$ 307,980
Executive Officer	2005	$ 46,057	$ 50,000	$ 578,227	-	$ -	$ 674,284
Jacek Rozga, M.D., Ph.D. [2]	2006	$ 183,333	-	-	-	$ 6,220	$ 189,553
Chief Scientist	2005	$ 199,177	$ -	$ 15,150	$ 24,000	$ 2,750	$ 241,077
	2004	$ 198,909	$ -	$ 55,123	$ 20,000	$ -	$ 274,032
	2003	$ 143,125	$ -	$ 3,461	$ 15,000	$ -	$ 161,586
Scott L. Hayashi,							
Vice President of							
Administration, Chief	2006	$ 109,167	$ -	$ 25,103	-	$ 3,759	$ 138,029
Financial Officer and	2005[3]	$ 102,291	$ -	$ 23,636	$ 9,450	$ 2,120	$ 137,497
Secretary	2004	$ 80,000	$ 12,000	$ 16,598	-	$ 8,000	$ 116,598
David J. Zeffren,	2006	$ 117,000	-	-	-	3,479	$ 120,479
Vice President of Product	2005	$ 114,346	$ -	$ 23,636	$ 5,400	$ 2,404	$ 145,786
Development	2004[4]	$ 120,000	$ -	$ 26,130	-	$ -	$ 146,130
Shawn P. Cain,[5]	2006	$ 160,000	$ -	$ 43,930	-	$ 5,505	$ 209,435
Vice President of Operations	2005	$ 110,000	$ -	$ 33,788	$ 12,000	$ 259	$ 156,047

(1) Mr. Ogier was appointed our President and Chief Executive Officer in November 2005.

(2) Dr. Rozga resigned as a full-time employee and executive officer in November 2006 and works for the Company as a part-time employee currently.

(3) Mr. Hayashi joined Arbios in February 2004. Mr. Hayashi received $8,000 in cash payments for health and benefits in 2004.

(4)

Mr. Zeffren joined Arbios Systems, Inc. in February 2004 as a consultant before becoming an executive officer of this company in November 2004. The compensation shown includes amounts paid both as a consultant and as an officer of the Company.

(5) Mr. Cain was employed by Arbios Systems, Inc. as a consultant from January 2005 to March 2005 and subsequently was appointed an executive officer in April 2005. Mr. Cain received $3,000 in consulting fees for the period from January 2005 to March 2005.

(6) Includes company matching contributions in the Arbios 401(k) Plan and group life insurance premium gross ups.

Aggregated Option Exercises in Last Fiscal Year and Outstanding Equity Awards at Year-End

The following table sets forth the number and value of unexercised options held by the Named Executive Officers as of December 31, 2006. There were no exercises of options by the Named Executive Officers in fiscal year 2006.

Name	Number of Securities Underlying Unexercised Options Exercisable	Number of Securities Underlying Unexercised Options Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options	Option Exercise Price	Option Expiration Date
Walter C. Ogier	291,666	208,334	500,000(1)	$ 1.85	11/8/2010
Jacek Rozga, M.D., Ph.D.	12,000	-	12,000(2)	$ 2.22	7/7/2012
	30,000	-	30,000(3)	$ 2.25	2/9/2011
	18,000	-	18,000(4)	$ 0.15	7/23/2012
	18,000	-	18,000(5)	$ 1.00	4/20/2010
Scott L. Hayashi	4,165	35,835	40,000(6)	$ 0.85	7/31/2013
	10,000	-	10,000(7)	$ 1.85	3/24/2010
	12,000	-	12,000(8)	$ 2.90	3/1/2010
	10,000	-	10,000(9)	$ 2.25	2/9/2009
David J. Zeffren	12,000	-	12,000(8)	$ 2.90	3/1/2010
	10,000	-	10,000(10)	$ 2.00	2/9/2009
Shawn P. Cain	7,290	62,710	70,000(11)	$ 0.85	7/31/2013
	28,750	1,250	30,000(12)	$ 1.65	3/31/2010

(1) The option to purchase 500,000 shares of common stock was granted on 11/08/2005 and vests according to the following schedule: 50% of the option shall vest on the one year anniversary 11/08/2006, the remaining 50% shall vest on a monthly basis during the second year following the date of grant.

(2) The option to purchase 12,000 shares of common stock was fully vested on 07/07/2006.

(3) The option to purchase 30,000 shares of common stock was fully vested on 02/11/2005.

(4) The option to purchase 18,000 shares of common stock was fully vested on 02/15/2003.

(5) The option to purchase 18,000 shares of common stock was fully vested on 04/21/2004.

(6) The option to purchase 40,000 shares of common stock was granted on 07/31/2006 and vests on a monthly basis for a period of 48 months from the grant date.

(7) The option to purchase 10,000 shares of common stock was fully vested on 03/24/2006.

(8) The option to purchase 12,000 shares of common stock was fully vested on 03/01/2006.

(9) The option to purchase 10,000 shares of common stock was fully vested on 02/11/2005.

(10) The option to purchase 10,000 shares of common stock was fully vested on 02/11/2005.

(11) The option to purchase 70,000 shares of common stock was granted on 07/31/2006 and vests on a pro-rata monthly basis for a period of 48 months from the date of grant.

(12) The option to purchase 30,000 shares of common stock was granted on 03/31/2005 and vests on a pro-rata monthly basis for a period of 24 months from the date of grant.

Compensation of Board of Directors

On March 24, 2005, the Board of Directors approved a plan for compensating the company's directors. On May 16, 2005, the Board amended the plan for the 2005 fiscal year and later renewed the plan on January 11, 2006 for FY 2006. The plan consists of the following:

Non-employee Directors will receive annual grants of stock options to purchase 15,000 shares of the company's common stock. The options will be granted on January 1 of each year. The options will have a term of seven years and will have an exercise price equal to the market price on the trading day preceding the grant date. The options will vest in equal monthly installments over the 12-month period following the grant date.

Upon election to the Board of Directors, each new Director will be granted a stock option to purchase 30,000 shares of the company's common stock. The option will have a term of seven years and will have an exercise price equal to the market price on the trading day preceding the date of grant. One half of the options will vest on the date of grant, and the balance will vest on the first anniversary of the grant date.

On January 1 of each year, committee members receive an annual grant of a stock option to purchase 5,000 shares of common stock for each committee for which they are a member of. The option will have a term of seven years and will have an exercise price equal to the market price on the trading day preceding the grant date. The option will vest in equal monthly installments over the 12-month period following the grant date.

Cash Compensation

Effective March 24, 2005, all non-employee directors were paid $1,500 for each day they attend a Board of Directors meeting in person ($1,000 if they attend a meeting by telephone), and $500 for each telephonic Board meeting ($1,000 for each telephonic meeting if the meeting lasts longer than two hours). In addition, the Chairman of the Board and Chairman of the Audit Committee would receive $25,000 annually (payable quarterly), and the Chairman of the Nomination Committee and the Chairman of the Compensation Committee would receive $10,000 annually (payable quarterly). Effective June 30, 2006, this policy was amended and the company terminated all cash compensation payments to non-employee directors. The company does reimburse all directors for any expenses incurred by them in attending meetings of the Board of Directors.

During the fiscal year ended December 31, 2006, each of our directors was granted an annual grant of stock options to purchase 15,000 shares of common stock at an exercise price of $1.66 per share. In addition, board committee members received an annual grant of stock options to purchase 5,000 shares of common stock at an exercise price of $1.66 per share for each committee they are a member. All director and committee member options are granted at the market price on the day preceding the date of grant and have a term of seven years and vest on a monthly basis from the date of grant. On June 30, 2006, the Board resolved to issue restricted stock instead of paying cash compensation to independent members in order to help the Company maintain its cash reserves. In November 2006, members of the Board of Directors received a total of 89,845 shares of restricted stock in lieu of cash compensation for services rendered during the period July 1, 2006 to December 31, 2006.

Director Compensation Table

Name	Fees Earned or Paid in Cash	Stock Awards	Option Awards	Total
John M. Vierling[1]	$ 17,500	$ 16,819	$ 33,704	$ 68,023
Jack E. Stover[2]	$ 17,500	$ 16,819	$ 33,704	$ 68,023
Thomas C. Seoh[3]	$ 10,000	$ 9,399	$ 34,664	$ 54,063
Thomas M. Tully[4]	$ 9,500	$ 9,399	$ 40,858	$ 59,758
Dennis Kogod[5]	$ 1,500	$ 4,452	$ 31,586	$ 37,538

The following notes describe stock option and restricted stock grants during FY 2006. The fair value of the stock options was determined using the Black Scholes option pricing model in accordance with SFAS 123R as described in Note 1 of the financial notes.

(1) John M. Vierling, M.D. received 1) an option to purchase 44,957 shares of common stock with a fair value of $33,704, and 2) a restricted stock grant of 26,563 shares with a fair value of $16,819.

(2) Jack E. Stover received 1) an option to purchase 44,957 shares of common stock with a fair value of $33,704, and 2) a restricted stock grant of 26,563 shares with a fair value of $16,819.

(3) Thomas C. Seoh received 1) an option to purchase 37,856 shares of common stock with a fair value of $34,664, and 2) a restricted stock grant of 14,844 shares with a fair value of $9,399.

(4) Thomas M. Tully received 1) an option to purchase 28,613 shares of common stock with a fair value of $40,858 and 2) a restricted stock grant of 14,844 shares with a fair value of $9,399.

(5) Dennis Kogod received 1) an option to purchase 30,294 shares of common stock with a fair value of $31,586 and 2) a restricted stock grant of 7,031 shares with a fair value of $4,452.

Employment Contracts and Termination of Employment, and Change-In-Control Arrangements

We entered into an agreement with David Zeffren, dated December 30, 2004, pursuant to which Mr. Zeffren has served as Vice President of Operations. The agreement provides for a salary of $120,000 per year that is subject to annual review and adjustment. The agreement provides that Mr. Zeffren's employment is "at will" and can be terminated at any time. Mr. Zeffren's title and responsibilities were changed in March 2005 to Vice President Product Development.

We have entered into an agreement with Scott Hayashi, dated March 29, 2005, pursuant to which Mr. Hayashi serves as Chief Financial Officer. The agreement provides for a salary of $105,000 per year that is subject to annual review and adjustment. Mr. Hayashi is eligible to receive an annual discretionary bonus of up to 15% of his salary based on achieving certain goals. The agreement also offered Mr. Hayashi a five-year qualified stock option to purchase 10,000 shares of our common stock. The shares are exercisable at $1.85 per share; 50% of the shares vested immediately and 50% of the shares vest one year from the grant date of the option. The agreement provides that Mr. Hayashi's employment is "at will" and can be terminated at any time.

We have entered into an agreement with Shawn Cain, dated March 22, 2005, pursuant to which Mr. Cain serves as Vice-President of Operations. The agreement provides for a salary of $160,000 per year. The agreement also offered Mr. Cain a five-year incentive stock option to purchase 30,000 shares of our common stock. The options have an exercise price of $1.65 per share and vest in monthly installments of 1,250 shares commencing on May 1, 2005. The agreement also provides that we will match Mr. Cain's contributions to a 401(k) plan at a rate of 50% up to 6% of total compensation per year. The agreement also offers to pay Mr. Cain's COBRA costs for an 18-month period commencing on the April 15, 2005. Mr. Cain is also eligible to receive an annual discretionary cash bonus of up to 15% of his base annual salary. The agreement provides that Mr. Cain's employment is "at will" and can be terminated at any time. Under the agreement, we must provide Mr. Cain three months' notice if we wish to terminate his employment. If we fail to provide the required notice, upon termination, we will pay Mr. Cain the salary equivalent of the shortened notice period.

We entered into an agreement with Walter C. Ogier, dated October 17, 2005, pursuant to which Mr. Ogier will serve as Chief Executive Officer commencing November 7, 2005. The agreement provides for an annual initial base salary of $300,000 that is subject to review and adjustment on an annual basis in accordance with the procedures established by the Board of Directors. Mr. Ogier is eligible to receive a discretionary annual cash bonus equal to up to 50% of his annual base salary. The agreement provides that upon commencement of employment, Mr. Ogier received an option to purchase 500,000 shares of our common stock, which will vest 250,000 shares on the one year anniversary of the date Mr. Ogier's employment commences and 250,000 shares will vest ratably at the end of each of the twelve months of the second year of his employment. If there is a liquidation or change-in-control of the Company and in connection with such transaction Mr. Ogier is terminated other than for cause or is no longer President and Chief Executive Officer of the surviving corporation, then all options shares granted to Mr. Ogier in connection with his employment will immediately and fully vest. Additionally, if Mr. Ogier terminates his employment for good reason or is terminated in anticipation of such a transaction, then all option shares granted to Mr. Ogier in connection with his employment will immediately and fully vest. The agreement provides that Mr. Ogier's employment is "at will" and can be terminated at any time. Mr. Ogier is entitled to 12 months of salary if the Company terminates him without cause or he terminates his employment for defined good reason.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information regarding beneficial ownership of our common stock as of April 30, 2007 (a) by each person known by us to own beneficially 5% or more of any class of our common stock, (b) by each of our Named Executive Officers and our directors and (c) by all executive officers and directors of this company as a group. As of April 30, 2007, there were 25,144,086 shares of our common stock issued and outstanding. Unless otherwise noted, we believe that all persons named in the table have sole voting and investment power with respect to all the shares beneficially owned by them. Except as otherwise indicated, the address of each stockholder is c/o the company at 1050 Winter Street, Suite 1000, Waltham, Massachusetts 02451.

Name and Address of Beneficial Owner	Shares Beneficially Owned (1)	Percent of Class
Jacek Rozga, M.D., Ph.D.	2,228,000(2)	8.8%
Achilles A. Demetriou, M.D., Ph.D. and Kristin P. Demetriou	2,500,000(3)	9.9%
John M. Vierling, M.D.	225,853(4)	*
Walter C. Ogier	421,667(5)	1.6%
Jack E. Stover	140,853(6)	*
Thomas C. Seoh	108,117(7)	*
Dennis Kogod	102,742(8)	*
Thomas Tully	130,957(9)	*
Scott L. Hayashi	44,167(10)	*
David Zeffren	72,000(11)	*
Shawn Cain	46,042(12)	*
Gary Ballen	1,139,222(13)	4.4%
LibertyView Funds, LP 111 River Street - Suite 1000 Hoboken, NJ 07030-5776	1,701,968(14)	6.6%
LibertyView Special Opportunities Fund, LP 111 River Street - Suite 1000 Hoboken, NJ 07030-5776	2,474,752(15)	9.6%
Neuberger Berman LLC 111 River Street - Suite 1000 Hoboken, NJ 07030-5776	4,805,931(16)	18.1%

All executive officers and directors as a group (10 persons)	3,520,397(17)	14.0%

* Less than 1%.

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Shares of common stock subject to options, warrants and convertible securities currently exercisable or convertible, or exercisable or convertible within 60 days, are deemed outstanding, including for purposes of computing the percentage ownership of the person holding such option, warrant or convertible security, but not for purposes of computing the percentage of any other holder.

(2) Includes currently exercisable options to purchase 78,000 shares of common stock.

(3) Consists of 2,500,000 shares owned by the A & K Demetriou Family Trust, of which Achilles A. Demetriou, M.D., Ph.D. and Kristin P. Demetriou each are co-trustees with the right to vote or dispose of the trust's shares.

(4) Consists of i) currently exercisable options to purchase 199,290 shares of common stock, ii) 26,563 shares of restricted common stock.

(5) Consists of i) currently exercisable options to purchase 416,667 shares of common stock and ii) 5,000 shares of common stock.

(6) Consists of i) currently exercisable options to purchase 113,290 shares of common stock ii) 26,563 shares of restricted common stock and iii)1,000 shares of common stock.

(7) Consists of i) currently exercisable options to purchase 93,273 shares of common stock, ii) 14,844 shares of restricted common stock.

(8) Consists of i) currently exercisable options to purchase 85,711 shares of common stock, ii) 7,031 shares of restricted common stock, and iii) 10,000 shares of common stock.

(9) Consists of i) currently exercisable options to purchase 116,113 shares of common stock, ii) 14,844 shares of restricted common stock.

(10) Consists of i) currently exercisable options to purchase 41,167 shares of common stock, ii) 3,000 shares of common stock.

(11) Consists of i) 25,000 shares owned by Mira Zeffren, David Zeffren's wife, (ii) warrants to purchase 25,000 shares registered in the name of Mira Zeffren, and (iii) currently exercisable options held by David Zeffren for the purchase of 22,000 shares of common stock.

(12) Consists of currently exercisable options to purchase 46,042 shares of common stock.

(13) Consists of (i) 417,000 shares of common stock registered in Mr. Ballen's name, (ii) currently exercisable warrants to purchase 600,000 shares of common stock owned by Mr. Ballen, and (iii) 122,222 shares registered in the name of American Charter & Marketing LLC, over which Mr. Ballen has voting and investment control.

(14) Consists of (i) 1,162,157 shares of common stock and (ii) currently exercisable warrants to purchase 539,811 shares of common stock. LibertyView Funds, LP, LibertyView Special Opportunities Fund, LP and Trust D for a Portion of the Assets of the Kodak Retirement Income Plan have a common investment advisor, Neuberger Berman, LLC, that has voting and dispositive power over the shares held by them, which is exercised by Richard A. Meckler. Since they have hired a common investment advisor, these entities are likely to vote together. Additionally, there may be common investors within the different accounts managed by the same investment advisor. The General Partner of LibertyView Special Opportunities Fund, LP and LibertyView Funds, LP is

Neuberger Berman Asset Management, LLC, which is affiliated with Neuberger Berman, LLC, a registered broker-dealer. LibertyView Capital Management, a division of Neuberger Berman, LLC, is affiliated with the General Partner of the LibertyView Health Sciences Fund, LP. The shares were purchased for investment in the ordinary course of business and at the time of purchase, there were no agreements or understandings, directly or indirectly, with any person to distribute the shares. Trust D for a Portion of the Assets of the Kodak Retirement Income Plan is not in any way affiliated with a broker-dealer.

(15) Consists of (i) 1,770,323 shares of common stock and (ii) currently exercisable warrants to purchase 704,429 shares of common stock. LibertyView Special Opportunities Fund, LP, LibertyView Funds, LP and Trust D for a Portion of the Assets of the Kodak Retirement Income Plan have a common investment advisor, Neuberger Berman, LLC, that has voting and dispositive power over the shares held by them, which is exercised by Richard A. Meckler. Since they have hired a common investment advisor, these entities are likely to vote together. Additionally, there may be common investors within the different accounts managed by the same investment advisor. The General Partner of LibertyView Special Opportunities Fund, LP and LibertyView Funds, LP is Neuberger Berman Asset Management, LLC, which is affiliated with Neuberger Berman, LLC, a registered broker-dealer. LibertyView Capital Management, a division of Neuberger Berman, LLC, is affiliated with the General Partner of the LibertyView Health Sciences Fund, LP. The shares were purchased for investment in the ordinary course of business and at the time of purchase, there were no agreements or understandings, directly or indirectly, with any person to distribute the shares. Trust D for a Portion of the Assets of the Kodak Retirement Income Plan is not in any way affiliated with a broker-dealer.

(16) Includes shares of common stock and currently exercisable warrants to purchase shares of common stock held by Liberty Funds, LP and LibertyView Special Opportunities Fund, LP (see footnotes 14 and 15). Also includes (i) 432,843 shares of common stock held by Trust D for a Portion of the Assets of the Kodak Retirement Income Fund and (ii) currently exercisable warrants to purchase 182,517 shares of common stock held by Trust D for a Portion of the Assets of the Kodak Retirement Income Plan. LibertyView Funds, LP, LibertyView Special Opportunities Fund, LP and Trust D for a Portion of the Assets of the Kodak Retirement Income Plan have a common investment advisor, Neuberger Berman, LLC, that has voting and dispositive power over the shares held by them, which is exercised by Richard A. Meckler. Since they have hired a common investment advisor, these entities are likely to vote together. Additionally, there may be common investors within the different accounts managed by the same investment advisor. The General Partner of LibertyView Special Opportunities Fund, LP and LibertyView Funds, LP is Neuberger Berman Asset Management, LLC, which is affiliated with Neuberger Berman, LLC, a registered broker-dealer. LibertyView Capital Management, a division of Neuberger Berman, LLC, is affiliated with the General Partner of the LibertyView Health Sciences Fund, LP. The shares were purchased for investment in the ordinary course of business and at the time of purchase, there were no agreements or understandings, directly or indirectly, with any person to distribute the shares. Trust D for a Portion of the Assets of the Kodak Retirement Income Plan is not in any way affiliated with a broker-dealer.

(17) Includes currently exercisable options and warrants to purchase 1,326,397 shares of common stock.

SELLING STOCKHOLDERS

Selling Stockholder Table

The shares to be offered by the selling stockholders are “restricted” securities under applicable federal and state securities laws and are being registered under the Securities Act of 1933, as amended, or the Securities Act, to give the selling stockholders the opportunity to publicly sell or otherwise dispose of those shares. The registration of these shares does not require that any of the shares be offered or sold by the selling stockholders. The shares included in this prospectus may be disposed of by the selling stockholders or their transferees on any stock exchange, market, or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices. We will not control or determine the price at which a selling stockholder decides to dispose of its shares.

No estimate can be given as to the amount or percentage of our common stock that will be held by the selling stockholders after any sales or other dispositions made pursuant to this prospectus because the selling stockholders are not required to sell any of the shares being registered under this prospectus. The following table assumes that the selling stockholders will sell all of the shares listed in this prospectus. The percentages in the following table are based on 25,144,086 shares of our common stock issued and outstanding as of May 31, 2007.

The following table sets forth the beneficial ownership of the selling stockholders:

	Beneficial Ownership Before Offering (1)			Beneficial Ownership After Offering (1)	
Selling Stockholder	Number of Shares	Percent	Number of Shares Being Offered	Number of Shares	Percent
MicroCapital Fund LP(2)	3,000,000(3)	11.26%	3,000,000		*
MicroCapital Fund Ltd.(2)	1,000,000(4)	3.90%	1,000,000		*
Dolphin Offshore Partners, L.P.(5)	2,000,000(6)	7.65%	2,000,000		*
Palo Alto Healthcare Master Fund, L.P.(7)	286,200(8)	1.13%	286,200		*
Palo Alto Healthcare Fund II, L.P.(7)	21,600(9)	*	21,600		*
Palo Alto Fund II, L.P.(7)	307,677(10)	1.22%	307,677		*
Micro Cap Partners, L.P.(7)	283,000(11)	1.12%	283,000		*
UBTI Free, L.P.(7)	24,600(12)	*	24,600		*
Moss Forest Ventures(13)	923,077(14)	3.60%	923,077		*
Bristol Investment Fund, Ltd(15)	923,077(16)	3.60%	923,077		*
Triremes 9 LLC(17)	923,077(18)	3.60%	923,077		*
David B. Musket(19)	1,146,615(20)	4.43%	1,146,615		*
V2M Life Sciences Fund, L.P.(21)	800,000(22)	3.13%	800,000		*
Alpha Capital Austalt(23)	769,231(24)	3.01%	769,231		*
Philip Klein	769,231(25)	3.01%	769,231		*

Balestra Spectrum Partners, LLC(26)	615,385(27)	2.42%	615,385	*
LibertyView Funds, LP(28)	123,077(29)	*	123,077	*
LibertyView Special Opportunities Fund, LP(30)	92,308(31)	*	92,308	*
Trust D for a portion of the assets of the Kodak Retirement Income Plan(32)	92,308(33)	*	92,308	*
Morris Klein	307,692(34)	1.22%	307,692	*
Westfield Capital Microcap Fund(35)	307,692(36)	1.22%	307,692	*
Centurion Capital LLC(37)	153,846(38)	*	153,846	*
Cahr 1999 Dynastic Trust, Michael E. Cahr, Trustee(39)	153,846(40)	*	153,846	*
Alexander & Judith Angerman TTE 98 Family Trust(41)	153,846(42)	*	153,846	*
T Morgen Capital LLC(43)	76,923(44)	*	76,923	*
Thomas J. Quinlan	40,000(45)	*	40,000	*
Hannah Hayashi(46)	9,231(47)	*	9,231	*
Richard Wehby(48)	230,000(49)	*	230,000	*

*Less than 1%

(1) Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and generally includes voting or investment power with respect to securities. Shares of common stock subject to options, warrants and convertible securities currently exercisable or convertible, or exercisable or convertible within 60 days, are deemed outstanding, including for purposes of computing the percentage ownership of the person holding the option, warrant or convertible security, but not for purposes of computing the percentage of any other holder.

(2) Ian P. Ellis has voting and investment control over the securities owned by MicroCapital Fund LP and MicroCapital Fund Ltd.

(3) Includes currently exercisable warrants to purchase 1,500,000 shares of common stock.

(4) Includes currently exercisable warrants to purchase 500,000 shares of common stock.

(5) Peter E. Salas has voting and investment control over the securities owned by Dolphin Offshore Partners, L.P.

(6) Includes currently exercisable warrants to purchase 1,000,000 shares of common stock.

(7) Mark Shamia has voting and investment control over the securities owned by Palo Alto Healthcare Master Fund, L.P., Palo Alto Healthcare Fund II, L.P., Palo Alto Fund II, L.P., Micro Cap Partners, L.P. and UBTI Free, L.P.

(8) Includes currently exercisable warrants to purchase 143,100 shares of common stock.

(9) Includes currently exercisable warrants to purchase 10,800 shares of common stock.

(10) Includes currently exercisable warrants to purchase 153,838 shares of common stock.

(11) Includes currently exercisable warrants to purchase 141,500 shares of common stock.

(12) Includes currently exercisable warrants to purchase 12,300 shares of common stock.

(13) Frank Montgomery has voting and investment control over the securities owned by Moss Forest Ventures.

(14) Includes currently exercisable warrants to purchase 461,538 shares of common stock.

(15) Paul Kessler, manager of Bristol Capital Advisors LLC, the investment advisor to Bristol Investment Fund, Ltd., has voting and investment control of the securities held by Bristol Investment Fund, Ltd. Paul Kessler disclaims beneficial ownership of these securities.

(16) Includes currently exercisable warrants to purchase 461,538 shares of common stock.

(17) Anastasios Parafesias has voting and investment control over the securities owned by Triremes 9 LLC.

(18) Includes currently exercisable warrants to purchase 461,538 shares of common stock.

(19) David B. Musket is the principal of Musket Research Associates, Inc., which acted as placement agent for the April 23, 2007 private placement.

(20) Includes currently exercisable warrants to purchase 746,615 shares of common stock.

(21) J. Misha Petkevich has voting and investment control over the securities owned by V2M Life Sciences Fund, L.P.

(22) Includes currently exercisable warrants to purchase 400,000 shares of common stock.

(23) Konrad Ackerman and Ira Lindenberg have voting and investment control over the securities owned by Alpha Capital Austalt.

(24) Includes currently exercisable warrants to purchase 384,615 shares of common stock.

(25) Includes currently exercisable warrants to purchase 384,615 shares of common stock.

(26) James Melcher and Jeff Margolis have voting and investment control of the securities held by Balestra Spectrum Partners, LLC.

(27) Includes currently exercisable warrants to purchase 307,692 shares of common stock.

(28) Neuberger Berman Asset Management, LLC is the general partner of LibertyView Funds, LP. Neuberger Berman LLC is the investment adviser to LibertyView Funds, LP and is responsible for the selection, acquisition and disposition of the portfolio securities by this fund. LibertyView Funds, LP is an affiliate of a registered broker-dealer. We have been informed by LibertyView Funds, LP that it acquired the securities offered by this prospectus for its own account in the ordinary course of business, and that, at the time it acquired such securities, it had no agreement or understanding, direct or indirect, with any person to distribute such securities.

(29) Includes currently exercisable warrants to purchase 61,538 shares of common stock.

(30) Neuberger Berman Asset Management, LLC is the general partner of LibertyView Special Opportunities Fund, LP. Neuberger Berman LLC is the investment adviser to LibertyView Special Opportunities Fund, LP and is responsible for the selection, acquisition and disposition of the portfolio securities by this fund. LibertyView Special Opportunities Fund, LP is an affiliate of a registered broker-dealer. We have been informed by LibertyView Special Opportunities Fund, LP that it acquired the securities offered by this prospectus for its own account in the ordinary course of business, and that, at the time it acquired such securities, it had no agreement or understanding, direct or indirect, with any person to distribute such securities.

(31) Includes currently exercisable warrants to purchase 46,154 shares of common stock.

(32) Boston Safe Deposit and Trust Company and Mellon Bank (DE) N.A. are the co-trustees of Trust D for a Portion of the Assets of the Kodak Retirement Income Plan ("Trust D"). Neuberger Berman, LLC is the investment manager of Trust D and is responsible for the selection, acquisition and disposition of the portfolio securities by Trust D pursuant to an investment management agreement. Trust D is not affiliated with a broker-dealer. Neuberger Berman, LLC, is a registered broker-dealer. We have been informed by Trust D that it acquired the securities offered by this prospectus for its own account in the ordinary course of business, and that, at the time it acquired such securities, it had no agreement or understanding, direct or indirect, with any person to distribute such securities.

(33) Includes currently exercisable warrants to purchase 46,154 shares of common stock.

(34) Includes currently exercisable warrants to purchase 153,846 shares of common stock.

(35) William A. Muggia and Jamie Nissen have voting and investment control over the securities owned by Westfield Capital Microcap Fund.

(36) Includes currently exercisable warrants to purchase 153,846 shares of common stock.

(37) William A. Wolkstein, M.D. has voting and investment control over the securities owned by Centurion Capital LLC.

(38) Includes currently exercisable warrants to purchase 76,923 shares of common stock.

(39) Michael E. Cahr is the Trustee of the Cahr 1999 Dynastic Trust and has voting and investment control over the securities owned by the Trust.

(40) Includes currently exercisable warrants to purchase 76,923 shares of common stock.

(41) Alexander Angerman and Judith Angerman Trustees have voting and investment control over the securities owned by the Angerman Family Trust.

(42) Includes currently exercisable warrants to purchase 76,923 shares of common stock.

(43) Arnold Lippa has voting and investment control of the securities owned by T Morgen Capital LLC.

(44) Includes currently exercisable warrants to purchase 38,462 shares of common stock.

(45) Includes currently exercisable warrants to purchase 20,000 shares of common stock.

(46) Hannah Hayashi is the wife of Scott Hayashi, the Company's Chief Financial Officer. Scott Hayashi disclaims beneficial ownership of securities held by Hannah Hayashi, as reported on a Form 4.

(47) Includes currently exercisable warrants to purchase 4,615 shares of common stock.

(48) Richard Wehby is the principal of Musket Research Associates, Inc., which acted as placement agent for the April 23, 2007 private placement.

(49) Consists of currently exercisable warrants to purchase 230,000 shares of common stock.

Relationships with Selling Stockholders

Other than David B. Musket and Richard Wehby, all stockholders are investors who acquired their securities from us in one or more private placements and who have had no position, office, or other material relationship (other than as purchasers of securities) with us or any of our affiliates within the past three years.

On January 11, 2005, two affiliates of LibertyView Health Sciences Fund, LP (LibertyView Special Opportunities Fund, LP and LibertyView Funds, LP) purchased a total of 1,357,466 shares of our common stock and warrants to purchase an additional 678,733 shares of our common stock. The foregoing purchases were part of a $6,611,905 private equity financing to a group of institutional investors and accredited investors. In that offering, we sold 2,991,812 shares of our common stock at a price of $2.21 per share to the investors and issued to them warrants to purchase an additional 1,495,906 shares of our common stock at an exercise price of $2.90 per share.

Hannah Hayashi is the wife of Scott Hayashi, the Company's Chief Financial Officer. Hannah Hayashi purchased 4,615 shares of common stock and warrants to purchase 4,615 shares of common stock in our April 23, 2007 private placement.

We paid Musket Research Associates, Inc., the principals of which are David B. Musket and Richard Wehby, a cash fee of $267,000 at the closing of our April 23, 2007 private placement and issued to David B. Musket warrants to purchase 346,615 shares of our common stock and to Richard Wehby warrants to purchase 230,000 shares of our common stock, which shares are included in this prospectus. The warrants issued to Mr. Musket and Mr. Wehby have a term of five years, exercise price of $0.65 per share, cashless exercise provisions and other terms and conditions similar to the warrants issued to the investors in the private placement.

The information in the above table is as of the date of this prospectus. Information concerning the selling stockholders may change from time to time and any such changed information will be described if and when necessary in supplements to this prospectus or, if appropriate, a post-effective amendment to the registration statement of which this prospectus is a part.

PLAN OF DISTRIBUTION

The selling stockholders, which as used herein includes donees, pledgees, transferees or other successors-in-interest selling shares of common stock or interests in shares of common stock received after the date of this prospectus from a selling stockholder as a gift, pledge, partnership distribution or other transfer, may, from time to time, sell, transfer or otherwise dispose of any or all of their shares of common stock or interests in shares of common stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These dispositions may be at fixed prices, at prevailing market prices at the time of sale, at prices related to the prevailing market price, at varying prices determined at the time of sale, or at negotiated prices.

The selling stockholders may use any one or more of the following methods when disposing of shares or interests therein:

- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent, but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- short sales effected after the date the registration statement of which this prospectus is a part is declared effective by the SEC;
- through the writing or settlement of options or other hedging transactions, whether through an options exchange or otherwise;
- broker-dealers may agree with the selling stockholders to sell a specified number of such shares at a stipulated price per share;
- a combination of any such methods of sale; and
- any other method permitted pursuant to applicable law.

The selling stockholders may, from time to time, pledge or grant a security interest in some or all of the shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock, from time to time, under this prospectus, or under an amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act amending the list of selling stockholders to include the pledgee, transferee or other successors in interest as selling stockholders under this prospectus. The selling stockholders also may transfer the shares of common stock in other circumstances, in which case the transferees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

In connection with the sale of our common stock or interests therein, the selling stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the common stock in the course of hedging the positions they assume. The selling stockholders may also sell shares of our common stock short and deliver these securities to close out their short positions, or loan or pledge the common stock to

broker-dealers that in turn may sell these securities. The selling stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The aggregate proceeds to the selling stockholders from the sale of the common stock offered by them will be the purchase price of the common stock less discounts or commissions, if any. Each of the selling stockholders reserves the right to accept and, together with their agents from time to time, to reject, in whole or in part, any proposed purchase of common stock to be made directly or through agents. We will not receive any of the proceeds from this offering. Upon any exercise of the warrants by payment of cash, however, we will receive the exercise price of the warrants.

The selling stockholders also may resell all or a portion of the shares in open market transactions in reliance upon Rule 144 under the Securities Act of 1933, provided that they meet the criteria and conform to the requirements of that rule.

The selling stockholders and any underwriters, broker-dealers or agents that participate in the sale of the common stock or interests therein may be “underwriters” within the meaning of Section 2(11) of the Securities Act. Any discounts, commissions, concessions or profit they earn on any resale of the shares may be underwriting discounts and commissions under the Securities Act. Selling stockholders who are “underwriters” within the meaning of Section 2(11) of the Securities Act will be subject to the prospectus delivery requirements of the Securities Act.

To the extent required, the shares of our common stock to be sold, the names of the selling stockholders, the respective purchase prices and public offering prices, the names of any agents, dealer or underwriter, any applicable commissions or discounts with respect to a particular offer will be set forth in an accompanying prospectus supplement or, if appropriate, a post-effective amendment to the registration statement that includes this prospectus.

In order to comply with the securities laws of some states, if applicable, the common stock may be sold in these jurisdictions only through registered or licensed brokers or dealers. In addition, in some states the common stock may not be sold unless it has been registered or qualified for sale or an exemption from registration or qualification requirements is available and is complied with.

We have advised the selling stockholders that the anti-manipulation rules of Regulation M under the Exchange Act may apply to sales of shares in the market and to the activities of the selling stockholders and their affiliates. In addition, we will make copies of this prospectus (as it may be supplemented or amended from time to time) available to the selling stockholders for the purpose of satisfying the prospectus delivery requirements of the Securities Act. The selling stockholders may indemnify any broker-dealer that participates in transactions involving the sale of the shares against certain liabilities, including liabilities arising under the Securities Act.

We have agreed to indemnify the selling stockholders against liabilities, including liabilities under the Securities Act and state securities laws, relating to the registration of the shares offered by this prospectus.

We have agreed with the selling stockholders to keep the registration statement of which this prospectus constitutes a part effective until the earlier of (1) such time as all of the shares covered by this prospectus have been disposed of pursuant to and in accordance with the registration statement or (2) the date on which the shares may be sold pursuant to Rule 144(k) of the Securities Act.

CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Agreement with AFO Advisors, LLC

Pursuant to a verbal agreement with AFO Advisors, LLC, we engaged Amy Factor to provide investor relations services to support our fundraising efforts as well as provide strategic, accounting, and financial advice. Ms. Factor is a former member of our Board of Directors and Chief Executive Officer and is the President of AFO Advisors, LLC. Under the arrangement, we agreed to pay Ms. Factor a $7,500 monthly retainer for a period of three months commencing January 1, 2006 to March 31, 2006 and granted a five year non-qualified stock option to purchase 30,000 shares of our common stock under our 2005 Stock Incentive Plan. The exercise price of the foregoing options is $1.80 per share, and they vest on a monthly basis during a period of three months beginning January 1, 2006. We have verbally extended the arrangement to provide Ms. Factor with $7,500 per month for investor relations services and financial services for an indefinite period.

DESCRIPTION OF SECURITIES

We are presently authorized to issue 60,000,000 shares of $0.001 par value common stock and 5,000,000 shares of $0.001 par value preferred stock. As of May 31, 2007, we had 25,144,086 shares of common stock issued and outstanding and no preferred stock issued and outstanding.

Common Stock

The holders of our common stock are entitled to equal dividends and distributions per share with respect to the common stock when, as and if declared by the board of directors from funds legally available therefore. No holder of any shares of common stock has a preemptive right to subscribe for any of our securities, nor are any common shares subject to redemption or convertible into other securities. Upon liquidation, dissolution or winding-up of our company, and after payment of creditors and preferred stockholders, if any, the assets will be divided pro rata on a share-for-share basis among the holders of the shares of common stock. All shares of common stock now outstanding are fully paid, validly issued and non-assessable. Each share of our common stock is entitled to one vote with respect to the election of any director or any other matter upon which stockholders are required or permitted to vote. We have not paid any dividends on our common stock to date and do not anticipate that we will be paying dividends in the foreseeable future. Any payment of cash dividends on our common stock in the future will be dependent upon the amount of funds legally available, our earnings, if any, our financial condition, our anticipated capital requirements and other factors that the Board of Directors may think are relevant. However, we currently intend for the foreseeable future to follow a policy of retaining all of our earnings, if any, to finance the development and expansion of our business and, therefore, do not expect to pay any dividends on our common stock in the foreseeable future.

Preferred Stock

Under our articles of incorporation, the board of directors has the power, without further action by the holders of the common stock, to designate the relative rights and preferences of the preferred stock, and to issue the preferred stock in one or more series as designated by the board of directors. The designation of rights and preferences could include preferences as to liquidation, redemption and conversion rights, voting rights, dividends or other preferences, any of which may be dilutive of the interest of the holders of the common stock or the preferred stock of any other series. The issuance of preferred stock may have the effect of delaying or preventing a change in control of the company without further stockholder action and may adversely affect the rights and powers, including voting rights, of the holders of the common stock.

Registration Rights

In 2003, we entered into registration rights agreements with the investors who, in the aggregate, purchased 4,400,000 Units. Each Unit consisted of one share of common stock and one common stock purchase warrant. In those registration rights agreements, we agreed to file a registration statement, at our expense, to register the resale of the 4,400,000 shares of our common stock that are issuable upon the exercise of the warrants held by those investors. Our Board of Directors has also approved the registration of the 4,400,000 shares that were included in the Units. The registration statement is required to be filed after January 31, 2004 if (i) requested in writing by the holders of a majority of the then outstanding warrants (including any shares previously issued upon the exercise of the warrants), and (ii) the closing price of our common stock has exceeded $2.50 for 20 consecutive trading days. We have registered the shares that we are obligated to register under the foregoing registration rights agreements.

The warrant that we issued to Wolfe Axelrod Weinberger Associates LLC for the purchase of 75,000 shares of our common stock granted the holder of that warrant “piggyback registration” rights. Under the piggyback registration provisions, we are required, subject to certain limited exceptions, to register the 75,000 shares of our common stock in any registration statement that we file. We have registered the 75,000 shares that we are obligated to register under the registration rights provision of the warrant.

In connection with the organization and initial capitalization of ATI, we granted certain “piggy-back” registration rights to The A & K Demetriou Family Trust, Jacek Rozga, and Cedars-Sinai Medical Center, our initial three stockholders. Under these agreements, subject to certain customary conditions and exceptions, the foregoing three stockholders have the right to include in any future registration statement filed by this company some or all of their shares of the common stock. The shares of common stock owned by Cedars-Sinai Medical Center have been included in a prior, currently effective, registration statement. Accordingly, unless that prior registration statement is withdrawn before Cedars-Sinai sells its shares under that registration statement, we will have no further obligation to register the shares of Cedars-Sinai. The A & K Demetriou Family Trust and Jacek Rozga have waived their rights to have their shares included in this prospectus.

On January 11, 2005, we sold 2,991,812 shares of our common stock and issued warrants to purchase 1,495,906 shares of our common stock. In connection with the sale of these securities, we entered into a registration rights agreement with the investors pursuant to which we agreed to file a registration statement, at our expense, to register the resale of the foregoing 2,991,812 shares of our common stock as well as the 1,495,906 shares of our common stock that are issuable upon exercise of the stock purchase warrants. This registration statement was prepared and filed as required by the foregoing registration rights agreement (to date, we believe that approximately 921,188 of the 2,991,812 shares that were covered by this prospectus have been sold by the holders thereof). We were required to use commercially reasonable efforts to have the registration statement declared effective by the SEC as soon as practicable. If sales cannot be made by the investors under this prospectus for any reason (including without limitation by reason of a stop order, or our failure to update the prospectus), then we will be required to pay each investor, as liquidated damages and not as a penalty, an amount equal to 1.5% of the aggregate purchase price paid by such

investor for his shares for each 30-day period or a pro rata payment for any portion thereof following the date by which the prospectus should have been effective.

On March 6, 2006, we announced that we have signed binding agreements and closed a private placement financing of Units, consisting of common stock and warrants, for gross proceeds of $1.35 million. Each Unit consists of one share of our common stock and one warrant to purchase 0.50 of a share of our common stock, comprising a total of 1,227,272 shares of our common stock and warrants to purchase 613,634 shares of our common stock. The offering was made to accredited investors, as defined in applicable SEC regulations. Under the terms of the purchase agreement, the Units were sold at a price of $1.10 per Unit, and the warrants will be exercisable for a period of five years at a price of $1.50 per share. Under the terms of the registration rights agreement, we agreed to file a registration statement with the SEC for the resale of the shares of common stock and the shares of common stock underlying the warrants sold in the private placement within 60 days of the March 6, 2006 closing. We have registered all of shares that we are obligated to register under the foregoing registration rights agreement. In the event that the resale registration statement has not been declared effective within certain time periods or if sales cannot be made pursuant to the registration statement following its effectiveness, each as described in the registration rights agreement, we will be obligated to pay to each investor liquidated damages, subject to certain limitations set forth in the registration rights agreement.

On April 23, 2007, we completed a $4,861,000 private equity financing to a group of current and new accredited investors. In the offering, we sold 3,739,231 Units. Each Unit was sold at a price of $1.30 per Unit. Each Unit consists of: i) two shares of our common stock, ii) one warrant to purchase one share of our common stock exercisable for a period of 2.5 years at an exercise price of $1.00 (“A Warrants”) and iii) one warrant to purchase one share of our common stock exercisable for a period of 5 years at an exercise price of $1.40 (“B Warrants”), comprising a total of 7,478,462 shares of our common stock and warrants to purchase 7,478,462 shares of our common stock. The warrants have no provision for cashless exercise and, subject to certain requirements, may be called by us provided that our common stock trades above $1.50 for the A Warrants and above $2.80 for the B Warrants for a specified time period. Under the terms of the registration rights agreement, we agreed to file a registration statement with the SEC for the resale of the shares of common stock and the shares of common stock underlying the warrants sold in the private placement within 60 days of the April 23, 2007 closing. This prospectus includes all shares that we are obligated to register under the foregoing registration rights agreement. In the event that the resale registration statement has not been declared effective within certain time periods or if sales cannot be made pursuant to the registration statement following its effectiveness, each as described in the registration rights agreement, we will be obligated to pay to each investor liquidated damages, subject to certain limitations set forth in the registration rights agreement. In connection with this private equity financing, we also granted piggyback registration rights to Musket Research Associates, Inc. with respect to 576,615 shares of our common stock issuable upon exercise of warrants issued in compensation for financial advisor and placement agent services performed in connection with the financing. This prospectus includes there 576,615 shares.

Delaware Law and Certain Charter and By-law Provisions

The provisions of Delaware law and of our Certificate of Incorporation and By-laws discussed below could discourage or make it more difficult to accomplish a proxy contest or other change in our management or the acquisition of control by a holder of a substantial amount of our voting stock. It is possible that these provisions could make it more difficult to accomplish, or could deter, transactions that stockholders may otherwise consider to be in their best interests or our best interests.

Business Combinations. We are subject to the provisions of Section 203 of the General Corporation Law of the State of Delaware. Section 203 prohibits a publicly-held Delaware corporation from engaging in a “business combination” with an “interested stockholder” for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner. A “business combination” includes mergers, asset sales and other transactions resulting in a financial benefit to the interested stockholder. Subject to specified exceptions, an “interested stockholder” is a person who, together with affiliates and associates, owns, or within three years did own, 15% or more of the corporation’s voting stock.

Limitation of Liability; Indemnification. Our charter contains provisions permitted under the General Corporation Law of the State of Delaware relating to the liability of directors. The provisions eliminate a director's liability for monetary damages for a breach of fiduciary duty as a director, except in circumstances involving wrongful acts, such as the breach of a director's duty of loyalty or acts or omissions which involve intentional misconduct or a knowing violation of law. The limitation of liability described above does not alter the liability of our directors and officers under federal securities laws. Furthermore, our charter and by-laws contain provisions to indemnify our directors and officers to the fullest extent permitted by the General Corporation Law of the State of Delaware. These provisions do not limit or eliminate our right or the right of any stockholder of ours to seek non-monetary relief, such as an injunction or rescission in the event of a breach by a director or an officer of his duty of care to us. We believe that these provisions will assist us in attracting and retaining qualified individuals to serve as directors.

Special Meeting of Stockholders. Our by-laws provide that special meetings of our stockholders may be called only by our chairman of the board, chief executive officer or by our board of directors.

Advance Notice Requirements for Stockholder Proposals and Director Nominations. Our by-laws provide that stockholders seeking to bring business before an annual meeting of stockholders, or to nominate candidates for election as directors at an annual or special meeting of stockholders, must meet specified procedural requirements. These provisions may preclude stockholders from bringing matters before an annual meeting of stockholders or from making nominations for directors at an annual or special meeting of stockholders.

Preferred Stock Issuances. Our Certificate of Incorporation provides that, without stockholder approval, we can issue up to 5,000,000 shares of preferred stock with rights and preferences determined by our board of directors.

Shares Eligible for Future Sale

As of the date of this prospectus, we had 25,144,086 shares of common stock outstanding. That number does not include (i) the 2,881,677 shares that are reserved for issuance under outstanding options and that may be issued if and when the options are exercised, or (ii) 17,152,156 shares that may be issued upon the exercise of currently outstanding warrants (including the warrants to purchase 8,055,077 shares that are owned by the selling stockholders listed in this prospectus).

Freely Tradeable Shares After Offering. As of the date of this prospectus, excluding the shares that are covered by this prospectus, 13,015,624 shares of our 25,144,086 currently outstanding shares can be publicly resold without restriction under the Securities Act. Upon the re-sale of the 7,478,462 currently outstanding shares covered by this prospectus, and the exercise and sale of the 8,055,077 warrant shares included in this prospectus, all of these 15,533,539 shares will also be freely tradable without restriction or limitation under the Securities Act. As a result, after the completion of this offering, there will be a total of 28,549,163 shares of our common stock that will be tradable without restriction under the Securities Act.

Rule 144. In general, under Rule 144 as currently in effect, a person (or persons whose shares are aggregated) who has beneficially owned restricted securities for at least one year, including persons who may be deemed our “affiliates,” as that term is defined under the Securities Act, would be entitled to sell within any three month period a number of shares that does not exceed the greater of 1% of the then outstanding shares (approximately 251,440 shares if the currently outstanding warrants and options are not exercised, or 451,779 shares if all outstanding options and warrants are exercised) or the average weekly trading volume of shares during the four calendar weeks preceding such sale. Sales under Rule 144 are subject to certain manner-of-sale provisions, notice requirements and the availability of current public information about the company. A person who has not been our affiliate at any time during the three months preceding a sale, and who has beneficially owned his shares for at least two years, would be entitled under Rule 144(k) to sell such shares without regard to any volume limitations under Rule 144. Subject to certain volume limitations and other conditions, all of the currently outstanding unregistered shares are eligible for public resale under Rule 144. The availability of Rule 144 to our holders of restricted securities is, however, conditioned on various factors, including the availability of certain public information concerning the Company.

Form S-8 Registration of Options. We have registered on Form S-8 all of the 1,000,000 shares of our common stock that are eligible for sale under options granted under our 2001 Stock Option Plan. In addition, we have also registered on Form S-8 all 3,000,000 shares of common stock that have been reserved for issuance under our 2005 Stock Incentive Plan, which would permit the resale of such shares in the public marketplace.

Transfer Agent

Our transfer agent currently is The Nevada Agency and Trust Company, 50 West Liberty Street, Suite 880, Reno, Nevada 89501.

INTERESTS OF NAMED EXPERTS AND COUNSEL

No expert or counsel was hired on a contingent basis that will receive a direct or indirect interest in our business that is valued at greater than $50,000.

The financial statements for the years ended December 31, 2006 and 2005 included in this prospectus have been audited by Stonefield Josephson, Inc. to the extent and for the periods indicated in their report thereon. Such financial statements have been included in this prospectus and registration statement in reliance upon the report of Stonefield Josephson, Inc. and upon the authority of such firm as experts in auditing and accounting.

DISCLOSURE OF COMMISSION POSITION ON INDEMNIFICATION FOR SECURITIES ACT LIABILITIES

Our Certificate of Incorporation provides that, to the fullest extent permitted by Section 145 of the Delaware General Corporation Law, we have the power to indemnify, and our By-laws state that we shall indemnify and hold harmless, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in our right) by reason of the fact that he is or was a director, officer, employee or agent of this corporation or is or was serving at our request as a director, officer, employee or agent of another corporation or enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or proceeding if such person acted in good faith and in a manner he reasonably believed to be in or not opposed to our best interests, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person's conduct was unlawful. Our By-laws also provide that expenses incurred by an officer or director in defending a suit shall be paid by us in advance of such proceeding's final disposition upon receipt of an undertaking by or on behalf of the director or officer to repay such amount if it shall ultimately be determined that he or she is not entitled to be indemnified by us.

Our Certificate of Incorporation also provides that no director shall be personally liable to us or to our stockholders for monetary damages for breach of his fiduciary duty as a director. Delaware law does not permit the elimination of liability (i) for any breach of the director's duty of loyalty to us or our stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) in respect of certain unlawful dividend payments or stock redemptions or repurchases or (iv) for any transaction from which the director derives an improper personal benefit. The effect of this provision in the Certificate of Incorporation is to eliminate the rights of this corporation and its stockholders (through stockholders' derivative suits on behalf of this corporation) to recover monetary damages against a director for breach of fiduciary duty as a director thereof (including breaches resulting from negligent or grossly negligent behavior) except in the situations described in clauses (i)-(iv), inclusive, above.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of the small business issuer pursuant to the foregoing provisions, or otherwise, the small business issuer has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against

public policy as expressed in the Securities Act and is, therefore, unenforceable.

LEGAL MATTERS

Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., Boston, Massachusetts, will provide us with an opinion as to the legal matters in connection with the securities we are offering.

WHERE YOU CAN FIND MORE INFORMATION

We have filed with the Securities and Exchange Commission a registration statement on Form SB-2 under the Securities Act for the common stock offered under this prospectus. We are subject to the informational requirements of the Exchange Act, and file annual reports, quarterly reports, current reports, proxy statements and other information with the Commission. These reports, proxy statements and other information filed by Arbios Systems, Inc. can be inspected and copied at the public reference facilities of the Commission at Station Place, 100 F Street, N.E., Washington, D.C. 20549. Copies of these materials can be obtained from the Public Reference Room of the Commission at Station Place, 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. You may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330. The Commission also maintains a Web site that contains reports, proxy statements, information statements and other information concerning Arbios Systems, Inc. at the site located at *http://www.sec.gov*. You may also access reports that we file with the Commission through our Web site at *http://www.arbios.com*. This prospectus does not contain all the information in the registration statement and its exhibits, which we have filed with the Commission under the Securities Act and to which reference is made.

INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Arbios Systems, Inc.
Los Angeles, California

We have audited the accompanying balance sheets of Arbios Systems, Inc. as of December 31, 2006 and 2005 and the related statements of operations, stockholders' equity and cash flows for the years then ended and from August 23, 2000 (inception) to December 31, 2006. 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 audit.

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 audit 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Arbios Systems, Inc. as of December 31, 2006 and 2005 and the results of its operations and its cash flows for the years ended December 31, 2006 and 2005, and from August 23, 2000 (inception) to December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 of the financial statements, the Company has suffered recurring losses from operations and has an accumulated deficit, and has been dependent on outside equity to finance operations, all of which raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note 1 to the consolidated financial statements, in 2006 the Company adopted Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payments.

/s/ Stonefield Josephson, Inc.
Certified Public Accountants

Los Angeles, California
April 13, 2007

ARBIOS SYSTEMS, INC.
(A development stage company)
BALANCE SHEETS
December 31, 2006 and 2005

	December 31, 2006	2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,054,280	$ 2,379,738
Short term investments	-	1,996,000
Prepaid expenses	147,163	195,841
Total current assets	2,201,443	4,571,579
Net property and equipment	73,110	101,629
Patent rights, net of accumulated amortization of $113,894 and $93,418, respectively	152,773	173,249
Other assets	62,827	55,773
Total assets	$ 2,490,153	$ 4,902,230
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 310,162	$ 160,649
Accrued expenses	132,073	152,362
Total current liabilities	442,235	313,011
Accrued warrant liability	763,654	-
Stockholders' equity		
Preferred stock, $.001 par value; 5,000,000 shares authorized: none issued and outstanding	-	-
Common stock, $.001 par value; 60,000,000 shares authorized; 17,460,181 and 16,232,909 shares issued and outstanding at December 31, 2006 and 2005 respectively	17,460	16,233
Additional paid-in capital	14,507,939	13,352,217
Deficit accumulated during the development stage	(13,241,135)	(8,779,231)
Total stockholders' equity	1,284,264	4,589,219
Total liabilities and stockholders' equity	$ 2,490,153	$ 4,902,230

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A development stage company)
STATEMENTS OF OPERATIONS

	For the years ended December 31,		Inception to December 31,
	2006	2005	2006
Revenues	$ -	$ -	$ 320,966
Operating expenses:			
General and administrative	3,315,174	2,394,546	8,322,089
Research and development	1,822,614	1,554,509	5,813,176
Total operating expenses	5,137,788	3,949,055	14,135,265
Loss before other income (expense)	(5,137,788)	(3,949,055)	(13,814,299)
Other income (expense):			
Change in fair value of warrant liability	521,187	-	521,187
Interest income	154,697	125,286	296,115
Interest expense	-	(134)	(244,138)
Total other income (expense)	675,884	125,152	573,164
Net loss	$ (4,461,904)	$ (3,823,903)	$ (13,241,135)
Net loss per share:			
Basic and diluted	$ (0.26)	$ (0.24)	
Weighted-average shares:			
Basic and diluted	17,244,988	16,137,676	

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A development stage company)
STATEMENTS OF CASH FLOWS

	For the year ended December 31,		Inception to December 31,
	2006	2005	2006
Cash flows from operating activities:			
Net loss	$ (4,461,904)	$ (3,823,903)	$ (13,241,135)
Adjustments to reconcile net loss to net cash used in operating activities:			
Amortization of debt discount	-	-	244,795
Depreciation and amortization	52,442	59,249	252,219
Change in fair value of warrant liability	(521,187)	-	(521,187)
Patent rights impairment	-	91,694	91,694
Interest earned on discounted short term investments	8,652	(8,652)	-
Issuance of common stock, options & warrants for compensation	1,186,803	557,079	2,799,934
Settlement of accrued expense	-	-	54,401
Deferred compensation costs	-	-	319,553
Changes in operating assets and liabilities:			
Prepaid expenses	48,678	(98,188)	(147,165)
Other assets	(7,054)	(22,609)	(62,827)
Accounts payable and accrued expenses	129,224	34,552	348,733
Other liabilities	-	64,695	64,695
Contract obligation	-	(250,000)	-
Net cash provided by operating activities	(3,564,346)	(3,396,083)	(9,796,290)
Cash flows from investing activities:			
Additions of property and equipment	(3,447)	(23,489)	(144,796)
Purchase of short term investments	(12,889,073)	(8,977,714)	(21,866,787)
Maturities of short term investments	14,876,421	6,990,366	21,866,787
Net cash provided by and (used in) investing activities	1,983,901	(2,010,837)	(144,796)
Cash flows from financing activities:			
Proceeds from issuance of convertible debt	-	-	400,000
Proceeds from common stock option/warrant exercise	-	62,500	65,200
Net proceeds from issuance of common stock and warrants	1,254,987	6,227,594	11,313,249
Net proceeds from issuance of preferred stock	-	-	238,732
Payments on capital lease obligation, net	-	(5,341)	(21,815)
Net cash provided by financing activities	1,254,987	6,284,753	11,995,366
Net (decrease) increase in cash	(325,458)	877,833	2,054,280
Cash at beginning of period	2,379,738	1,501,905	-

Cash at end of period	$ 2,054,280	$ 2,379,738	$ 2,054,280
Supplemental disclosures of non-cash financing activity			
Issuance of securities for obligation related to finder's fees	-	-	$ 47,500
Accrued warrant liability	$ 763,654	-	$ 763,654

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO DECEMBER 31, 2006

	Preferred Stock		Common Stock		Additional		Deficit Accumulated	
	Shares	Amount	Shares	Amount	Paid-In Capital	Deferred Costs	During the Development Stage	Total
Balance, August 23, 2000 (inception) restated for effect of reverse merger with Historical Autographs U.S.A. Inc.			-	$ -	$ -			$ -
Stock issuance in exchange for cash			5,000,000	50	4,950			5,000
Net loss							(9,454)	(9,454)
Balance, December 31, 2000, as restated	-	-	5,000,000	50	4,950	-	(9,454)	(4,454)
Issuance of junior preferred stock for cash of $250,000 and in exchange for $400,000 in patent rights, research and development costs, and employee loanout costs less issuance expenses of $11,268, June 29, 2001	681,818	7			958,278	(343,553)		614,732
Issuance of common stock in exchange for patent rights and deferred research and development costs			362,669	4	547,284			547,288

Services receivable						(550,000)		(550,000)
Deferred employee loan-out costs receivable earned						82,888		82,888
Net loss							(237,574)	(237,574)
Balance, December 31, 2001	681,818	7	5,362,669	54	1,510,512	(810,665)	(247,028)	452,880

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO DECEMBER 31, 2006

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Deferred Costs	Deficit Accumulated During the Development Stage	Total
Amendment of December 31, 2001 agreement for the issuance of common stock agreement in exchange for research and development services					(495,599)	550,000		54,401
Deferred employee loan out costs receivable earned						171,776		171,776
Issuance of common stock for compensation			70,000	1	10,499			10,500
Issuance of common stock for cash			999,111	9	149,857			149,866
Net loss							(494,780)	(494,780)
Balance, December 31, 2002	681,818	7	6,431,780	64	1,175,269	(88,889)	(741,808)	344,643
Issuance of common stock for cash less issuance expense of $2,956			417,000	417	246,827			247,244
Issuance of common stock in private placement for cash less issuance expense of $519,230			4,000,000	4,000	3,476,770			3,480,770

Issuance of common stock for convertible debenture less issuance expense of $49,500	400,000	400	350,100	350,500
Shares issued in connection with acquisition of Historical Autographs U.S.A., Inc. on October 30, 2003	1,220,000	8,263	(8,263)	-

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO DECEMBER 31, 2006

	Preferred Stock		Common Stock		Additional		Deficit Accumulated During the	
	Shares	Amount	Shares	Amount	Paid-In Capital	Deferred Costs	Development Stage	Total
Value of warrants and beneficial conversion feature of bridge loan					244,795			244,795
Deferred employee loan-out costs receivable earned						88,889		88,889
Preferred Stock converted to Common Stock	(681,818)	(7)	681,818	7				
Net loss							(885,693)	(885,693)
Balance, December 31, 2003	-	-	13,150,598	13,151	5,485,498	-	(1,627,501)	3,871,148
Issuance of common stock options and warrants for compensation					972,430			972,430
Exercise of common stock options			18,000	18	2,682			2,700
Issuance of securities for payable			47,499	47	47,451			47,498
Net loss							(3,327,827)	(3,327,827)
Balance, December 31, 2004	-	-	13,216,097	13,216	6,508,061	-	(4,955,328)	1,565,949

Issuance of common stock in private placement for cash less issuance expense of $384,312	2,991,812	2,992	6,224,601	6,227,593
Issuance of common stock options and warrants for compensation			557,080	557,080
Exercise of common stock options	25,000	25	62,475	62,500

The accompanying notes are an integral part of these financial statements.

(A Development Stage Company)
STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO DECEMBER 31, 2006

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Deferred Costs	Deficit Accumulated During the Development Stage	Total
Net loss							(3,823,903)	(3,823,903)
Balance, December 31, 2005	-	-	16,232,909	$ 16,233	$ 13,352,217	-	($8,779,231)	$ 4,589,219
Issuance of common stock in private placement for cash less issuance expense of $95,013			1,227,272	1,227	1,253,760			1,254,987
Issuance of common stock options and warrants for compensation					703,839			703,839
Stock warrant term extension			-		482,964			482,964
Warrant liability					(1,284,841)			(1,284,841)
Net loss							(4,461,904)	(4,461,904)
Balance, December 31, 2006	-	-	17,460,181	$ 17,460	$ 14,507,939	-	($13,241,135)	$ 1,284,264

The accompanying notes are an integral part of these financial statements.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies:

General:

Arbios Systems, Inc., a Delaware corporation (the "Company"), seeks to develop, manufacture and market liver assist devices to meet the urgent need for therapy of liver failure.

The Company has a lead product under development, the SEPET™ Liver Assist Device, which is a blood purification therapy device for patients with liver failure. The Company has a second product candidate, the HepatAssist™ Cell-Based Liver Support System, which is a bioartificial liver; whose development is currently on hold pending raising of additional funds via a corporate partnership.

On October 30, 2003, Historical Autographs U.S.A., Inc. and Arbios Technologies, Inc. consummated a reverse merger, in which Arbios Technologies, Inc. became the wholly owned subsidiary of Historical Autographs U.S.A., Inc. Concurrently with the merger, Historical Autographs U.S.A., Inc. changed its named to Arbios Systems, Inc. and is herein referred to as "Arbios Systems". The stockholders of Arbios Technologies, Inc. transferred ownership of one hundred percent of all the issued and outstanding shares of their capital stock of Arbios Technologies, Inc. in exchange for 11,930,598 newly issued shares, or approximately 91%, of the common stock, $.001 par value, of Arbios Systems. At that time, the former management of Arbios Systems resigned and was replaced by the same persons who served as officers and directors of Arbios Technologies, Inc. Inasmuch as the former owners of Arbios Technologies, Inc. controlled the combined entity after the merger, the combination was accounted for as a purchase by Arbios Technologies, Inc. as acquirer, for accounting purposes in accordance with Statement of Financial Accounting Standards No. 141 using reverse merger accounting, and no adjustments to the carrying values of the assets or liabilities of the acquired entity were required. Proforma operating results, as if the acquisition had taken place at the beginning of the period, have not been presented as the operations of the acquiree were negligible. The financial position and results of operations of Arbios Systems is included in the statements of the Company from the date of acquisition.

On July 25, 2005, Arbios Systems, Inc. completed its reincorporation as a Delaware corporation by merging with and into Arbios Systems, Inc., a Delaware corporation. The foregoing merger was approved by the Company's stockholders at the annual meeting of stockholders held on July 7, 2005. In order to consolidate the functions and operations of Arbios and ATI, on July 26, 2005, ATI merged into Arbios. As a result, Arbios now owns all of the assets of ATI and all of the operations of the two companies have been consolidated into Arbios. Unless the context indicates otherwise, references herein to the "Company" during periods prior to July 26, 2005 include Arbios Systems, Inc., a Nevada corporation and Arbios Technologies, Inc.

Development Stage Enterprise and Going Concern:

The Company is a development stage enterprise as defined in Statement of Financial Accounting Standards ("SFAS") No. 7, "Accounting and Reporting by Development Stage Enterprises." The Company is devoting substantially all of its present efforts to establish a new business. Its planned principal commercial operations have not yet commenced. Research and development, which were initiated in 2000 is being vigorously pursued including conduct of a human clinical trial. All losses accumulated since inception, have been considered as part of the Company's development

stage activities. As of March 2007, the Company currently does not have sufficient resources to fund operations for the next twelve months and its ability to continue as a going concern is in doubt. Our financial statements have been prepared on the basis of a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. We have not made any adjustments to the financial statements as a result of the outcome of the uncertainty described above. Accordingly, the value of the Company in liquidation may be different from the amounts set forth in our financial statements. The Company is currently in the process of seeking additional capital, but makes no assurances that these funds can or will be raised.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies, Continued:

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates were used in the calculation of stock option valuation, warrant liability valuation, property and equipment, and amortization of patents.

Federal Government Grants:

The Company has been partially funded by certain governmental grants. Payments received under contracts to fund certain research activities are recognized as revenue in the period in which the research activities are performed. Payments received in advance that are related to future performance are deferred and recognized as revenue when the research projects are performed. Reimbursements recorded under these grants are subject to governmental audit. Management believes that subsequent audits will not result in material adjustments to the costs reflected in the accompanying financial statements, and that the Company has utilized all remaining government grant funds in accordance with their intended use.

Comprehensive Income:

SFAS No. 130, "Reporting Comprehensive Income", establishes standards for the reporting and display of comprehensive income and its components in the financial statements. As of December 31, 2006 and 2005, the Company has no items that represent comprehensive income and therefore, the Company has not included a schedule of comprehensive income in the financial statements.

Property and Equipment:

Property and equipment are stated at cost. Depreciation is provided using the straight-line method over the estimated useful lives of the assets of five to seven years.

Patent Rights:

In accordance with FASB No. 2, the costs of intangibles that are purchased from others for use in research and development activities and that have alternative future uses are capitalized and amortized. We capitalize certain patent rights that are believed to have future economic benefit. The licensed capitalized patents costs were recorded based on the estimated value of the equity security issued by us to the licensor. The value ascribed to the equity security took into account, among other factors, our stage of development and the value of other companies developing extracorporeal bioartificial liver assist devices. These patent rights are amortized using the straight-line method over the remaining life of the patent. Certain patent rights received in conjunction with purchased research and development costs have been expensed. Legal costs incurred in obtaining, recording and defending patents are

expensed as incurred.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies, Continued:

We periodically evaluate whether events or circumstances have occurred that may affect the estimated useful lives or the recoverability of the remaining balance of the patents. Impairment of the assets is triggered when the estimated future undiscounted cash flows do not exceed the carrying amount of the intangible assets. If the events or circumstances indicate that the remaining balance of the assets may be permanently impaired, such potential impairment will be measured based upon the difference between the carrying amount of the assets and the fair value of such assets, determined using the estimated future discounted cash flows generated.

Fair Value of Financial Instruments:

The Company's financial instruments include cash, short-term investments, accounts payable, accrued expenses, and warrant liability, some of which have carrying amounts which approximate fair value due to their short maturities.

Cash and Cash Equivalents:

The Company considers highly liquid debt instruments with original maturities of 90 days or less to be cash equivalents.

Short Term Investments:

Short-term investments generally mature between three and twelve months. Short-term investments consist of U.S. Government Agency Notes purchased at a discount with interest accruing to the notes full value at maturity. All of the Company's short-term investments are classified as available-for-sale and are carried at fair market value which approximates cost plus accrued interest.

Income Taxes:

Deferred income taxes will be recognized for the tax consequences in future years of temporary differences, if any, between the tax bases of assets and liabilities and their financial reported amounts at each period end, based on enacted tax laws and statutory tax rates applicable to the period in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes represents the tax payable for the period, if any, and the change during the period in deferred tax assets and liabilities.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies, Continued:

Stock-Based Compensation, Continued:

Commencing January 1, 2006 the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 123R, "Share Based Payment ("SFAS 123R"), which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on fair values.

Prior to adopting SFAS 123R, the Company accounted for stock-based employee compensation under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," as allowed by SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). The Company has applied the modified prospective method in adopting SFAS 123R. Accordingly, periods prior to adoption have not been restated.

The following table illustrates the effect on net income and earnings per share if the fair value method had been applied to the prior period.

		Year ended December 31, 2005
Net loss as reported	$	(3,823,903)
Compensation recognized under:		
SFAS 123		(984,514)
Pro forma net loss	$	(4,808,417)
Basic and diluted loss per common share:		
As reported	$	(0.24)
Pro forma	$	(0.30)

Under SFAS 123R, forfeitures are estimated at the time of valuation and reduce expense ratably over the vesting period. This estimate is adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from the previous estimate. The Company utilized a 5% forfeiture rate based upon historical forfeitures. Under SFAS 123 and APB 25, the Company elected to account for forfeitures when awards were actually forfeited, at which time all previous pro forma expense was reversed to a reduced pro forma expense for the period in which the forfeiture occurred.

For non-employee stock based compensation the Company recognizes an expense in accordance with SFAS 123 and values the equity securities based on the fair value of the security on the date of grant with subsequent adjustments based on the fair value of the equity security as it vests. The fair value of expensed options is estimated using the Black Scholes option-pricing model.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

Summary of Significant Accounting Policies, Continued:

Stock-Based Compensation, Continued:

As of December 31, 2006, there was $307,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under existing stock option plans. This cost is expected to be recognized over a weighted average period of 1.57 years. The total fair value of shares vested and unvested during the twelve months ended December 31, 2006 was $695,000, of which $663,000 is attributed to employee options.

The fair value of options granted to employees was estimated using the Black Scholes option-pricing model. These same assumptions are also used in applying the Black Scholes option-pricing model for any stock based option and warrant compensation paid to non-employees. The fair value of options and warrants at the date of grant and the assumptions utilized are indicated in the following table:

	For the Year Ended December 31 ,	
	2006	2005
Weighted average of fair value at date of grant for options granted during the period	$ 0.87	$ 1.31
Risk-free interest rates	4.35% - 5.04%	3.77% - 4.45%
Expected option life in years	7	5-7
Expected stock price volatility	.72 - .77	.83 - .72
Expected dividend yield	-	-

Expected Volatility. The Company calculates the expected volatility of its stock options using historical volatility of weekly stock prices.

Expected Term. The expected term is based on historical observations of employee exercise patterns during the Company's history.

Risk-Free Interest Rate. The interest rate used in valuing awards is based on the yield at the time of grant of the U.S. Treasury security 5 year constant maturity rate.

Dividend Yield. The Company has never paid cash dividends, and does not currently intend to pay cash dividends, and thus has assumed a 0% dividend yield.

Net Loss Per Common Share:

The Company utilizes SFAS 128, "Earnings per Share." Basic loss per share is computed by dividing loss available to common shareholders by the weighted-average number of common shares outstanding. Diluted loss per share is computed similar to basic loss per share except that the denominator is increased to include the number of additional

common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The computation of diluted loss per share does not assume conversion, exercise or contingent exercise of securities that would have an anti-dilutive effect on losses. For the years ended December 31, 2006 and 2005, potential common shares aggregating 10,694,000 and 9,345,000, respectively, were excluded in computing the per share amounts because they are anti-dilutive.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies Continued:

Recent Accounting Pronouncements:

In July 2006, the FASB issued FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109*, ("FIN48"). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is "more-likely-than-not" that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to FASB Statement No. 109, *Accounting for Income Taxes.* The interpretation clearly scopes out income tax positions related to FASB Statement No. 5, *Accounting for Contingencies.* We do not anticipate that the adoption of this statement will have a material effect on our financial position or results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ("SAB 108"), to address diversity in practice in quantifying financial statement misstatements. SAB 108 requires that we quantify misstatements based on their impact on each of our financial statements and related disclosures. SAB 108 is effective for the first fiscal year ending after November 15, 2006, allowing a one-time transitional cumulative effect adjustment to retained earnings as of January 1, 2006 for errors that were not previously deemed material, but are material under the guidance in SAB 108. We adopted provisions of SAB 108 in the quarter ended December 31, 2006 without any impact on our financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 with earlier application encouraged. We are evaluating the impact of adopting SFAS 157 on our financial statements.

In December 2006, the FASB issued FASB Staff Position ("FSP") EITF 00-19-2, *Accounting for Registration Payment Arrangements*. This FSP addresses how to account for registration payment arrangements and clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. This accounting pronouncement further clarifies that a liability for liquidated damages resulting from registration statement obligations should be recorded in accordance with SFAS No. 5, *Accounting for Contingencies*, when the payment of liquidated damages becomes probable and can be reasonably estimated. This FSP shall be effective immediately for registration payment arrangements and the financial instruments subject to those arrangements that are entered into or modified subsequent to the date of issuance of this FSP. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of this FSP, this guidance shall be effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. The Company is currently assessing the impact that this FSP may have in its financial statements.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(1) Summary of Significant Accounting Policies Continued:

Recent Accounting Pronouncements Continued:

In February 2007, the FASB issued Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115* ("SFAS 159"). SFAS 159 permits companies to measure many financial instruments and certain other items at fair value at specified election dates. SFAS 159 will be effective beginning January 1, 2008. The Company is currently assessing the impact of SFAS 159 on its financial statements.

(2) Property and Equipment:

Property and equipment consisted of the following:

	2006	2005
Office equipment	$ 8,589	$ 8,589
Office furniture	7,297	7,297
Computer equipment	45,915	42,468
Medical equipment	107,993	107,993
	169,794	166,347
Less: accumulated depreciation	(96,684)	(64,718)
	$ 73,110	$ 101,629

Depreciation expense was $31,966, $29,649 and $96,684 for the years ended December 31, 2006 and 2005, and the period from August 23, 2000 (inception) to December 31, 2006, respectively.

(3) Patent Rights:

In June 2001, the Company acquired, in exchange for junior preferred stock, exclusive rights to five existing patents, at which time the aggregate value of these rights was $400,000. At December 31, 2006 and 2005, the accumulated amortization of these rights was $113,894 and $93,418, and the estimated remaining life was 6 years. Amortization expense was $20,476 for the year ended December 31, 2006 and $29,602 for the year ended December 31, 2005 and $155,533 for the period from August 23, 2000 (inception) to December 31, 2006.

In conjunction with the preparation of the December 31, 2005 financial statements, and in accordance with FASB 144 "Accounting for the impairment or disposal of long-lived assets," management reviewed the portfolio of capitalized patent rights and determined that two patents related to the LIVERAID membrane technology would not have future commercial uses or have economic benefit to the Company and concluded that the carrying value of the two patents is not recoverable. The two patents had a combined original value of $133,333, with $41,639 in amortized expense through December 31, 2005, resulting in an expense charge of $91,694, representing the remaining unamortized balance as of December 31, 2005.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(3) Patent Rights Continued:

Future estimated amortization expense in each of the years from 2007 through 2011 is $20,476 and $50,393 thereafter.

In conjunction with certain patents rights described above, the Company committed to the licensor to spend a total of $1,760,000 in research and development expenses toward the development and promotion of products, commencing from the acquisition date until June 30, 2008. The Company has made expenditures to date to satisfy the entire research and development costs obligation of the agreement.

The Company is also subject to paying royalty fees to the licensor initially equal to 1.5% of the gross sales price of royalty bearing products. From year three to the tenth year of the license, the royalty fee percent will phase out evenly to 0%. As of December 31, 2006 and 2005, the Company had not paid any royalty fees since it did not have any sales of royalty bearing products.

In April 2004, the Company purchased patents and other selected assets from Circe Biomedical, Inc. In connection with the acquisition of these patents, the Company assumed a Royalty Agreement dated as of January 29, 1999, between Circe Biomedical, Inc. and Circe Acquisition Corp. The Company assumed the obligation to pay a royalty of 2% of “net sales” of any product that utilizes or incorporates the bioartificial liver patents, technology, inventions, and technical or scientific data that the Company acquired from Circe Biomedical. As of December 31, 2006 and 2005, the Company had not paid any royalty fees to Circe Biomedical Inc. since it did not have any sales of royalty bearing products.

Further patent rights are described in Footnote (11) Subsequent Event.

(4) Deferred Employee Loan-Out Costs:

In June 2001, the Company received a commitment from a shareholder in the Company for the loan-out of certain employees over a two-year period in exchange for junior preferred stock (see Note 7). The Company deferred the estimated loan-out costs over the two-year period. The loan-out costs were expensed as the services were performed. At the expiration of the two-year period, the Company received an extension of the employee loan-out agreement for an additional two years. The employee loan out agreement expired on June 30, 2005. For the years ended December 31, 2006 and 2005, the employee loan out costs were $0 and $140,524, respectively. The employee loan out costs from inception to December 31, 2006 were $905,649.

(5) Convertible Promissory Notes:

In September 2003, the Company issued units of convertible subordinated notes and warrants, consisting of convertible promissory notes (the “Notes”) for an aggregate principal amount of $400,000 and warrants for the purchase of 300,000 shares of the Company’s common stock at $1 per share. The Notes bore interest at 7% per annum and were due on the earlier of March 31, 2004 or upon the occurrence of various other events or conditions set forth in the Notes. Under the terms of the Notes, the holders retained the right, subject to certain exceptions, to convert all or any part of the principal outstanding under the Notes into (i) shares of the Company’s Common Stock at a conversion price per share equal to $1 and (ii) warrants for the purchase of the Company’s common stock at $2.50 per share. For each

share issued upon the conversion of the note, each noteholder received additional warrants for the purchase of common stock. The conversion price was subject to adjustment in the event of a stock split, combination or like transaction. The warrant price was subject to adjustment in the event of a stock split, combination or like transaction. The fair value of the warrants was determined using the Black Scholes option pricing model using the following assumptions: dividend yield 0%, volatility 233%, risk free interest rate 5.5% and expected life of three years.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(5) Convertible Promissory Notes Continued:

The Company recorded the Notes, net of a discount equal to the relative fair value allocated to the warrants issued of $122,390. The Notes also contained a beneficial conversion feature, which resulted in an additional debt discount of $122,390. The beneficial conversion amount was measured using the intrinsic value method of accounting, i.e. the excess of the aggregate fair value of the common stock into which the debt is convertible over the proceeds allocated to the security.

In October 2003, the Notes were converted into 400,000 shares of common stock at $1 per share. The Company recognized interest expense totaling $224,401 for the unamortized warrants and beneficial conversion feature discount in accordance with Emerging Issues Task Force 00-27.

(6) Commitments and Contingencies:

Description of Property

The Company currently maintains laboratory and office space at Cedars-Sinai Medical Center (“Cedars-Sinai”) in Los Angeles, California, which facilities are leased under a three-year lease that expires on June 30, 2007. Cedars-Sinai has informed us that the lease will not be renewed. The Company currently pays rent of $4,059 per month for the 1,008 square foot facility under the lease. Cedars-Sinai Medical Center is a stockholder of the Company.

Since April 1, 2004, the Company has leased 1,700 square feet of executive and administrative office space in a building across the street from its laboratories. In September 2005, the Company leased an additional 300 square feet of space for a total of 2,000 square feet. The rent for this space is $5,777 per month and the lease has a term of two years commencing September 2005.

The Company leased an animal breeding facility in Connecticut at $12,009 per month for two years commencing April 2005. The lease will terminate on March 31, 2007 and the Company does not intend to renew the lease at this time.

ARBIOS SYSTEMS, INC.
(A DEVELOPMENT STAGE COMPANY)

NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(6) Commitments and Contingencies Continued:

In December 2005, the Company entered into a lease agreement for executive office space in Waltham, Massachusetts through June 30, 2006 at a total cost for the lease period of $18,040. The lease was extended in October 2006 at a rate of $5,102 per month, and is on a month-to-month basis.

Future minimum lease payments required under the operating leases for non-cancelable lease terms in excess of one year are $106,600 for 2007.

Rent expense was $312,239, $229,079, and $692,494 for the years ended December 31, 2006 and 2005, and the period from August 23, 2000 (inception) to December 31, 2006, respectively.

Agreements

In April 2004, the Company purchased certain assets of Circe Biomedical, Inc. including Circe's patent portfolio, rights to a bioartificial liver (HepatAssist™), a Phase III investigational drug application, selected equipment, clinical and marketing data, and over 400 standard operating procedures and clinical protocols previously reviewed by the Food and Drug Administration. In exchange for these assets, the Company paid a $200,000 upfront payment and committed to make a $250,000 payment due the earlier of April 12, 2006 or when the Company had raised accumulated gross proceeds of $4 million from the issuance of debt or equity securities.

The Company raised in excess of $4 million in its January 2005 equity financing and on January 18, 2005, the Company paid the $250,000 contractual commitment to Circe Biomedical, Inc. The Company expensed the cost of the acquisition in the fiscal quarter ended June 30, 2004 as part of acquired research and development costs, as the underlying rights have not yet reached the stage at which their commercial feasibility can be established.

The Company entered into clinical study agreements with Albert Einstein Medical Center in Philadelphia, Pennsylvania in August 2005 and with Cedars-Sinai Medical Center in Los Angeles, California in September 2005, the University of California, San Diego Medical Center in La Jolla, California in March 2006, and the University of California, San Francisco in San Francisco in August 2006 for the Company's feasibility clinical trial for SEPET™. The total estimated cost to conduct the entire clinical trial is $530,000 and is based upon a total enrollment of 15 patients at the four medical centers. Additionally, the Company anticipates expenditures of approximately $309,000 for expenses associated with the clinical trial including data safety monitoring board fees, database design and analysis of clinical results and clinical trial insurance.

ARBIOS SYSTEMS, INC.
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NOTES TO FINANCIAL STATEMENTS

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(7) Stockholders' Equity:

Preferred Stock

The Company has 5,000,000 shares of preferred stock authorized. There are no shares of preferred stock issued or outstanding. The Board of Directors has the authority to set by resolution the particular designation, preferences and other special rights and qualification of preferred stock.

Junior Preferred Stock

In June 2001, Arbios Technologies, Inc. issued 681,818 shares of junior preferred stock in exchange for $250,000 in cash, exclusive rights to certain patents and one pending patent valued at $400,000 (see Note 3), and future services of certain employees valued at $319,553 (see Note 4). In October 2003, all issued and outstanding shares of the junior preferred stock were converted into 681,818 shares of common stock.

Common Stock

In August 2000, Arbios Technologies, Inc. issued 5,000,000 shares of common stock, $0.001 par value, to the Company's two founders in exchange for $5,000 in cash.

In December 2001, Arbios Technologies, Inc. issued 362,669 shares of common stock in exchange for future research costs valued at $550,000, an exclusive license (see Note 8), a manufacturing and supply agreement (see Note 8), and exclusive rights to two patents.

In June 2002, Arbios Technologies, Inc. issued 70,000 shares of common stock to a Board member as compensation for services rendered valued at $10,500.

In July 2002, Arbios Technologies, Inc. issued 999,111 shares of common stock to investors in exchange for $149,866 in cash, or $0.15 per share.

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(7) Stockholders' Equity, Continued:

Common Stock

In July 2002, Arbios Technologies, Inc. issued options to purchase 18,000 shares of common stock to each of its five Board members for services rendered. The options are exercisable at $0.15 per share. The options vested 50% in six months and 50% in 12 months from the beginning date of service provided by the respective Board members.

In July 2002, Arbios Technologies, Inc. issued a warrant to purchase 100,000 shares of common stock to a Board member for services rendered to the Company. The warrant is exercisable at $0.15 per share and has a 7-year life. The warrant also has conversion rights in lieu of payment of the exercise price and is not transferable.

In January 2003, Arbios Technologies, Inc. issued 417,000 shares of common stock and a three year warrant to purchase 600,000 shares of common stock at an exercise price of $1.00 per share to an investor in exchange for $250,200 in cash. The Company recognized $2,956 in stock issuance costs. The warrant expiration date of January 23, 2006 was extended to September 2006 in exchange for the investor's agreement to not sell his Company stock holdings during the extension period.

In July 2003, Arbios Technologies, Inc. issued a warrant to purchase 50,000 shares of common stock to a Board member for services rendered to the Company. The warrant is exercisable at $1.00 per share and has a five-year life. The warrant grant resulted in a non-cash charge of $7,180 determined utilizing the Black Scholes pricing model and the following economic assumptions: dividend yield 0%, volatility .05, risk free interest rate 3% and an expected life of 5 years.

In September 2003, convertible promissory notes totaling $400,000 were converted into 400,000 shares of the Company's common stock. The Company also issued warrants to purchase 300,000 shares of common stock. The warrants are exercisable at $1.00 per share and have a three-year life.

In September and October 2003, Arbios Technologies, Inc, issued 4,000,000 shares of common stock and warrants to purchase 4,000,000 shares of common stock at an exercise price of $2.50 in exchange for $4,000,000 in cash. The Company recognized $519,230 in stock issuance costs, which was comprised of $505,500 in third party fees and $13,730 in related legal fees. These costs were charged against additional paid in capital.

In October 2003, Arbios Technologies, Inc. entered into a reorganization transaction wherein the stockholders of Arbios Systems retained 1,220,000 shares of the reorganized entity after the transaction. Since Arbios Systems was treated as the acquired company for accounting purposes, those shares were accounted for as being issued as of that date.

In January 2004, Arbios Systems, Inc. issued 40,000 shares of common stock and warrants to purchase 40,000 shares of common stock to a director as compensation for finder's fees. The warrant has a three-year life and is exercisable at $2.50 per share. The warrant grant resulted in a non-cash charge of $16,000 determined utilizing the Black Scholes pricing model and the economic assumptions listed in Note 1, Stock Based Compensation.

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(7) Stockholders' Equity, Continued:

Common Stock

In February 2004, Arbios Systems, Inc. issued 7,500 shares of common stock and a warrant to purchase 7,500 shares of common stock to a son of a director as compensation for finder's fees. The warrant has a three-year life and is exercisable at $2.50 per share. The warrant grant resulted in a non-cash charge of $11,000 determined utilizing the Black Scholes pricing model and the economic assumptions listed in Note 1, Stock Based Compensation.

In March 2004, Arbios Systems, Inc. entered into a retainer agreement with an investor relations firm and issued a warrant to purchase 150,000 shares of common stock as compensation. The warrant has a five year life and is exercisable at $3.40 per share. Pursuant to the terms of the warrant, the number of shares that can be purchased under the warrant was reduced in December 2004 to 75,000 shares. The warrant grant resulted in a non-cash charge of $203,000 determined utilizing the Black Scholes pricing model and the economic assumptions listed in Note 1, Stock Based Compensation.

In July 2004, Arbios Systems, Inc. entered into an agreement with an investor relations firm based in Switzerland to perform investor relation services for the Company in Europe. The Company issued two warrants to purchase an aggregate of 100,000 shares of common stock. The first warrant for 50,000 shares vested immediately with an exercise price of $1.50 per share and has a five-year expiration term. The second warrant for 50,000 shares vested ratably each month over one year with an exercise price of $3.50 per share and has a five-year expiration term. The warrant grants resulted in a non-cash charge of $298,000 determined utilizing the Black Scholes pricing model and the economic assumptions listed in Note 1, Stock Based Compensation.

In October 2004, an option holder exercised his option to purchase 18,000 shares of common stock at an exercise price of $0.15 per share.

In January 2005, the Company completed a $6,611,905 private equity financing to a group of institutional investors and accredited investors. In the offering, 2,991,812 shares of the Company's common stock was sold, at a price of $2.21 per share and the investors also received warrants to purchase an additional 1,495,906 shares of our common stock at an exercise price of $2.90 per share. The warrants are exercisable for five years and can be redeemed by the Company after January 11, 2007 if the average trading price of our common stock for 20 consecutive trading days is equal to or greater than $5.80 and the average trading volume of the common stock is at least 100,000 shares during those 20 days. The placement agent in the offering was issued warrants to purchase 114,404 shares of common stock.

On March 6, 2006, we completed a $1,350,000 private equity financing to a group of institutional investors and accredited investors. In the offering, we sold 1,227,272 shares of our common stock at a price of $1.10 per share to the investors and issued to them warrants to purchase an additional 613,634 shares of our common stock at an exercise price of $1.50 per share. The warrants are exercisable for a period of five years.

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(7) Stockholders' Equity, Continued:

Common Stock

The Company also entered into a Registration Rights Agreement with the investors in the January 2005 and March 2006 private placements pursuant to which the Company agreed to register and to maintain an effective registration statement for the shares of common stock issued in the private placement and for the common stock to be issued upon the exercise of warrants issued in the transaction. The Registration Rights Agreement provides for liquidated damages of 1.5% of the aggregate purchase price for each 30 day period, with a maximum of eight 30 day periods (12% maximum liquidating damages), if the Company fails to maintain the effectiveness of such registration statement. In accordance with "EITF 00-19: Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" and other authoritative literature, it was determined that the warrants issued in the January 2005 private placement and the Registration Rights Agreement are free standing derivative financial instruments as defined in EITF 00-19. Further, as of the closing date of the private placement, and as of March 31, 2005, June 30, 2005, September 30, 2005, and December 31, 2005, the warrants meet the requirements of equity classification as specified in EITF 00-19 since the maximum amount of liquidating damages was less than the value ascribed to the difference between the fair value of registered versus unregistered common stock.

Restricted Common Stock

In November 2006, the Company granted an aggregate of 89,845 shares of restricted stock to members of the Company's Board of Directors in lieu of cash compensation for services rendered during the second half of FY 2006. The restricted stock grants vest 100% on June 30, 2007 and had a market price of $0.64 per share on the date of grant.

Warrants

In February 2005 the Company issued a warrant to purchase 200,000 shares of our common stock to an advisor as additional compensation for services rendered to us during the past 15 months. The warrant has a term of five years and an exercise price of $2.90 per share (the closing trading price of our common stock on the OTC Bulletin Board on the date of grant). The warrant was issued pursuant to an exemption available under Section 4(2) of the Securities Act.

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(7) Stockholders' Equity, Continued:

Warrants

In March 2005, a warrant holder exercised his option to purchase 25,000 shares of common stock at an exercise price of $2.50 per share.

On September 28, 2006 the Company amended outstanding warrants to purchase an aggregate of 1,300,000 shares of common stock of the Company at exercise prices ranging from $1.00 to $2.50 (the "Warrants"). The Warrants were originally issued to investors in 2003 in connection with certain financing transactions and were scheduled to expire on either September 30, 2006 or October 23, 2006. The amendment extends the expiration date of the Warrants until February 15, 2007. The value of the extension of the warrants was calculated using a Black Scholes valuation and resulted in a charge of $103,000 which was booked to our income statement during the third quarter of FY 2006.

On October 29, 2006 the Company amended outstanding warrants to purchase an aggregate of 4,375,000 shares of common stock of the Company, each of which has an exercise price of $2.50 (the "Warrants"). The Warrants were originally issued to investors in 2003 in connection with certain financing transactions. Warrants to purchase 3,975,000 shares of common stock were scheduled to expire on October 29, 2006 and 400,000 of the Warrants are scheduled to expire on February 15, 2007. The amendment extends the expiration date of the Warrants until October 29, 2008. The value of the extension of the warrants was calculated using a Black Scholes valuation and resulted in a charge of $380,000 which was booked to our income statement during the fourth quarter of FY 2006.

In addition, the Warrants contain a call provision whereby the Company can require the holders of the Warrants to exercise them if the market trading price of the Company's common stock trades at a level of at least $4.00 per share for 20 consecutive trading days (the "Call Provision"). In addition to amending the expiration date of the Warrants as described in the preceding paragraphs, the Company amended the Call Provision by lowering the trading price at which the Call Provision may be triggered from $4.00 per share to $3.25 per share.

In accordance with "EITF 00-19: Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19") and other authoritative literature, it was determined that the warrants issued in the January 2005 and March 2006 private placements and the related registration rights agreements, discussed below, are free standing derivative financial instruments as defined in EITF 00-19. In accordance with EITF 00-19, the value and balance sheet classification of the warrants are reviewed each reporting period and, while the warrants are classified as a liability, any changes in the value of the warrants on a re-measurement date will be recorded in the statement of operations.

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(7) Stockholders' Equity, Continued:

Warrants

On March 6, 2006, the Company completed a $1,350,000 private equity financing to a group of institutional investors and an accredited investor. In the offering, the Company sold 1,227,272 shares of its common stock at a price of $1.10 per share to the investors and issued to them warrants to purchase an additional 613,634 shares of its common stock at an exercise price of $1.50 per share. The Company also entered into a Registration Rights Agreement with the investors in the March 2006 private placement pursuant to which the Company agreed to register and to maintain an effective registration statement for the shares of common stock issued in the private placement and for the common stock to be issued upon the exercise of warrants issued in the transaction.

In January 2005, the Company completed a $6,611,905 private equity financing to a group of institutional investors and accredited investors. In the offering, 2,991,812 shares of the Company's common stock were sold, at a price of $2.21 per share and the investors also received 5-year warrants to purchase an additional 1,495,906 shares of our common stock at an exercise price of $2.90 per share. The placement agent received 5-year warrants to purchase 114,404 shares of the Company's common stock in addition to cash compensation of $253,000 plus expenses. The Company also entered into a Registration Rights Agreement with the investors in the January 2005 private placement pursuant to which the Company agreed to register and to maintain an effective registration statement for the shares of common stock issued in the private placement and for the common stock to be issued upon exercise of warrants issued in the transaction. As a result of the Company's March 6, 2006 private equity financing discussed above, an anti-dilution provision from the January 2005 private equity financing was triggered which resulted in an additional 94,033 warrant shares being issuable to warrant holders from the January 2005 private equity financing. Additionally, the exercise price was adjusted from $2.90 to $2.74 per share. The warrants are exercisable for five years from the date of issuance and can be redeemed by the Company after January 11, 2007 if the average trading price of the Company's common stock for 20 consecutive trading days is equal to or greater than $5.80 and the average trading volume of the common stock is at least 100,000 shares during those 20 days.

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(7) Stockholders' Equity, Continued:

Warrants

The registration rights agreement associated with the January 2005 and March 2006 private placements provides for liquidated damages of 1.5% of the aggregate purchase price for each 30 day period for a maximum of eight 30 day periods, capped at 12%, if the Company failed to register such shares, or fails to warrant shares or maintain the effectiveness of such registration. As of the date the warrants were issued and for each subsequent reporting period through December 31, 2005, the Company determined that settlement in unregistered shares was an economic settlement alternative to delivering unregistered shares and consequently recorded the fair value of the warrants as equity. However, as of March 31, 2006 for the January 2005 private placement financing and as of September 30, 2006 for the March 2006 private placement, due primarily to a reduction in the fair market value of the Company's common stock share price, the potential liquidated damages exceeded the reasonable discount between registered and unregistered shares thereby making the settlement alternative uneconomic, and the warrants, valued at $1,285,000 were reclassified from equity to accrued warrant liability, based on the fair value of the warrants. For the quarters ended June 30, September 30 and December 31, 2006, the potential liquidated damages continued to exceed a reasonable discount between the fair value of the registered and unregistered shares, thereby making net share settlement an uneconomic alternative. The accrued warrant liability has been reduced by $521,000 based on the change in the fair value of the warrant liability. The fair value of the warrant liability at December 31, 2006 was $764,000.

The warrants were valued using a Black Scholes option pricing model. Furthermore, the warrant agreements from the January 2005 and March 2006 financings contain anti-dilution provisions whereby in the event that, during the five year life of the warrants, the Company issues additional shares of common stock, subject to certain exceptions, at a lower common stock offering price than the then effective exercise price of the warrants, 1) the exercise price of the warrants would be adjusted downward based on a weighted average formula described in the agreement and 2)additional warrant shares would be allocated to the warrant holder based on the described formula. Such potential changes in exercise price and additional warrant shares were taken into account in the valuation of the anti-dilution provision based on the estimated potential dilutive effects of future successive equity financings including consideration of potential cash requirements, potential size, timing and terms of such financings, projected future prices and volatility of the Company's stock, and other factors. The value of those estimated warrant shares issuable, together with the adjusted value of the estimated warrant shares with reduced exercise price, were determined using the Black Scholes option pricing model.

For the valuation of all warrants including their anti-dilution provisions, the assumptions used in the applications of the Black Scholes option pricing model are as follows: risk free interest rate 3.71%-5.07%, stock price volatility 0.71-0.83, expected life 1-5 years, dividend yield 0%.

At December 31, 2006, outstanding warrants to acquire shares of the Company's common stock are as follows:

Number of Shares	Exercise Price	Expiration date
100,000	$ 0.15	August 18, 2009
900,000	1.00	

		February 15, 2007
50,000	1.00	July 3, 2008
4,375,000	2.50	October 29, 2008
47,500	2.50	January 5, 2007
75,000	3.40	April 1, 2009
50,000	1.50	August 4, 2009
50,000	3.50	August 4, 2009
200,000	2.90	February 1, 2010
1,704,343	2.74	January 11, 2010
613,634	1.50	March 6, 2011
8,165,477		

The weighted average exercise price of warrants outstanding at December 31, 2006 was $2.29 and the weighted average remaining contractual life of the warrants was 2.11 years.

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(7) Stockholders' Equity, Continued:

Warrant transactions are summarized as follows:

	For the year ended December 31,					
	2006			2005		
	Shares		Weighted Average Price	Shares		Weighted Average Price
Warrants at beginning of year	7,457,810	$	2.30	5,672,500	$	2.11
Warrants issued	707,667	$	1.66	1,810,310	$	2.90
Warrants exercised				(25,000)	$	2.50
Warrants forfeited						
Warrants at end of year [2]	8,165,477	$	2.29[1]	7,457,810	$	2.30

[1] Amount reflects adjusted exercise price for certain warrants due to antidulition provision discussed above.

[2] All warrants are exercisable at 12/31/06

2001 Stock Option Plan

In 2001, Arbios Systems, Inc. adopted the 2001 Stock Option Plan (the "2001 Plan") for the purpose of granting incentive stock options and/or non-statutory stock options to employees, consultants, directors and others. Under the 2001 Plan, the Company is authorized to grant options to purchase up to 1,000,000 shares. The 2001 Plan is administered by the Board of Directors of the Company or by a committee of the Board. However, in connection with the reorganization transaction between Arbios Systems and Arbios Technologies, Inc. in October 2003, Arbios Systems assumed all of the 314,000 outstanding options granted by Arbios Technologies, Inc. under its existing stock option plan and the options previously issued under that plan were cancelled. None of the terms of the assumed options were changed. The options assumed under the Company Plan are identical to the options that were previously granted under the Arbios Technologies, Inc. Plan.

2005 Stock Incentive Plan

In 2005, Arbios Systems, Inc. adopted the 2005 Stock Incentive Plan (the "2005 Plan") for the purpose of granting incentive stock options and/or non-statutory stock options to employees, consultants, directors and others. Under the 2005 Plan, the Company is authorized to grant options to purchase up to 3,000,000 shares. The Company Plan is administered by the Board of Directors of the Company or by a committee of the Board.

For the years ended December 31, 2006 and 2005, the Company granted 30,000 and 60,000 options, respectively, to consultants and recorded expenses of $33,000 and $58,000 for the years ended December 31, 2006 and 2005 relating to the vested portion of these options.

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FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(7) Stockholders' Equity, Continued:

Stock Options (Continued)

Transactions under the 2001 Plan during the year ended December 31, 2006 and 2005 are summarized as follows:

	For the year ended December 31,					
	2006			2005		
	Shares		Weighted Average Price	Shares		Weighted Average Price
Options at beginning of year	982,000	$	1.88	731,000	$	1.79
Options issued				266,000	$	2.12
Options exercised						
Options forfeited	-			(15,000)	$	2.25
Options at end of year	982,000	$	1.88	982,000	$	1.88
Options exercisable at end of year	978,000	$	1.87	935,000	$	1.87

As of December 31, 2006, no options were available for future grant under the 2001 Stock Option Plan.

Transactions under the 2005 Plan during the year ended December 31, 2006 and 2005 are summarized as follows:

	For the year ended December 31, 2006			For the year ended December 31, 2005		
	Shares		Weighted Average Price	Shares		Weighted Average Price
Options at beginning of year	905,000	$	1.98	-		-
Options issued	432,000	$	1.25	910,000	$	1.98
Options exercised						
Options forfeited				(5,000)	$	1.80
Options at end of year	1,337,000	$	1.75	905,000	$	1.98
Options exercisable at end of year	1,003,000	$	1.83	284,000	$	2.17

As of December 31, 2006, 1,251,000 options were available for future grant under the 2005 Stock Option Plan.

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(7) Stockholders' Equity, Continued:

Stock Options (Continued)

Additional information with respect to option activity is summarized as follows:

	December 31, 2006				
	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares	Weighted Average Remaining Contractually (in years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
$0.15 - $0.90	276,000	6.45	$ 0.73	154,000	$ 0.63
$1.00 - $1.85	1,327,000	3.77	1.59	1,111,000	1.54
$2.00 - $2.97	706,000	4.51	2.59	706,000	2.59
$3.40	10,000	2.32	3.40	10,000	3.40
	2,319,000	4.31	1.80	1,981,000	1.85

The following summarizes the activity of the Company's non-vested stock options for the year ended December 31, 2006.

	Shares	Weighted Average Exercise Price
Non vested at December 31, 2005	668,000	$ 1.89
Granted	432,000	1.25
Vested	(763,000)	1.71
Non vested at December 31, 2006	337,000	$ 1.48

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FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(8) Research Costs:

On December 26, 2001, the Company received a commitment for research costs in the amount of $550,000 from Spectrum Laboratories, Inc. ("Spectrum"), partially in exchange for 362,669 shares of common stock (See Note 6). Spectrum was required to expend at least $137,500 per year toward the development of the Company's liver-assist devices.

In July 2002, the original agreement was amended. The Company and Spectrum agreed that, since the prototype system had been delivered early, all 362,669 shares issued to Spectrum on December 26, 2001, were deemed fully vested and any future obligations related to the $550,000 research cost commitment was deemed fulfilled. In addition, any additional research and development work requested from Spectrum by the Company and the cost of such work will be negotiated in good faith before the work is initiated. Furthermore, the Company agreed that billings of $109,360, through September 29, 2002, were due for research costs already provided, in addition to the $550,000 obligation. This amount was reduced by $54,400 in payment for the 362,669 shares previously received, and the Company paid the balance of $54,960 to Spectrum in cash in monthly payments over an 18-month period starting November 1, 2002. As of May 1, 2004, the Company has fulfilled its obligation to pay the $54,960 cash payment to Spectrum.

(9) Income Taxes:

The following table presents the current and deferred tax provision for (benefit from) federal and state income taxes for the years ended December 31, 2006 and 2005:

	2006	2005
Current		
Federal	-	-
State	-	_
Total Current Liability	-	-
Deferred		
Federal	($1,430,000)	($1,010,000)
State	($488,000)	($289,000)
Total Deferred Liability	($1,918,000)	($1,299,000)
Valuation Allowance	$ 1,918,000	$ 1,299,000
Total	-	-

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(9) Income Taxes, continued:

At December 31, 2006, components of net deferred tax assets (liabilities) in the accompanying balance sheet include the following amounts of deferred tax liabilities:

	2006	2005
Deferred Tax Assets (Liability)		
Current		
Interest	$ 105,000	$ 105,000
Intangible	$ 194,000	$ 193,000
NOL	$ 4,439,000	$ 2,706,000
Deferred state tax	($377,000)	($211,000)
Stock options	$ 276,000	-
Credits	$ 150,000	-
Other	$ 76,000	$ 103,000
Non-Current		
Amortization	($92,000)	($66,000)
Depreciation	($15,000)	$ 8,000
Net Deferred Tax Assets	$ 4,756,000	$ 2,838,000
Less Valuation Allowance	($4,756,000)	($2,838,000)
Net Deferred Tax Asset (Liability)	-	-

As of December 31, 2006, the Company has approximately $10,342,000 and $10,241,000 of Net Operating Losses (“NOL”) for federal and state purposes which begin to expire between 2022 and 2025 for federal and 2012 and 2015 for state purposes respectively. The utilization of NOL carryforwards may be limited under the provisions of Internal Revenue Code Section 382 and similar state provisions.

Section 382 of the Internal Revenue Code of 1986 generally imposes an annual limitation on the amount of NOL carryforwards that may be used to offset taxable income where a corporation has undergone significant changes in its stock ownership.

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(9) Income Taxes, continued:

The income tax expense differs from the amounts computed by applying the United States federal income tax rate of 34% to income taxes as a result of the following for the years ended December 31, 2006 and 2005:

	2006	2005
Federal tax on pretax income at statutory rates	($1,459,000)	($1,300,000)
State tax, net of federal benefit	($327,000)	($191,000)
Other	($131,000)	$ 192,000
Valuation Allowance	$ 1,917,000	$ 1,299,000
Total	-	-

(10) Related Party Transactions:

In 2001, the Company received the exclusive worldwide rights and a license to use certain proprietary rights from Spectrum Laboratories, Inc. (“Spectrum”), partially in exchange for 362,669 shares of common stock. The Chairman of the Board of Spectrum (“Spectrum Chairman”) is one of the majority stockholders of Spectrum Laboratories, Inc. and was previously a Director of the Company. In 2002, the Spectrum Chairman received stock options to purchase 18,000 shares of common stock at an exercise price of $0.15 per share as compensation as a Director of the Company. In 2003, the Spectrum Chairman received stock options to purchase 18,000 shares of common stock at an exercise price of $1.00 per share as compensation as a Director of the Company. In 2004, the Spectrum Chairman received options to purchase 30,000 shares of common stock at an exercise price of $2.25 per share as compensation as a Director of the Company. In 2005, the Spectrum Chairman received options to purchase 15,000 shares of common stock at an exercise price of $2.48 per share as compensation as a Director of the Company.

In 2003, a Director received warrants to purchase 50,000 shares of common stock exercisable at $1 per share as a finder’s fee.

In 2004, the son of a Director received 7,500 shares of common stock valued at $1 per share and warrants to purchase 7,500 shares of common stock exercisable at $2.50 per share as a finder’s fee.

In 2004, a Director received common stock valued at $1.00 per share and warrants to purchase 40,000 shares of common stock exercisable at $2.50 per share as a finder’s fee.

In 2005, a Director received cash compensation totaling $23,687 and a 5 year option to purchase 30,000 shares of common stock at $1.80 per share for consulting services.

There were no related party transactions during fiscal year 2006.

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NOTES TO FINANCIAL STATEMENTS

FOR THE YEARS ENDED DECEMBER 31, 2006 AND 2005

(11) Employee Benefit Plan:

In May 2005, the Company adopted a 401-K defined contribution profit-sharing plan covering its employees. Contributions to the plan are based on employer contributions as determined by the Company and allowable discretionary contributions, as determined by the Company's Board of Directors, subject to certain limitations. Contributions by the Company to this plan amounted to $27,331 and $10,924 for the years ended December 31, 2006 and 2005.

(12) Subsequent Events:

In March, 2007, the Company in-licensed a family of U.S. patents plus foreign counterparts and pending patent applications, and certain related trade secrets. The issued patents include broad claims for methods of treating liver failure, multi-organ failure, multi-organ dysfunction syndrome, sepsis, septic shock, systemic inflammatory response syndrome, and related inflammatory disorders by selective blood filtration. The patents and applications relate to the use of blood filtration devices which remove, from the blood of patients with the above disease conditions, a broad spectrum of inflammatory and other disease mediators ranging from small molecules through intermediate size blood proteins with molecular weights up to the size of beneficial immunoglobulins. The patents and/or applications also relate to the combined use of replacement fluids including human serum albumin or combined uses of secondary selective plasma adsorption devices and/or certain classes of anti-inflammatory therapeutic drugs, and to apparatus suitable for the above uses.

Included in this in-licensed family are five issued U.S. patents, four pending U.S. patents, and two pending European patents. The Company will owe royalties on net sales of products which are covered by the license, including potentially the SEPET™ Liver Assist Device, ranging from low- to mid-single digit percentages of net sales. The Company will also owe maintenance fees and certain other minimum spending obligations under the license and may owe contingent milestone fees. The fixed obligations under the license will total less than $500,000 over the next 4 years, a portion of which includes spending on future product development possibly leading to future sales revenues for Arbios. The contingent obligations under the license will total less than $500,000 over approximately the same period (however dependent on the pace of potential future patent issuances).

In connection with the license, the Company has also issued a warrant to the licensor for 225,000 common shares with an exercise price of $1.50 per share and a 6-year term expiring in March, 2013. The Company is further obligated to issue 50,000 stock options to a medical consultant in July, 2008, at the then fair market price of Arbios common stock, with a reasonable vesting term to be defined by Arbios.

ARBIOS SYSTEMS, INC.
(A development stage company)
CONDENSED BALANCE SHEETS

	March 31, 2007 (Unaudited)	December 31, 2006 (Audited)
ASSETS		
Current assets		
Cash and cash equivalents	$ 1,344,817	$ 2,054,280
Prepaid expenses	105,300	147,163
Total current assets	1,450,117	2,201,443
Net property and equipment	66,256	73,110
Patent rights, net of accumulated amortization of $119,014 and $113,894, respectively	147,653	152,773
Other assets	50,818	62,827
Total assets	$ 1,714,844	$ 2,490,153
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 446,933	$ 310,162
Accrued expenses	550,941	132,073
Total current liabilities	997,874	442,235
Long term contract obligations	250,000	-
Accrued warrant liability	-	763,654
Total liabilities	1,247,874	1,205,889
Stockholders' equity		
Preferred stock, $.001 par value; 5,000,000 shares authorized: none issued and outstanding	-	-
Common stock, $.001 par value; 60,000,000 shares authorized; 17,460,181 shares issued and outstanding at March 31, 2007 and December 31, 2006	17,460	17,460
Additional paid-in capital	16,080,301	14,507,939
Deficit accumulated during the development stage	(15,630,791)	(13,241,135)
Total stockholders' equity	466,970	1,284,264
Total liabilities and stockholders' equity	$ 1,714,844	$ 2,490,153

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A development stage company)
CONDENSED STATEMENTS OF OPERATIONS
(Unaudited)

	For the three months ended March 31, 2007	2006	Inception to March 31, 2007
Revenues	$ -	$ -	$ 320,966
Operating expenses:			
General and administrative	675,831	744,064	8,997,920
Research and development	1,030,993	366,190	6,844,169
Total operating expenses	1,706,824	1,110,254	15,842,089
Loss before other income (expense)	(1,706,824)	(1,110,254)	(15,521,123)
Other income (expense):			
Change in fair value of warrant liability	-	-	521,187
Equity offering contingency	(180,000)	-	(180,000)
Interest income	18,355	40,786	314,470
Interest expense	-	-	(244,138)
Total other income (expense)	(161,645)	40,786	411,519
Net loss	$ (1,868,469)	$ (1,069,468)	$ (15,109,604)
Net loss per share:			
Basic and diluted	$ (0.11)	$ (0.06)	
Weighted-average shares:			
Basic and diluted	17,460,181	16,587,454	

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A development stage company)
CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	For the three months ended March 31, 2007	2006 (Restated)	Inception to March 31, 2007
Cash flows from operating activities:			
Net loss	$ (1,868,469)	$ (1,069,468)	$ (15,109,604)
Adjustments to reconcile net loss to net cash used in operating activities:			
Amortization of debt discount	-	-	244,795
Depreciation and amortization	11,974	12,651	264,193
Change in fair value of warrant liability	-	-	(521,187)
Patent rights impairment	-	-	91,694
Interest earned on discounted short term investments	-	8,406	-
Issuance of common stock, options and warrants for compensation	212,951	210,739	3,012,885
Insurance of warrant for patent acquisition	74,570		74,570
Settlement of accrued expense	-	-	54,401
Deferred compensation costs	-	-	319,553
Changes in operating assets and liabilities:			
Prepaid expenses	41,863	43,348	(105,302)
Other assets	12,009	4,987	(50,818)
Accounts payable and accrued expenses	555,639	(24,758)	904,372
Other liabilities	-	-	64,695
Contractual obligation	250,000	-	250,000
Net cash provided by operating activities	(709,463)	(814,095)	(10,505,753)
Cash flows from investing activities:			
Additions of property and equipment	-	(3,447)	(144,796)
Purchase of short term investments	-	(5,954,653)	(21,866,787)
Maturities of short term investments	-	4,965,947	21,866,787
Net cash provided by and (used in) investing activities	-	(992,153)	(144,796)
Cash flows from financing activities:			
Proceeds from issuance of convertible debt	-	-	400,000
Proceeds from common stock option/warrant exercise	-	-	65,200
Net proceeds from issuance of common stock and warrants	-	1,310,092	11,313,249
Net proceeds from issuance of preferred stock	-	-	238,732
Payments on capital lease obligation, net	-	-	(21,815)
Net cash provided by financing activities	-	1,310,092	11,995,366
Net (decrease) increase in cash	(709,463)	(496,156)	1,344,817
Cash at beginning of period	2,054,280	2,379,738	-

Cash at end of period	$	1,344,817	$	1,883,582	$	1,344,817
Supplemental disclosures of non-cash financing activity						
Issuance of securities for obligation related to finder's fees		-		-	$	47,500
Accrued warrant liability	$	-	$	951,841	$	1,284,841

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO MARCH 31, 2007
(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Deferred Costs	Deficit Accumulated During the Development Stage	Total
Balance, August 23, 2000 (inception) restated for effect of reverse merger with Historical Autographs U.S.A. Inc.			-	$ -	$ -			$ -
Stock issuance in exchange for cash			5,000,000	50	4,950			5,000
Net loss							(9,454)	(9,454)
Balance, December 31, 2000, as restated	-	-	5,000,000	50	4,950	-	(9,454)	(4,454)
Issuance of junior preferred stock for cash of $250,000 and in exchange for $400,000 in patent rights, research and development costs, and employee loanout costs less issuance expenses of $11,268, June 29, 2001	681,818	7			958,278	(343,553)		614,732
Issuance of common stock in exchange for patent rights and deferred research and development costs			362,669	4	547,284			547,288

Services receivable						(550,000)		(550,000)
Deferred employee loan-out costs receivable earned						82,888		82,888
Net loss							(237,574)	(237,574)
Balance, December 31, 2001	681,818	7	5,362,669	54	1,510,512	(810,665)	(247,028)	452,880

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO MARCH 31, 2007
(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Deferred Costs	Deficit Accumulated During the Development Stage	Total
Amendment of December 31, 2001 agreement for the issuance of common stock agreement in exchange for research and development services					(495,599)	550,000		54,401
Deferred employee loan out costs receivable earned						171,776		171,776
Issuance of common stock for compensation			70,000	1	10,499			10,500
Issuance of common stock for cash			999,111	9	149,857			149,866
Net loss							(494,780)	(494,780)
Balance, December 31, 2002	681,818	7	6,431,780	64	1,175,269	(88,889)	(741,808)	344,643
Issuance of common stock for cash less issuance expense of $2,956			417,000	417	246,827			247,244
Issuance of common stock in private placement for cash less issuance expense of $519,230			4,000,000	4,000	3,476,770			3,480,770

Issuance of common stock for convertible debenture less issuance expense of $49,500	400,000	400	350,100	350,500
Shares issued in connection with acquisition of Historical Autographs U.S.A., Inc. on October 30, 2003	1,220,000	8,263	(8,263)	-

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO MARCH 31, 2007
(Unaudited)

	Preferred Stock Shares	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Deferred Costs	Deficit Accumulated During the Development Stage	Total
Value of warrants and beneficial conversion feature of bridge loan					244,795			244,795
Deferred employee loan-out costs receivable earned						88,889		88,889
Preferred Stock converted to Common Stock	(681,818)	(7)	681,818	7				
Net loss							(885,693)	(885,693)
Balance, December 31, 2003	-	-	13,150,598	13,151	5,485,498	-	(1,627,501)	3,871,148
Issuance of common stock options and warrants for compensation					972,430			972,430
Exercise of common stock options			18,000	18	2,682			2,700
Issuance of securities for payable			47,499	47	47,451			47,498
Net loss							(3,327,827)	(3,327,827)
Balance, December 31, 2004	-	-	13,216,097	13,216	6,508,061	-	(4,955,328)	1,565,949
Issuance of common stock in private								

placement for cash less issuance expense of $384,312	2,991,812	2,992	6,224,601	6,227,593
Issuance of common stock options and warrants for compensation			557,080	557,080
Exercise of common stock options	25,000	25	62,475	62,500

The accompanying notes are an integral part of these condensed financial statements.

ARBIOS SYSTEMS, INC.
(A Development Stage Company)
CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
PERIOD FROM AUGUST 23, 2000 (INCEPTION) TO MARCH 31, 2007
(Unaudited)

	Preferred Stock		Common Stock		Additional Paid-In	Deferred	Accumulated During the Development	
	Shares	Amount	Shares	Amount	Capital	Costs	Stage	Total
Net loss							(3,823,903)	(3,823,903)
Balance, December 31, 2005	-	-	16,232,909	$ 16,233	$ 13,352,217	-	($8,779,231)	$ 4,589,219
Issuance of common stock in private placement for cash less issuance expense of $95,013			1,227,272	1,227	1,253,760			1,254,987
Issuance of common stock options and warrants for compensation					703,839			703,839
Stock warrant term extension			-		482,964			482,964
Warrant liability					(1,284,841)			(1,284,841)
Net loss							(4,461,904)	(4,461,904)
Balance, December 31, 2006	-	-	17,460,181	$ 17,460	$ 14,507,939	-	($13,241,135)	$ 1,284,264
Cumulative effect of change in accounting principle:								
Adjust retained earnings at January 1, 2007 for change in accounting principle							(521,187)	(521,187)
Reclassification of warrants					1,284,841			1,284,841
Issuance of common stock, options and warrants for compensation					153,926			153,926

Stock warrant term extension			-		59,025			59,025
Insurance of warrant for patent acquisition					74,570			74,570
Net loss							(1,868,469)	(1,868,469)
Balance, March 31, 2007	-	-	17,460,181	$ 17,460	$ 16,080,301	-	($15,630,791)	$ 466,970

The accompanying notes are an integral part of these condensed financial statements.

Arbios Systems, Inc. (A Development Stage Company)
Notes to Condensed Financial Statements (Unaudited)
Three Months Ended March 31, 2007

(1) Basis of Presentation:

Arbios Systems, Inc., a Delaware corporation (the “Company”), seeks to develop, manufacture and market liver assist devices to meet the urgent need for therapy of liver failure. On July 25, 2005, Arbios Systems, Inc. changed its state of incorporation from Nevada to Delaware. On July 26, 2005, Arbios Technologies, Inc., the wholly-owned subsidiary of Arbios Systems, Inc., merged with and into Arbios Systems, Inc. Unless the context indicates otherwise, references herein to the “Company” during periods prior to July 26, 2005 include both Arbios Systems, Inc., a Nevada corporation and Arbios Technologies, Inc.

On October 30, 2003, Historical Autographs U.S.A., Inc. and Arbios Technologies, Inc. consummated a reverse merger, in which Arbios Technologies, Inc. became the wholly owned subsidiary of Historical Autographs U.S.A., Inc. Concurrently with the merger, Historical Autographs U.S.A., Inc. changed its named to Arbios Systems, Inc. and is herein referred to as “Arbios Systems”. The stockholders of Arbios Technologies, Inc. transferred ownership of one hundred percent of all the issued and outstanding shares of their capital stock of Arbios Technologies, Inc. in exchange for 11,930,598 newly issued shares, or approximately 91%, of the common stock, $.001 par value, of Arbios Systems. At that time, the former management of Arbios Systems resigned and was replaced by the same persons who served as officers and directors of Arbios Technologies, Inc. The former owners of Arbios Technologies, Inc. controlled the combined entity after the merger, and the combination was accounted for as a purchase by Arbios Technologies, Inc. as the acquirer, for accounting purposes in accordance with Statement of Financial Accounting Standards No. 141: Business combinations, using reverse merger accounting, and no adjustments to the carrying values of the assets or liabilities of the acquired entity were required. Pro forma operating results, as if the acquisition had taken place at the beginning of the period, have not been presented as the operations of the acquiree were negligible. The financial position and results of operations of Arbios Systems are included in the statements of the Company from the date of acquisition.

The unaudited condensed financial statements and notes are presented as permitted by Form 10-QSB. These unaudited financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures, normally included in financial statements prepared in accordance with generally accepted accounting principles, have been omitted pursuant to such SEC rules and regulations. In the opinion of the management of the Company, the accompanying unaudited financial statements include all adjustments, including those that are normal and recurring considered necessary to present fairly the financial position as of March 31, 2007, and the results of operations for the period presented. These condensed financial statements should be read in conjunction with the Company's audited financial statements and the accompanying notes included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2006 filed with the SEC. The Company’s operating results will fluctuate for the foreseeable future. Therefore, period-to-period comparisons should not be relied upon as predictive of the results in future periods. The results of operations for the period ended March 31, 2007 are not necessarily indicative of the results to be expected for any subsequent periods or for the entire fiscal year. As of the date of the filing of the Company’s Quarterly Report on Form 10-QSB for the quarter ended March 31, 2007, the Company estimates that it has cash to operate for at least the next twelve months, based in part upon the private placement on April 23, 2007 which raised gross proceeds of $4,861,000 reduced by estimated fund raising costs of $400,000 resulting in estimated net proceeds of $4,461,000.

(2) Restatement of Condensed Financial Statements

In January 2005 and March 2006, we closed financing transactions that included the issuance of warrants and the grant of registration rights for securities issued in the transactions. The Company has been accounting for the warrants in accordance with "EITF 00-19: Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" ("EITF 00-19"). Beginning in the quarter ended March 31, 2006 for the warrants issued in the January 2005 financing and in the quarter ended September 30, 2006 for the warrants issued in the March 2006 financing, in accordance with EITF 00-19, the Company recorded the fair value of these warrants as an accrued warrant liability and reduced additional paid-in capital by the amount of the recorded liability. The Company has determined that it should have included in the calculation of the fair value of the warrant the value of the anti-dilution provisions contained in the warrant agreements. The calculations of the fair value of the warrants did not include the value of the anti-dilutions provision for the filed financial statements included in our Quarterly Report Form 10-QSB for the quarter ended March 31, 2006. Therefore, we restated the financial statements for the three month period ended March 31, 2006 to reflect that additional paid in capital decreased by $271,000 and the accrued warrant liability increased by a corresponding amount. The following table shows the net effect of the restatement on net loss, accrued warrant liability and additional paid in capital for the three months ended March 31, 2006.

		Three months ended March 31, 2006
Net loss		
As originally reported	$	(1,069,468)
Adjustment		
As adjusted	$	(1,069,468)
Accrued warrant liability		
As originally reported	$	680,841
Adjustment		271,000
As adjusted	$	951,841
Additional paid-in capital		
As originally reported	$	14,190,980
Adjustment		(271,000)
As adjusted	$	13,919,980

(3) Recent Accounting Pronouncements

None.

(4) Stock-Based Compensation:

In the quarter ended March 31, 2007, the Company granted 120,000 options to directors with exercise prices of $0.51 per share which vest over one year. The fair value of the options was determined using the Black Scholes option pricing model utilizing the following assumptions: risk free interest rate 4.75%, stock price volatility 0.79, expected life 7 years, dividend yield 0%.

In the quarter ended March 31, 2007, the Company granted 82,354 shares of restricted stock to consultants at a price of $0.01 per share. The amount of restricted shares issued was based on the closing price of the Company's common stock on the date of grant.

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A grant of 225,000 warrants to purchase common stock exercisable at $1.50 per share was made in conjunction with the acquisition of certain patents. The warrants were fair valued using the Black Scholes pricing model utilizing the following assumptions: risk free interest rate 4.48%, stock price volatility 0.79, expected life 7 years, dividend yield 0%.

(5) Accrued Warrant Liability

In accordance with EITF 00-19 and other authoritative literature, it was determined that the warrants issued in the January 2005 and March 2006 private placements and the related registration rights agreements, discussed below, are free-standing derivative financial instruments as defined in EITF 00-19. In accordance with EITF 00-19, the value and balance sheet classification of the warrants are reviewed each reporting period and, while the warrants are classified as a liability, any changes in the value of the warrants on a re-measurement date will be recorded in the statement of operations.

On March 6, 2006, the Company completed a $1,350,000 private equity financing to a group of institutional investors and an accredited investor. In the offering, the Company sold 1,227,272 shares of its common stock at a price of $1.10 per share to the investors and issued to them warrants to purchase an additional 613,634 shares of its common stock at an exercise price of $1.50 per share. The Company also entered into a Registration Rights Agreement with the investors in the March 2006 private placement pursuant to which the Company agreed to register and to maintain an effective registration statement for the shares of common stock issued in the private placement and for the common stock to be issued upon the exercise of warrants issued in the transaction.

In January 2005, the Company completed a $6,611,905 private equity financing to a group of institutional investors and accredited investors. In the offering, 2,991,812 shares of the Company's common stock were sold, at a price of $2.21 per share and the investors also received 5-year warrants to purchase an additional 1,495,906 shares of our common stock at an exercise price of $2.90 per share. The placement agent received 5-year warrants to purchase 114,404 shares of the Company's common stock in addition to cash compensation of $253,000 plus expenses. The Company also entered into a Registration Rights Agreement with the investors in the January 2005 private placement pursuant to which the Company agreed to register and to maintain an effective registration statement for the shares of common stock issued in the private placement and for the common stock to be issued upon exercise of warrants issued in the transaction. As a result of the Company's March 6, 2006 private equity financing discussed above, an anti-dilution provision from the January 2005 private equity financing was triggered which resulted in an additional 94,033 warrant shares being issuable to warrant holders from the January 2005 private equity financing. Additionally, the exercise price of the warrants was adjusted from $2.90 to $2.74 per share. The warrants are exercisable for five years from the date of issuance and can be redeemed by the Company after January 11, 2007 if the average trading price of the Company's common stock for 20 consecutive trading days is equal to or greater than $5.80 and the average trading volume of the common stock is at least 100,000 shares during those 20 days.

The registration rights agreements associated with the January 2005 and March 2006 private placements provide for liquidated damages of 1.5% of the aggregate purchase price for each 30 day period for a maximum of eight 30 day periods, capped at 12%, if the Company fails to register such shares, or fails to maintain the effectiveness of such registration. As of the date the warrants were issued and for each subsequent reporting period through December 31, 2005, the Company determined that settlement in unregistered shares was an economic settlement alternative to delivering unregistered shares and consequently recorded the fair value of the warrants as equity. However, as of March 31, 2006 for the January 2005 private placement financing and as of September 30, 2006 for the March 2006 private placement, due primarily to a reduction in the fair market value of the Company's common stock share price, the potential liquidated damages exceeded the reasonable discount between registered and unregistered shares thereby making the settlement alternative uneconomic, and the warrants, valued using the Black Scholes pricing model were reclassified from equity to accrued warrant liability, based on the fair value of the warrants. For the quarters ended June 30, September 30 and December 31, 2006 the potential liquidated damages continued to exceed a reasonable

discount between the fair value of the registered and unregistered shares, thereby making net share settlement an uneconomic alternative.

The warrant agreements from the January 2005 and March 2006 financings contain anti-dilution provisions whereby in the event that, during the five year life of the warrants, the Company issues additional shares of common stock, subject to certain exceptions, at a lower common stock offering price than the then effective exercise price of the warrants, 1) the exercise price of the warrants would be adjusted downward based on a weighted average formula described in the agreement and 2) additional warrant shares would be allocated to the warrant holder based on the described formula. Such potential changes in exercise price and additional warrant shares were taken into account in the valuation of the anti-dilution provision based on the estimated potential dilutive effects of future successive equity financings including consideration of potential cash requirements, potential size, timing and terms of such financings, projected future prices and volatility of the Company's stock, and other factors. The value of those estimated warrant shares issuable, together with the adjusted value of the estimated warrant shares with reduced exercise price, were determined using the Black Scholes pricing model.

For the valuation of all warrants including their anti-dilution provisions, the assumptions used in the applications of the Black Scholes pricing model are as follows: risk free interest rate 3.71%-5.07%, stock price volatility 0.71-0.83, expected life 1-5 years, dividend yield 0%.

In accordance with the Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, or FASB 154, the Company is recording a change in accounting principal related to Financial Accounting Standards Board Staff Position No. Emerging Issues Task Force 00-19-2, "Accounting for Registration Payment Arrangements", ("EITF 00-19-2"). EITF 00-19-2 was issued December 21, 2006 and is effective for fiscal periods beginning after December 15, 2006, and calls for the registration right agreement and any registration rights payments to be considered separately from the financial instruments. In accordance with EITF 00-19-2, the Company has reversed the classification of the warrant liability from debt to equity during the period ended March 31, 2007 as the warrants and registration rights agreement were previously accounted for as a single instrument, and without the consideration of the registration rights payments, the warrants are properly classified as equity in accordance with EITF 00-19. In accordance with Financial Accounting Standards No. 5, Accounting for Contingencies, or FASB, the Company has booked as estimated accrual of $180,000 to the balance sheet to estimate the contingent liability related to the probability of registration rights payments.

(6) Warrant Extension

On February 2, 2007, the Company amended certain terms of outstanding warrants to purchase an aggregate of 907,500 shares of common stock of the Company; 900,000 shares have an exercise price of $1.00 and 7,500 shares have an exercise price of $2.50. The warrants were originally issued in 2003 and 2004 in connection with certain financing transactions and were scheduled to expire in February 2007, the amendments extend the expiration date for warrants to purchase 900,000 shares of common stock with an exercise price of $1.00 until February 15, 2008 and extend the expiration date for the warrants to purchase 7,500 shares of common stock with an exercise price of $2.50 until October 29, 2008. The extension of the warrants was calculated using the Black Scholes option pricing model and resulted in a charge of approximately $59,000, which was recorded to the income statement during the first quarter of FY 2007.

In addition, all of the warrants contain a call provision whereby the Company can require the holders of the warrants to exercise the warrants if the market trading price of the Company's common stock trades at a level of at least $4.00 per share for 20 consecutive trading days (the "Call Provision"). In addition to amending the expiration date of the warrants as described in the preceding paragraph, the Company amended the Call Provision by lowering the trading price at which the Call Provision may be triggered from $4.00 per share to $3.25 per share.

(7) Patent Acquisitions

On March 29, 2007, the Company entered into a license agreement pursuant to which we in-licensed a family of issued U.S. patents and various U.S. and foreign patent applications which include claims for methods of treating liver failure, multi-organ failure, multi-organ dysfunction syndrome, sepsis, septic shock, systemic inflammatory response syndrome, and related inflammatory disorders by selective blood filtration. Included in this in-licensed family are five issued U.S. patents, four pending U.S. patents, and two pending European patents. The license is an exclusive, worldwide license to research, develop, make, import, have made, use, offer for sale, sell and have sold the patented technologies and products employing such technologies. The Company will owe royalties on net sales of products which are covered by the license, including potentially the SEPET™ Liver Assist Device. The Company will also owe maintenance fees, certain other minimum spending obligations and contingent milestone payments under the license. The Company's fixed obligations under the license will total less than $500,000 over the next 4 years. Our contingent obligations under the license will total less than $500,000 over approximately the same period, however, the timing of these contingent obligations will depend on the pace of potential future patent issuances.

In accordance with FASB No. 2, Accounting for Research and Development Costs, the Company has expensed the patent acquisition costs since they do not have alternative future uses.

In connection with this license agreement, the Company issued a warrant to the licensor to acquire up to 225,000 shares of its common stock at a purchase price per share of $1.50. The warrant is immediately exercisable and expires on March 29, 2013. The warrants were valued at $74,570 using the Black Scholes pricing model as discussed in note 4.

(8) Subsequent Event

On April 23, 2007, the Company completed a $4,861,000 private equity financing reduced by estimated fund raising costs of $400,000 resulting in estimated net proceeds of $4,461,000 to a group of current and new accredited investors. In the offering, the Company sold 3,739,231 Units. Each Unit was sold at a price of $1.30 per Unit. Each Unit consists of: 1) two shares of the Company's common stock, 2) one warrant to purchase one share of the Company's common stock exercisable for a period of 2.5 years at an exercise price of $1.00 ("A Warrants") and 3) one warrant to purchase one share of the Company's common stock exercisable for a period of 5 years at an exercise price of $1.40 ("B Warrants"), comprising a total of 7,478,462 shares of the Company's common stock and warrants to purchase 7,478,462 shares of the Company's common stock. The warrants have no provision for cashless exercise and, subject to certain requirements, may be called by the Company provided that the common stock of the Company trades above $1.50 for the A Warrants and above $2.80 for the B Warrants for a specified time period. The Company is obligated to pay to the placement agent, Musket Research Associates: 1) a cash fee of $252,000, 2) a warrant to purchase 576,615 shares of common stock with an exercise price of $0.65 and a term of five years, and 3) a contingent cash fee of 7% of cash proceeds generated in connection with any additional payments, equity purchases or warrant exercises originating from investors from the April 2007 financing within 12 months of the closing of the financing. As a result of the April 2007 financing and pursuant to certain anti-dilution terms of the Company's prior equity financings, the Company adjusted upwards the number of shares issuable under the warrants issued in the 2005 and 2006 financing by approximately 702,000 shares.