

EDEN BIOSCIENCE CORP  
Form 10-Q  
August 10, 2007

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

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2007**

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the transition period from to \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number 0-31499**

**Eden Bioscience Corporation**

(Exact name of registrant as specified in its charter)

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**91-1649604**  
(IRS Employer Identification No.)

**11816 North Creek Parkway N.  
Bothell, Washington 98011-8201**  
(Address of principal executive offices, including zip code)

**(425) 806-7300**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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

State the number of shares outstanding of each of the registrant's classes of common equity, as of the latest practicable date:

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Class  
Common Stock, \$.0025 Par Value

Outstanding as of August 10, 2007  
8,149,554

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Eden Bioscience Corporation

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## Item 1. Unaudited Financial Statements

## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

## ASSETS

	June 30, 2007	December 31, 2006
Current assets:		
Cash and cash equivalents	\$ 6,004,702	\$ 4,185,225
Accounts receivable, net of sales allowances	26,784	186,175
Note receivable	204,493	
Inventory, current	85,597	2,284,300
Prepaid expenses and other current assets	100,459	289,892
Total current assets	6,422,035	6,945,592
Inventory, non-current	39,612	41,758
Property and equipment, net	99	698,061
Other assets	85,991	287,879
Total assets	\$ 6,547,737	\$ 7,973,290

## LIABILITIES AND SHAREHOLDERS EQUITY

Current liabilities:		
Accounts payable	\$ 143,329	\$ 279,224
Accrued liabilities	150,689	528,284
Total current liabilities	294,018	807,508
Other long-term liabilities		456,722
Total liabilities	294,018	1,264,230
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$.01 par value, 10,000,000 shares authorized; no shares issued and outstanding at June 30, 2007 and December 31, 2006		
Common stock, \$.0025 par value, 33,333,333 shares authorized; 8,149,554 issued and outstanding shares at June 30, 2007 and December 31, 2006	20,374	20,374
Additional paid-in capital	132,860,628	132,849,727
Accumulated other comprehensive income		91,896
Accumulated deficit	(126,627,283)	(126,252,937)
Total shareholders' equity	6,253,719	6,709,060
Total liabilities and shareholders' equity	\$ 6,547,737	\$ 7,973,290

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

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Product sales, net of sales allowances	\$ 83,127	\$ 1,760,040	\$ 271,899	\$ 3,408,427
Operating expenses:				
Cost of goods sold	15,093	839,572	138,335	1,855,052
Research and development		372,937	136,442	689,475
Selling, general and administrative	233,718	1,379,502	633,500	2,938,288
Loss on impairment of equipment and leasehold improvements		4,880,516		4,880,516
Gain on sale of equipment		(26,979)		(44,557)
Total operating expenses	248,811	7,445,548	908,277	10,318,774
Loss from operations	(165,684)	(5,685,508)	(636,378)	(6,910,347)
Other income:				
Gain on sale of Harpin Protein Technology			113,968	
Gain on sale of investment				99,884
Interest income	84,103	55,558	148,064	116,672
Total other income	84,103	55,558	262,032	216,556
Loss before income taxes	(81,581)	(5,629,950)	(374,346)	(6,693,791)
Income taxes				
Net loss	\$ (81,581)	\$ (5,629,950)	\$ (374,346)	\$ (6,693,791)
Basic and diluted net loss per share	\$ (0.01)	\$ (0.69)	\$ (0.05)	\$ (0.82)
Weighted average shares outstanding used to compute net loss per share	8,149,554	8,143,950	8,149,554	8,139,752

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

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

	Six Months Ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net loss	\$ (374,346)	\$ (6,693,791)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization		350,744
Gain on sale of Harpin Protein Technology	(113,968)	
Recognition of cumulative translation adjustment	103,470	

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	Six Months Ended June 30,	
Loss on impairment of equipment and leasehold improvements		4,880,516
Stock compensation expense	10,901	203,959
Gain on sale of equipment		(44,557)
Gain on sale of investment		(99,884)
Accretion expense	5,672	15,406
Deferred rent payable	(1,406)	78,756
Changes in assets and liabilities:		
Accounts receivable	149,544	(990,527)
Inventory	281,438	835,914
Prepaid expenses and other assets	327,571	78,909
Accounts payable	(135,895)	(112,185)
Accrued liabilities	(318,917)	(210,183)
Net cash from operating activities	(65,936)	(1,706,923)
Cash flows from investing activities:		
Proceeds from sale of Harpin Protein Technology	1,903,074	
Purchase of equipment		(16,377)
Proceeds from sale of investment		100,000
Proceeds from sale of equipment	50,000	164,557
Net cash from investing activities	1,953,074	248,180
Cash flows from financing activities:		
Proceeds from issuance of common stock		21,000
Net cash from financing activities		21,000
Effect of foreign currency exchange rates on cash and cash equivalents	(67,661)	54,514
Net increase (decrease) in cash and cash equivalents	1,819,477	(1,383,229)
Cash and cash equivalents at beginning of period	4,185,225	6,825,652
Cash and cash equivalents at end of period	\$ 6,004,702	\$ 5,442,423

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

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Summary of Significant Accounting Policies**

***Organization and Business***

Eden Bioscience Corporation ( Eden Bioscience or the Company ) was incorporated in the State of Washington on July 18, 1994. On February 28, 2007, the Company sold its proprietary harpin protein-based technology and substantially all of its assets used in the manufacturing and distribution of harpin-based products used in the worldwide agricultural and horticultural markets ( Harpin Protein Technology ) to Plant Health Care, Inc. ( PHC ). From December 1, 2006 through February 28, 2007, the Company operated under an Independent Distribution Agreement whereby PHC served as the exclusive distributor of the Company s products for all channels of trade, other than to retail distributors and

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consumers (the Home and Garden Market), in substantially all worldwide territories. The Company's business strategy after the sale is to sell harpin protein-based products to the Home and Garden Market (the Home and Garden Business) and use its available cash and any revenue generated from its Home and Garden Business to explore whether there may be opportunities to realize potential value from its remaining business assets, primarily its tax loss carryforwards.

The Company is subject to a number of risks including, among others: realizing potential value from tax loss carryforwards is highly speculative and subject to numerous material uncertainties; dependence on one manufacturer for the supply of harpin protein-based products; dependence on a limited number of products and the commercialization of those products, which may not be successful; reliance on independent distributors and retailers to sell the Company's products; ability to retain existing personnel; and competition from other companies with greater financial, technical and marketing resources.

### ***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and pursuant to the instructions to Form 10-Q. Accordingly, they do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2006 has been derived from the audited financial statements at that date but does not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the financial statements and notes as of and for the year ended December 31, 2006 included in the Company's Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 30, 2007.

In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting only of normal recurring adjustments, necessary to state fairly the financial information set forth therein. Results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of the results expected for the full fiscal year or for any future period. Since the Company is continuing to sell harpin protein-based products to the Home and Garden Market and historically has had one asset group for purposes of assessing asset impairment and one operating segment, the condensed consolidated financial statements properly do not present discontinued operations.

On April 17, 2006, the Company amended its Restated Articles of Incorporation to reduce the Company's number of authorized shares of common stock from 100,000,000 to 33,333,333 and to effect a 1-for-3 reverse stock split of the Company's outstanding common stock. The reverse stock split was effective with respect to shareholders of record at 5:00 p.m., Pacific daylight time, on April 18, 2006 and the Company's common stock began trading as adjusted for the reverse stock split on April 19, 2006. As a result of the reverse stock split, each three shares of common stock were exchanged for one share of common stock and the total number of shares outstanding was reduced from 24,406,870 shares to 8,135,554 shares. The Company has retroactively adjusted all the share information to reflect the reverse stock split in the accompanying condensed consolidated financial statements and footnotes.

### ***Liquidity***

The Company's operating expenditures have been significant since its inception. The Company currently anticipates that its operating expenses in 2007, although substantially less than its operating expenses in 2006, will significantly exceed net sales of its harpin protein-based home and garden products (Home and Garden Products) in the Home and Garden Market and that net losses and working capital requirements will consume a material

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## **EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

### **NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

amount of its cash resources in 2007. The Company's future capital requirements will depend on the success of its Home and Garden Business and its ability to successfully implement its strategy of realizing potential value from its remaining business assets, primarily its tax loss carryforwards. The Company does not plan to make a substantial investment toward the development of its Home and Garden Business. Management of the Company believes that the balance of its cash and cash equivalents at June 30, 2007 will be sufficient to meet its anticipated cash needs for net losses, working capital and capital expenditures for more than the next 12 months, although there can be no assurance in that regard.

### ***Estimates Used in Financial Statement Preparation***

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The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the 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. Examples include fair value and depreciable lives of property and equipment; expense accruals; provisions for sales allowances, warranty claims, inventory valuation and classification; cash flow projections used in evaluating whether asset impairment loss is recorded; fair value of stock compensation arrangements and bad debts. Such estimates and assumptions are based on historical experience, where applicable, management's plans, use of a third-party valuation specialist and other assumptions. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the financial statements prospectively when they are determined to be necessary. Actual results could differ from these estimates.

### ***Accounts and Note Receivable***

In determining the adequacy of the allowance for doubtful accounts, the Company considers a number of factors, including the aging of the accounts receivable portfolio, customer payment trends, the financial condition of its customers, historical bad debts and current economic trends. Based upon an analysis of outstanding net accounts and note receivable, no allowance for doubtful accounts was recorded at June 30, 2007 or December 31, 2006.

### ***Inventory***

Inventory is valued at the lower of average cost or market. Costs include material, labor and overhead. The Company estimates inventory cost reductions based on expected sales value, including expected bulk sale, the results of quality control testing and the amount and age of product in the Company's inventory.

### ***Property and Equipment***

Equipment and leasehold improvements are stated at estimated fair value as a result of asset impairment charges recorded as of June 30, 2006 in the amount of \$4,880,516. Prior to June 30, 2006, equipment and leasehold improvements were stated at historical cost. Improvements and replacements are capitalized. Maintenance and repairs are expensed when incurred. The provision for depreciation and amortization is determined using straight-line and units-of-production methods, which allocate costs less salvage value over their estimated useful lives of two to twenty years. Leasehold improvements are amortized over the shorter of their estimated useful lives or lease term, which range between two to ten years.

Long-lived assets are reviewed for impairment whenever events or circumstances indicate that the carrying value may not be recoverable. In reviewing for impairment, the Company compares the carrying value of such assets to the undiscounted cash flows expected from the use of the assets and their eventual disposition. When necessary, an impairment loss is recognized equal to the difference between the assets' fair value and their carrying value.

### ***Other Assets***

As of June 30, 2007, other non-current assets consist principally of prepaid insurance. As of December 31, 2006, other non-current assets consist principally of restricted investments held as deposits in connection with the Company's operating lease. In the first quarter of 2006, the Company sold a minority stock investment for \$100,000 that resulted in a gain of \$99,884.

### ***Revenues***

The Company recognizes revenue from product sales, net of sales allowances, when product is delivered to its distributors and all significant obligations of the Company have been satisfied, unless acceptance provisions or other

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

contingencies or arrangements exist. If acceptance provisions or contingencies exist, revenue is deferred and recognized later if such provisions or contingencies are satisfied. As part of the analysis of whether all significant obligations of the Company have been satisfied or situations where acceptance provisions or other contingencies or arrangements exist, the Company considers the following elements, among others: sales

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terms and arrangements, historical experience and current incentive programs. Distributors do not have price protection or product-return rights. The Company provides an allowance for warranty claims based on historical experience and expectations. Shipping and handling costs related to product sales that are paid by the Company are included in cost of goods sold.

Sales allowances represent allowances granted to independent distributors for sales and marketing support and are estimated based on the terms of the distribution arrangements or other arrangements. Sales allowances are estimated and accrued when the related product sales are recognized or when services are provided and are paid in accordance with the terms of the then-current distributor program arrangements or other arrangements. Distributor program arrangements expire annually, generally on December 31.

Gross product sales and sales allowances are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Gross product sales	\$83,127	\$ 1,829,118	\$271,235	\$ 3,782,654
Sales allowances		(160,754)		(507,932)
Elimination of previously recorded sales allowance liabilities		91,676	664	133,705
Product sales, net of sales allowances	\$83,127	\$ 1,760,040	\$271,899	\$ 3,408,427

Net product sales by geographical region were:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
United States	\$74,403	\$ 1,556,058	\$252,067	\$3,150,008
Spain	8,724	140,224	19,832	140,224
Other regions		63,758		118,195
Product sales, net of sales allowances	\$83,127	\$ 1,760,040	\$271,899	\$3,408,427

### ***Accounting for Stock Compensation***

The Company maintains a stock equity incentive plan under which it may grant non-qualified stock options, incentive stock options or restricted stock to employees, non-employee directors and consultants. Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ). Total stock-based compensation expense recognized in the condensed consolidated statement of operations for the three months ended June 30, 2007 and 2006 was \$5,398 and \$78,830, respectively. Total stock-based compensation expense recognized in the condensed consolidated statement of operations for the six months ended June 30, 2007 and 2006 was \$10,901 and \$203,959, respectively. As of June 30, 2007, total unrecognized stock-based compensation expense related to nonvested stock options was approximately \$15,000 and the Company expects to recognize approximately \$9,000 in the remainder of 2007 and approximately \$6,000 in 2008.

The expected life of each award granted was calculated using the simplified method in accordance with Staff Accounting Bulletin No. 107. Expected stock price volatility is based on historical volatility of the Company's stock. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with an equivalent remaining term. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future.

### ***Income Taxes***

The Company accounts for income taxes under the provisions of FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* ( SFAS No. 109 ). SFAS No. 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the



## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

differences between the financial reporting and tax bases of assets and liabilities and operating loss and tax credit carryforwards using enacted tax rates in effect for the year in which the differences and carryforwards are expected to reverse.

*Foreign Currency Translation*

The Company conducts its operations in two primary functional currencies: the U.S. dollar and the euro. Balance sheet accounts of the Company's foreign operations are translated from foreign currencies into U.S. dollars at period-end exchange rates while income and expenses are translated at average exchange rates during the period. Cumulative translation gains or losses related to net assets located outside the U.S. are shown as a component of shareholders' equity. Gains and losses resulting from foreign currency transactions, which are denominated in a currency other than the entity's functional currency, are included in the consolidated statements of operations. As of February 28, 2007, the cumulative translation adjustment related to the Company's European subsidiary totaling \$103,470 was reclassified from accumulated other comprehensive income and reported as part of the gain on sale of Harpin Protein Technology as this subsidiary was substantially liquidated as a result of the sale to PHC. There were no significant gains or losses on foreign currency transactions in the three and six months ended June 30, 2006.

*Net Loss per Share*

Basic net loss per share is the net loss divided by the average number of shares outstanding during the period. Diluted net loss per share is the net loss divided by the sum of the average number of shares outstanding during the period plus the additional shares that would have been issued had all dilutive stock options been exercised, less shares that would be repurchased with the proceeds from such exercise using the treasury stock method. The effect of including outstanding stock options is antidilutive for all periods presented. Therefore, stock options totaling 446,910 and 864,963 as of June 30, 2007 and 2006, respectively, have been excluded from the calculation of diluted net loss per share.

**2. Sale of Harpin Protein Technology to Plant Health Care, Inc.**

On February 28, 2007, under the terms of an asset purchase agreement, the Company sold the Harpin Protein Technology to PHC for \$1,396,824 in cash, net of transaction costs incurred after January 1, 2007 totaling \$103,176, a promissory note in the principal amount of \$700,751 payable on December 28, 2007 and the assumption by PHC of certain of the liabilities relating to or arising out of the Company's Harpin Protein Technology. The promissory note has an interest rate of 5% per annum and is secured by equipment, certain intellectual property and other assets acquired by PHC and unconditionally guaranteed by PHC's indirect parent, Plant Health Care plc. On June 6, 2007, PHC sold substantially all of the equipment that secured the promissory note and, in accordance with the terms of the promissory note, paid the Company 75% of the proceeds from the sale which amounted to \$506,250. The Company also sold \$261,820 of finished goods to PHC under the Independent Distribution Agreement. Harpin Protein Technology includes substantially all of the Company's assets used in the creation of plant health technology incorporating harpin proteins and the manufacture of biopesticide, plant health and nutrient products utilizing the Harpin Protein Technology. These assets include all intellectual property, contracts (including the Company's license agreement with the Cornell Research Foundation (CRF)) and manufacturing and office facility lease), equipment and inventory related to the Company's worldwide agricultural and horticultural markets.

The sale of Harpin Protein Technology to PHC resulted in a gain calculated as follows:

Cash portion of purchase price	\$ 1,500,000
Promissory note portion of purchase price	700,751
Less transaction costs incurred after January 1, 2007	(103,176)
Assets sold to PHC:	
Inventory	(1,895,978)
Equipment held for sale	(63,750)
Property and equipment held and used	(647,962)
Liabilities assumed by PHC:	
Accrued liabilities	59,625

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Other long-term liabilities	460,988
Recognition of cumulative translation adjustment	103,470
Gain on sale of assets to PHC	\$ 113,968

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### EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Under the asset purchase agreement, all liabilities and obligations under the Company's non-cancelable office and manufacturing facility lease were assigned to PHC as of February 28, 2007, including future minimum lease payments totaling \$184,970 in 2007, \$229,424 in 2008 and \$238,366 in 2009. PHC provided all of the deposits required by the lease to the landlord and the Company's restricted cash and deposit totaling \$287,879 were released by the landlord and returned to the Company in March 2007. In conjunction with the assignment of this lease, PHC also assumed the Company's liabilities recorded for rent expense in excess of rent payments of \$73,131 at February 28, 2007 and the Company's asset retirement obligation associated with this facility lease of \$287,857 at February 28, 2007.

Under the asset purchase agreement, all rights, liabilities and obligations under the Company's exclusive worldwide licensing agreement with CRF for certain patents, patent applications and biological material relating to harpin proteins and related technology have been assigned to PHC. As consideration for the license, the Company originally issued 133,333 shares of common stock to CRF in May 1995, funded certain research and development activities at Cornell University and agreed to pay a 2% royalty on net sales of current Harp-N-Tek Products that incorporate the licensed technology, subject to a \$200,000 minimum annual royalty payment. Effective July 1, 2006, the license agreement was amended to establish a development fund at CRF to advance harpin technology and reduced the minimum obligation required to maintain the rights under the license agreement to contributions to the development fund of \$100,000 in each of the 2006, 2007 and 2008 license years. The amendment also required a payment to CRF of \$100,000 by May 30, 2008, which was recorded in other long-term liabilities on the balance sheet at December 31, 2006.

As of February 28, 2007, the cumulative translation adjustment related to the Company's European subsidiary totaling \$103,470 was reclassified from accumulated other comprehensive income and reported as part of the gain on sale of Harpin Protein Technology as this subsidiary was substantially liquidated as a result of the sale to PHC.

All of the Company's obligations under the change-in-control agreement with Dr. Zhongmin Wei, the Company's former Chief Science Officer, were assigned to PHC and Dr. Wei resigned from the Company on February 28, 2007. The agreement provides that, upon a change in control, as defined in the agreement, the Company or the acquiring company would continue to employ Dr. Wei for a period of two years following such change in control. During that time, the agreement provides that the position, authority, duties and responsibilities of Dr. Wei would be substantially the same as they were during the 90-day period prior to the change in control, and that his annual base salary would be at least equal to his annual base salary established by the Company's Board of Directors prior to the change in control. If, during this two-year period, the employment of Dr. Wei is terminated by the acquiring company other than for cause, as defined in the agreements, or by the executive for good reason, as defined in the agreement, the terminated executive would be entitled to receive (i) his annual base salary, and pro rata annual bonus, through the date of termination, and any deferred compensation; and (ii) a severance payment equal to twice the sum of his annual base salary and the average of his past three annual bonuses.

The Company retained its cash, accounts receivable, tax attributes and assets relating to its Home and Garden Business, consisting primarily of inventory designated for the Home and Garden Market. In conjunction with the sale of its Harpin Protein Technology, the Company entered into a license and supply agreement with PHC, pursuant to which PHC granted the Company an exclusive worldwide right and license to sell harpin protein-based products for the protection of plants and seeds and the promotion of plant health in the Home and Garden Market and a royalty free, exclusive worldwide license to use the Messenger, MightyPlant and Harp-N-Tek trademarks in connection with the sale of its Home and Garden Products. Under the license and supply agreement, PHC will supply the Company harpin proteins and harpin-protein based products for its Home and Garden Business. The license and supply agreement will continue until the expiration of the last U.S. or foreign patent relating to the products held or acquired by PHC in connection with the asset purchase agreement and, thereafter, for automatic additional consecutive five year periods. The Company retained all liabilities associated with the Home and Garden Business and all liabilities associated with its Harpin Protein Technology that occurred or existed prior to February 28, 2007 that were not specifically assumed by PHC.

The Company has indemnified PHC and Plant Health Care plc, and PHC and Plant Health Care plc have indemnified the Company, for any damages incurred in connection with a breach of the Company's or PHC's and Plant Health Care plc's respective representations and warranties, covenants or obligations contained in the asset purchase agreement. The Company has also indemnified PHC in connection with any losses

relating to liabilities and obligations that the Company retained after the sale of the Harpin Protein Technology, and PHC and Plant

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Health Care plc have indemnified the Company against any losses relating to liabilities and obligations that PHC assumed in connection with the purchase of the Harpin Protein Technology or that arise in connection with the ownership and operation of the Harpin Protein Technology after February 28, 2007. The indemnification obligation will not apply until the aggregate amount of losses for which any party otherwise is entitled to be indemnified exceeds \$50,000, at which time the indemnified party will be entitled to be paid for the full amount of all losses, up to a maximum amount of \$700,751, the principal amount of PHC's promissory note.

#### 3. Stock Options

At June 30, 2007, the Company had reserved 113,332 shares of common stock for issuance under the 1995 Combined Incentive and Nonqualified Stock Option Plan, all of which had been granted, and 1,149,392 shares for issuance under the 2000 Stock Incentive Plan. Options totaling 333,578 under the 2000 Stock Incentive Plan had been granted at June 30, 2007, leaving 815,814 options available for future grant.

The following table summarizes stock option activity:

	Number of Shares	Weighted Average Exercise Price Per Share
Balance at December 31, 2006	741,384	\$ 8.31
Granted		
Forfeited	(294,474)	6.46
Balance at June 30, 2007	446,910	9.92
Exercisable at June 30, 2007	429,688	\$ 10.04

#### 4. Inventory

Inventory, at the lower of average cost or market, consists of the following:

	June 30, 2007	December 31, 2006
Raw materials	\$ 11,314	\$ 418,597
Bulk manufactured goods		340,313
Finished goods	113,895	1,567,148
Total inventory	125,209	2,326,058
Less non-current portion of inventory	(39,612)	(41,758)
Current portion of inventory	\$ 85,597	\$2,284,300

The non-current portion of inventory consists of raw materials and finished goods that the Company does not expect to utilize in the next twelve months following the balance sheet date.

As of December 31, 2006, the Company reviewed assets for impairment in connection with the sale of the Company's Harpin Protein Technology to PHC by comparing the carrying value at February 28, 2007 of assets sold to consideration received from PHC and recorded

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liabilities assumed by PHC. Based on this review, the carrying value of inventory sold to PHC exceeded the consideration received from PHC and recorded liabilities assumed by PHC. Accordingly, the Company recorded a \$452,347 charge for impairment to inventory as of December 31, 2006.

### 5. Property and Equipment

Property and equipment are recorded at estimated fair value using an orderly liquidation method and leasehold improvements were estimated to have zero fair value. At June 30, 2007, property and equipment consist of assets used in the Company's Home and Garden Business. At December 31, 2006, property and equipment consists primarily of assets used to manufacture and sell the Company's products and assets used in research and administration.

The Company recorded depreciation and amortization of \$174,667 for the three months ended June 30, 2006 and \$350,744 for the six months ended June 30, 2006. No depreciation was recorded after June 30, 2006 for equipment

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

depreciated under the units-of-production method due to no production during the period or for equipment depreciated under the straight-line method as estimated fair value approximated salvage value.

In reviewing for impairment in connection with the preparation of the Company's financial statements for the quarter ended June 30, 2006, the Company compared the carrying value of such assets to updated undiscounted cash flows expected from the use of the asset group. As a result of continuing operating losses and lower sales and growth rates in the first half of 2006 compared to forecasts, the carrying value of the group of assets exceeded undiscounted cash flows expected from the use of this asset group. Consequently, the Company concluded on July 31, 2006 that a charge for impairment to its equipment and leasehold improvements was required and a \$4,880,516 impairment loss was recognized at June 30, 2006. The Company estimated the fair value of equipment using an orderly liquidation method and no fair value was attributed to leasehold improvements.

### 6. Accrued Liabilities

Accrued liabilities consist of the following:

	<u>June 30, 2007</u>	<u>December 31, 2006</u>
Compensation and benefits	\$ 55,929	\$ 136,697
Legal fees and expenses	6,858	107,809
Facility costs	2,229	70,352
Research and development field trial expenses		59,725
Royalty		39,794
Promotions	38,003	38,683
Warranty	25,000	25,000
Other	22,670	50,224
Total accrued liabilities	\$ 150,689	\$ 528,284

### 7. Warranty Liability

The Company provides a limited warranty to its customers that products, at the time of the first sale, conform to the chemical description on the label and under normal conditions are reasonably fit for the purpose referred to in the directions for use, subject to certain inherent risks. The Company records, at time revenues are recognized, a liability for warranty claims based on a percentage of sales. The warranty accrual

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percentage is reviewed periodically and adjusted as necessary, based on historical experience, the results of product quality testing and future expectations. There were no changes to the Company's warranty liability during the three months ended June 30, 2007.

### 8. Commitments and Contingencies

#### *Employment Agreement*

On July 25, 2007, the Company entered into an employment agreement with Bradley S. Powell, its President and Chief Financial Officer. Under the terms of the employment agreement, the Company has agreed to pay Mr. Powell an annual base salary initially set at \$205,000, and a lump sum amount payable upon execution of the employment agreement equal to the retroactive application of his annual base salary to December 15, 2006, the date on which he became the Company's President. Mr. Powell may receive, at the Compensation Committee's sole discretion, a bonus upon completion of an acquisition, merger or consolidation to which the Company is a party. Mr. Powell is also entitled to participate, subject to and in accordance with applicable eligibility requirements, in fringe benefit programs provided to other employees of the Company. The employment agreement includes noncompetition and nonsolicitation provisions that apply to Mr. Powell during his employment and for a period of 18 months thereafter, and includes customary nondisclosure and inventions assignment provisions.

The employment agreement extinguished Mr. Powell's change-in-control agreement, dated August 16, 2000, and severance agreement, dated January 28, 2002, in exchange for supplemental payments totaling \$356,145. The supplemental payments are payable in installments as follows: one-half on execution of the employment agreement; one-quarter on September 30, 2007; and one-quarter on January 1, 2008. Any remaining unpaid supplemental

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

payment shall not be made in the event Mr. Powell's employment is terminated by the Company for cause, as defined in the agreement, or if Mr. Powell voluntarily terminates his employment for any reason. If Mr. Powell's employment is terminated by the Company without cause or as a result of his death or total disability, as defined in the agreement, any remaining unpaid supplemental payment shall be accelerated and paid on the date of termination and Mr. Powell's unvested stock options would accelerate and become fully vested and exercisable.

#### *Legal Proceedings*

The Company is subject to various claims and legal actions that arise in the ordinary course of business and believes that the ultimate liability, if any, with respect to these claims and legal actions will not have a material effect on its condensed consolidated financial statements.

### 9. Major Customers

Net product sales to the following distributors accounted for more than ten percent of net revenues for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Customer A	\$	\$ **	\$42,000	\$ **
Customer B	7,000		35,000	
Customer C	9,000	**	**	**
Customer D		297,000		667,000
Customer E		204,000		460,000
Customer F		212,000		393,000

\*\* Less than ten percent.

## 10. Income Taxes

The Company files a U.S. Federal and certain foreign and state tax returns and did not record an income tax benefit for any of the periods presented because it has experienced operating losses since inception. The Company's total U.S. Federal tax net operating loss carryforwards were approximately \$115,800,000 at December 31, 2006 and expire between 2009 and 2026. The Company's total foreign tax net operating loss carryforwards were approximately \$8,400,000 at December 31, 2006 of which \$5,600,000 expires between 2007 and 2016 and approximately \$2,800,000 does not expire. The Company has total net operating loss carryforwards in 19 U.S. states that range from approximately \$12,500,000 to approximately \$2,000 per state and expire between 2007 and 2026. The Company's total U.S. general business credit carryforwards were approximately \$1,400,000 at December 31, 2006 and expire between 2013 and 2026.

If the Company were to undergo an ownership change as defined in Section 382 of the U.S. Internal Revenue Code (the Code), its net tax loss and general business credit carryforwards generated prior to the ownership change would be subject to annual limitations, which could reduce, eliminate, or defer the utilization of these losses. Based upon a review of past changes in the Company's ownership, the Company believes that it may have experienced ownership changes (as defined under Section 382) on March 20, 1996 and October 2, 2000 that may result in limitations on the Company's future ability to use tax loss carryforwards generated prior to those dates. The Company does not believe that the sale to PHC resulted in another ownership change that would further limit its future ability to use tax loss carryforwards generated after October 2000 because it was a sale of assets. However, the IRS or some other taxing authority may disagree with the Company's position and contend that the Company has already experienced other such ownership changes or that the sale of assets resulted in an ownership change. In such case, the Company's ability to use its tax loss carryforwards to offset future taxable income would be severely limited. If the sale of assets to PHC results in an ownership change as defined in Section 382 of the Code, the Company's tax loss carryforwards available to offset future taxable income could be severely limited and the tax loss carryforwards may expire as a result of the limitation. If an ownership change does not occur as a result of the sale to PHC, there is still the potential for an ownership change to occur under Section 382 as a result of future changes in stock ownership. Net operating loss carryforwards may expire if the Company does not generate sufficient income to utilize the losses before their normal expiration. In addition to Section 382, certain other statutory provisions and common law doctrine could limit the Company's opportunities to realize potential value.

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

from, or otherwise adversely affect the Company's ability to preserve and utilize, the Company's tax loss carryforwards.

## 11. Shareholder Rights Plan

The Board of Directors of Eden Bioscience Corporation declared a dividend of one preferred share purchase right for each outstanding share of the Company's common stock pursuant to a rights agreement dated as of June 1, 2007, between Eden Bioscience and Mellon Investor Services LLC as Rights Agent (the Rights Agreement). The dividend was paid on June 4, 2007 to the Company's shareholders of record on that date. In addition, the Board of Directors authorized the issuance of one preferred share purchase right for each additional share of common stock that becomes outstanding between June 1, 2007 and the earliest of:

the distribution date, which is the earliest of: (1) the close of business on the tenth business day after a public announcement that a person has acquired beneficial ownership of 5% or in the case of any person or group that owned beneficially 5% or more of the outstanding shares of common stock on June 1, 2007, 13% (or 18% in the case of SF Holding Corp., an existing investor that owns in excess of 16% of the outstanding shares) or more of the outstanding shares of common stock (such 5% or 13% being hereafter referred to as the Requisite Percentage); and (2) a date that the Board of Directors designates following the commencement of, or first public disclosure of an intent to commence, a tender or exchange offer for outstanding shares of common stock that could result in the offeror becoming the beneficial owner of the Requisite Percentage or more of the outstanding shares of common stock;

the date on which the rights expire, June 1, 2017; and

the date, if any, on which the Board of Directors redeems the preferred share purchase rights.

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Each preferred share purchase right entitles its registered holder to purchase from the Company one one-hundredth of a share of the Series R Participating Cumulative Preferred Stock, at a price of \$12.00 per one one-hundredth of a preferred share, subject to adjustment as described below.

To preserve the economic value of the preferred share purchase rights, the number of preferred shares or other securities issuable upon exercise of a preferred share purchase right, the purchase price, the redemption price and the number of preferred share purchase rights associated with each outstanding common share are all subject to adjustment by the Board of Directors. The Board of Directors may make adjustments in the event of any change in the common or preferred shares, including, for example, changes associated with stock dividends or stock splits, recapitalizations, mergers or consolidations, split-ups, split-offs or spin-offs, or distributions of cash, assets, options, warrants, indebtedness or subscription rights to holders of common or preferred shares.

If a person acquires beneficial ownership of the Requisite Percentage or more of the Company's outstanding shares of common stock after June 1, 2007, the preferred share purchase rights will entitle each right holder, other than such person or any affiliate or associate of that person, to purchase, for the purchase price, the number of shares of common stock which at the time of the transaction would have a market value of twice the purchase price.

After a person becomes the beneficial owner of the Requisite Percentage or more of the outstanding shares of common stock, but before a person becomes the beneficial owner of more than 50% of these shares, the Board of Directors may elect to exchange each preferred share purchase right, other than those that have become null and void and nontransferable as described above, for shares of common stock, without payment of the purchase price. The exchange rate in this situation would be one-half of the number of shares of common stock that would otherwise be issuable at that time upon the exercise of one preferred share purchase right.

At any time prior to any person acquiring beneficial ownership of the Requisite Percentage or more of the outstanding shares of common stock, the Board of Directors may redeem the preferred share purchase rights in whole, but not in part. The redemption price of \$0.0025 per preferred share purchase right, subject to adjustment as provided in the Rights Agreement, may be paid in cash, shares of common stock or other Eden Bioscience securities deemed by the Board of Directors to be at least equivalent in value.

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### EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At any time prior to any person's or group's acquiring beneficial ownership of the Requisite Percentage or more of the outstanding shares of common stock, the Board of Directors may, without the approval of any holder of the preferred share purchase rights, supplement or amend any provision of the Rights Agreement, including the date on which the distribution date or expiration date would occur, the time during which the preferred share purchase rights may be redeemed and the terms of the preferred shares.

The principal purpose of the preferred share purchase rights is to protect the utilization of the Company's net operating tax loss carryforwards, which could be jeopardized in the event that any investor accumulates a large position in the Company's stock. The preferred share purchase rights have certain antitakeover effects and will cause substantial dilution to a person that attempts to acquire Eden Bioscience on terms not approved by the Board of Directors. The preferred share purchase rights should not affect any prospective offeror willing to make an all cash offer at a full and fair price, or willing to negotiate with the Board of Directors. Similarly, the preferred share purchase rights will not interfere with any merger or other business combination approved by the Board of Directors since the board of directors may, at its option, redeem all, but not less than all, of the then outstanding preferred share purchase rights at the redemption price.

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### EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

#### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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*This discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes thereto included in this report and with our 2006 audited financial statements and notes thereto included in our most recent Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 30, 2007.*

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties, such as statements regarding the impact of the asset sale on our future financial condition and results of operations; our ability to preserve and employ our tax loss carryforwards; our belief that our cash balance at June 30, 2007 will be sufficient to meet anticipated cash needs for more than the next 12 months; and our belief that we will significantly reduce operating expenses during 2007. We use words such as anticipate, believe, expect, future, intend, and the negative of these terms and similar expressions to identify forward-looking statements. However, these words are not the exclusive means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the following factors:*

*Our inability to be successful in our Home and Garden Business, which has a limited operating history, has generated only limited revenue to date and in which we do not currently expect to substantially increase our investment.*

*The failure of PHC to perform its obligations under the promissory note issued in connection with the sale of our Harpin Protein Technology or of Plant Health Care plc to perform its obligations under the guaranty, in which case we may not receive some or all of the deferred consideration payable by PHC under the asset purchase agreement, which could adversely affect our operations.*

*Our inability to reduce operating losses and negative cash flow and achieve profitability or sustain operations.*

*The failure of PHC, on whom we are dependent for the manufacture and supply of harpin proteins and harpin protein-based products for our Home and Garden Business, to provide timely delivery of high-quality products, which could adversely affect our business and results of operations.*

*Our inability to be successful in building greater market awareness and increasing sales in our Home and Garden Business, which is relatively new and has limited market awareness.*

*Our inability to establish or maintain successful relationships with independent distributors and retailers, which could adversely affect our sales and our ability to generate revenue from our Home and Garden Business.*

*Our inability to compete successfully in the market for Home and Garden Products.*

*Our inability to compete with PHC's Harpin Protein Technology business until after February 28, 2009.*

*Our inability to achieve profitability or our inability to identify and acquire other businesses on favorable terms in order to increase our revenues and generate new income.*

*Our inability to obtain regulatory approvals, or to comply with ongoing and changing regulatory requirements, which could delay or prevent sales of our current or any future Home and Garden Products.*

*Our inability to adequately distinguish our products from genetically modified plants and products, which could negatively impact market acceptance and regulatory approval of our products.*

*The occurrence of product liability claims which could adversely affect our operations.*

*Rapid changes in technology, which could render our current or any future products we may develop unmarketable or obsolete.*

*Our inability to retain our existing personnel, which could impair our ability to successfully manage our business or achieve our objectives.*

*Our inability to realize value from our tax loss carryforwards.*



**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Our inability to use our tax loss carryforwards because we are unable to generate taxable income.*

*IRS challenge of the amount of our tax loss carryforwards.*

*Changes in legislation that could negatively affect our ability to use the tax benefits associated with our tax loss carryforwards.*

*More information about factors that potentially could affect our financial results and our business include, but are not limited to, those discussed under Item 1A Risk Factors in our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2007. You should not place undue reliance on our forward-looking statements, which apply only as of the date of this report. The cautionary statements made in this report apply to all forward-looking statements wherever they appear in this report. Except as may be required by law, we undertake no obligation to release publicly any revisions to these forward-looking statements that may be made to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.*

**Overview**

We have incurred significant operating losses since our inception in 1994. As of June 30, 2007, we had an accumulated deficit of \$126,627,283. We incurred net losses of \$374,346 in the first six months of 2007, \$9,445,185 in 2006, \$10,857,865 in 2005, and \$8,886,252 in 2004. On February 28, 2007, we sold our proprietary harpin protein-based technology and substantially all of our assets used in our worldwide agricultural and horticultural markets to PHC for \$2,097,575 (net of transaction costs incurred after January 1, 2007) and assumption of certain liabilities by PHC, including all of our obligations under our office and manufacturing facility lease, under our license with the Cornell Research Foundation ( CRF ) and under our change in control agreement with our former Chief Science Officer, Dr. Zhongmin Wei. From December 1, 2006 through February 28, 2007, we operated under an Independent Distribution Agreement whereby PHC served as the exclusive distributor of our products for all channels of trade, other than the Home and Garden Market, in substantially all worldwide territories. We believe that this sale will enable us to significantly reduce our future operating losses and liabilities, generate cash for our Home and Garden Business and preserve the potential future value of our remaining business assets, primarily our tax loss carryforwards. As described in more detail below, we retained our cash, accounts receivable and assets relating to our Home and Garden Business. As part of the closing, we entered into a license and supply agreement with PHC, pursuant to which PHC granted us an exclusive worldwide right and license to sell harpin protein-based products for the protection of plants and seed and the promotion of overall plant health in the Home and Garden Market and a royalty free, exclusive worldwide license to use the Messenger, MightyPlant and Harp-N-Tek trademarks in connection with the sale of our Home and Garden Products. Under the license and supply agreement, PHC will supply us harpin proteins and harpin-protein based products for our Home and Garden Business. We retained all liabilities associated with the Home and Garden Business and all liabilities associated with the Harpin Protein Technology that occurred or existed prior to February 28, 2007 that were not specifically assumed by PHC.

Our business strategy following the sale is to use any revenue generated by our Home and Garden Business to support our continued operations while we explore whether there may be opportunities to realize potential value from our remaining business assets, primarily our tax loss carryforwards. We have no current intention to make substantial investments to grow our Home and Garden Business. We expect to incur additional net losses as we proceed with our Home and Garden Business and as we explore whether there may be opportunities to realize potential value from our remaining business assets.

**Sale of Harpin Protein Technology to Plant Health Care, Inc.**

On February 28, 2007, under the terms of the Asset Purchase Agreement, we sold our Harpin Protein Technology to PHC for \$1,396,824 in cash, net of transaction costs incurred after January 1, 2007 totaling \$103,176, a promissory note in the principal amount of \$700,751 payable on December 28, 2007 and the assumption by PHC of certain of the liabilities relating to or arising out of our Harpin Protein Technology totaling \$520,613. The promissory note has an interest rate of 5% per annum and is secured by equipment, certain intellectual property and other assets acquired by PHC and unconditionally guaranteed by PHC's indirect parent, Plant Health Care plc. On June 6, 2007, PHC sold substantially all of the equipment that secured the promissory note and, in accordance with the terms of the promissory note, paid us 75% of the proceeds from the sale which amounted to \$506,250. Harpin Protein Technology includes substantially all of our assets used in the creation of plant health technology incorporating harpin proteins and the manufacture of biopesticide, plant health and nutrient products utilizing the Harpin Protein Technology. These assets include all intellectual property, contracts (including our license agreement

**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

with CRF and our office and manufacturing facility lease), equipment and inventory related to our worldwide agricultural and horticultural markets.

We believe that the sale of our Harpin Protein Technology will have the following effects on our future financial condition and results of operations:

Product sales are expected to decrease significantly in 2007 compared to 2006. The Harpin Protein Technology accounted for 91% of gross product sales in 2006.

Cost of goods sold is expected to decrease significantly in 2007 compared to 2006 as a result of the decrease in product sales and the elimination of idle capacity charges after February 28, 2007.

Research and development expenses are expected to decrease to less than \$140,000 in 2007.

Selling, general and administrative expenses are expected to decrease significantly in 2007 compared to 2006.

The sale of our Harpin Protein Technology had the following effects on our condensed consolidated financial statements:

Cash and cash equivalents increased by \$1,500,000 on February 28, 2007. This increase was offset by the payment of transaction costs totaling \$103,176 incurred and recorded in the first three months of 2007 (approximately \$320,000 was incurred and recorded in selling, general and administrative expense in 2006). Cash and cash equivalents also increased and other long-term assets decreased by \$287,879 for the release of restricted cash and return of deposit by the facility lease landlord. On June 6, 2007, cash and cash equivalents increased and note receivable decreased by \$506,250 as a result of collecting a portion of the note receivable from PHC.

Current inventory decreased by \$1,895,978 for inventory sold to PHC. We also sold \$261,820 of finished goods to PHC under our Independent Distribution Agreement with PHC. The remaining inventory consists primarily of raw materials and finished goods used for our Home and Garden Business.

Other current assets decreased by \$63,750 for equipment classified as held for sale and sold to PHC.

Property and equipment decreased by \$647,962 for assets sold to PHC.

Current accrued liabilities decreased by \$59,625 due to PHC's assumption of these liabilities.

Other long-term liabilities decreased to zero due to PHC's assumption of our office and manufacturing facility lease liabilities recorded for rent expense in excess of rent payments totaling \$73,131 and asset retirement obligation of \$287,857 and our \$100,000 liability to CRF.

As of February 28, 2007, the cumulative translation adjustment related to our European subsidiary totaling \$103,470 was reclassified from accumulated other comprehensive income and reported as part of the gain on sale of Harpin Protein Technology as this subsidiary was substantially liquidated as a result of the sale to PHC.

The sale of Harpin Protein Technology to PHC resulted in a gain calculated as follows:

Cash portion of purchase price	\$ 1,500,000
Promissory note portion of purchase price	700,751

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Less transaction costs incurred after January 1, 2007	(103,176)
Assets sold to PHC:	
Inventory	(1,895,978)
Equipment held for sale	(63,750)
Property and equipment held and used	(647,962)
Liabilities assumed by PHC:	
Accrued liabilities	59,625
Other long-term liabilities	460,988
Recognition of cumulative translation adjustment	103,470
Gain on sale of assets to PHC	\$ 113,968

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Additionally, future minimum lease payments under the non-cancelable office and manufacturing facility lease totaling \$184,970 in 2007, \$229,424 in 2008 and \$238,366 in 2009 were assumed by PHC as of February 28, 2007.

All of our rights, liabilities and obligations under the exclusive worldwide license agreement with CRF for certain patents, patent applications and biological material relating to harpin proteins and related technology have been assigned to PHC. The license agreement required funding of certain research and development activities at Cornell University and payment of a 2% royalty on net sales of products that incorporate the licensed technology, subject to a \$200,000 minimum annual royalty payment. Effective July 1, 2006, the license agreement was amended to establish a development fund at CRF to advance harpin technology and reduced the minimum obligation required to maintain the rights under the license agreement to contributions to the development fund of \$100,000 in each of the 2006, 2007 and 2008 license years.

We have agreed to indemnify PHC and Plant Health Care plc, and PHC and Plant Health Care plc each has agreed to indemnify us, for any damages incurred in connection with a breach of our or PHC's and Plant Health Care plc's respective representations and warranties, covenants and obligations contained in the Asset Purchase Agreement. We have also agreed to indemnify PHC in connection with any losses relating to liabilities and obligations that we retained after the sale of the Harpin Protein Technology, and PHC and Plant Health Care plc each has agreed to indemnify us against any losses relating to liabilities and obligations that PHC assumed in connection with the purchase of the Harpin Protein Technology or that arise in connection with the ownership and operation of the Harpin Protein Technology after February 28, 2007. The indemnification obligations do not apply until the aggregate amount of losses for which any party otherwise is entitled to be indemnified exceeds \$50,000, at which time the indemnified party will be entitled to be paid for the full amount of all losses, up to a maximum amount of \$700,751, the principal amount of PHC's promissory note.

**Results of Operations**

*Three Months and Six Months Ended June 30, 2007 and 2006*

*Revenues*

Product sales revenue through February 28, 2007, prior to the sale of our Harpin Protein Technology, has resulted primarily from sales of Messenger STS, N-Hibit™, ProAct™, MightyPlant™ and other related products (hereafter referred to collectively as Harp-N-TeK™ products) primarily to distributors in the agricultural markets in the United States and Spain. Product sales revenue after the sale of our Harpin Protein Technology has resulted primarily from sales of Messenger and Messenger Seed Treatment primarily to distributors and consumers in the Home and Garden Market in the United States. Revenues from product sales are recognized when (a) the product is delivered to independent distributors, (b) we have satisfied all of our significant obligations and (c) any acceptance provisions or other contingencies or arrangements have been satisfied, including whether collection is reasonably assured. As part of the analysis of whether all of our significant obligations have been satisfied or situations where acceptance provisions or other contingencies or arrangements exist, we consider the following elements, among others: sales terms and arrangements, historical experience and current incentive programs. Our distributor arrangements provide no price protection or product-return rights. Net product sales by geographical region were:

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
United States	\$74,403	\$1,556,058	\$252,067	\$3,150,008
Spain	8,724	140,224	19,832	140,224
Other regions		63,758		118,195
Product sales, net of sales allowances	\$83,127	\$1,760,040	\$271,899	\$3,408,427

Net product sales revenue for the second quarter of 2007 was \$83,127, a decrease of \$1,676,913 from \$1,760,040 in the same quarter of 2006. Net product sales revenue for the first six months of 2007 was \$271,899, a decrease of \$3,136,528 from \$3,408,427 in the first six months of 2006. The decrease is a result of selling our Harpin Protein Technology to PHC on February 28, 2007, which was offset by the recognition of sales of Messenger STS in Spain, as described below. Net product sales to foreign customers in other regions were zero in 2007 and \$63,758 in the second quarter of 2006 and \$118,195 in the first six months of 2006. This decrease was due to the sale of our Harpin Technology to PHC and our Independent Distribution Agreement entered into with PHC on December 1, 2006, whereby product orders received from customers in other regions were fulfilled by PHC in the United States.

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net product sales to consumers in the Home and Garden Market in the United States totaled \$74,403 and \$112,305 in the three months ended June 30, 2007 and 2006, respectively, and \$209,058 and \$343,486 in the six months ended June 30, 2007 and 2006, respectively. We believe this decrease in sales volume is due to higher levels of product inventory in the distribution channel, lower spending on personnel, marketing and advertising and poor weather conditions in the first half of 2007. Based on the decline in sales in the first half of 2007 compared to the same period in 2006, we expect sales to consumers in this market in the second half of 2007 to be significantly lower than to sales in the second half of 2006 which totaled \$49,516. Our only two employees in home and garden sales and marketing resigned effective on July 20, 2007 and August 14, 2007. Although we intend to continue to operate our home and garden business with our remaining two employees, we do not currently intend to fill these positions at this time and do not intend to significantly increase our investment toward the development of this business. We expect this to negatively impact our sales in the second half of 2007.

In February 2004, we received approval to sell Messenger in Spain. We initiated marketing activities in March 2004, but the approval was not received in time to meet initial sales activity. In order to ensure that an adequate supply of Messenger STS was quickly disbursed in the new distribution channel and to limit the amount of working capital required by our new distributors at this early stage of introduction, we granted flexible and/or extended payment terms to distributors in this new market. Because of this combination of factors, revenues from product deliveries to certain distributors were deferred and are recognized as payment is received. We recognized net revenue of \$8,724 in the second quarter of 2007 and \$19,832 in the first six months of 2007. Gross revenues of approximately \$47,000 and cost of goods sold of approximately \$26,000 are deferred at June 30, 2007 and will be recognized when payment is received.

Due to the growing seasons in the United States, we expect usage of our Home and Garden Products to be highly seasonal. Based on the recommended application timing, we expect the second quarter to be the most significant period of use. Our Home and Garden Product sales to distributors are also expected to be seasonal. However, actual timing of orders received from distributors will depend on many factors, including the amounts of our products in distributors' inventories.

*Sales Allowances*

Product sales revenue is reported net of applicable sales allowances, as follows:

Three Months Ended June 30,		Six Months Ended June 30,	
2007	2006	2007	2006

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	Three Months Ended June 30,		Six Months Ended June 30,	
Gross product sales	\$83,127	\$1,829,118	\$271,235	\$3,782,654
Sales allowances		(160,754)		(507,932)
Elimination of previously recorded sales allowance liabilities		91,676	664	133,705
Product sales, net of sales allowances	\$83,127	\$1,760,040	\$271,899	\$3,408,427

Sales allowances represent allowances granted to independent distributors for sales and marketing support and are estimated based on the terms of the distribution arrangements. Sales allowances are estimated and accrued when the related product sales revenue is recognized or when services are provided and are paid in accordance with the terms of the then-current distributor program arrangements. Distributor program arrangements expire annually, generally on December 31.

Sales allowances during the quarter and six months ended June 30, 2007 were zero compared to \$160,754 (9% of gross product sales) in the second quarter of 2006 and \$507,932 (13% of gross product sales) in the first half of 2006. The decrease was due to the sale of Harpin Protein Technology to PHC on February 28, 2007. As a result of the sale of the Harpin Protein Technology to PHC, we expect sales allowances to be less than 1% of sales in 2007. Net revenue for second quarter of 2006 included the reduction by \$91,676 of sales allowance recognized in prior quarters that were not paid because actual amounts earned by distributors were less than amounts previously estimated. For the six months ended June 30, 2007 and 2006, these sales allowance reductions totaled \$664 and \$133,705, respectively.

*Cost of Goods Sold*

Cost of goods sold includes the cost of products sold to distributors, idle capacity charges, royalty expense, shipping and handling and other costs necessary to deliver product to distributors, and the cost of products used for promotional purposes. Cost of goods sold was \$15,093 in the second quarter of 2007, compared to \$839,572 in the

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

second quarter of 2006 and totaled \$138,335 in the first half of 2007, compared to \$1,855,052 in the first half of 2006. The decrease in cost of goods sold was primarily due to lower sales volumes in our Home and Garden Business and lower sales volumes, idle capacity charges, royalty expense, shipping and handling costs and products used for promotional purposes as a result of the sale of Harpin Protein Technology to PHC.

As a result of the sale of the Harpin Technology to PHC, cost of goods sold is expected to be significantly less in 2007 compared to 2006. Royalty expenses and idle capacity charges ceased as of February 28, 2007 and we currently expect that the cost of products used for promotional purposes will be less than \$5,000 in 2007.

*Research and Development Expenses*

Research and development expenses consist primarily of personnel, field trial, laboratory, regulatory, patent and facility expenses. Research and development expenses were zero in the second quarter of 2007 compared to \$372,937 in the second quarter of 2006 and totaled \$136,442 and \$689,475 the first half of 2007 and 2006, respectively. This decrease was primarily a result of the sale of Harpin Protein Technology to PHC and lower personnel, facility, depreciation and field trial costs. Stock compensation expense included in research and development was zero in 2007 and \$6,708 and \$13,416 in the second quarter and first half of 2006, respectively. As a result of the sale of our Harpin Protein Technology to PHC, we do not expect to incur any additional research and development expenses for the remainder of 2007.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses consist of payroll and related expenses for sales and marketing, executive and administrative personnel; advertising, marketing and professional fees; and other corporate expenses. Selling, general and administrative expenses decreased \$1,145,784 from \$1,379,502 in the second quarter of 2006 to \$233,718 in the same quarter of 2007. For the first six months of 2007, selling, general and administrative expenses decreased \$2,304,788 from \$2,938,288 in 2006 to \$633,500 in 2007. The decrease resulted primarily from

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reductions in personnel, advertising and marketing expenses, facility costs and the sale of Harpin Protein Technology to PHC. Stock compensation expense included in selling, general and administrative expenses was \$5,398 and \$72,122 in the second quarter of 2007 and 2006, respectively, and \$10,901 and \$190,543 in the first half of 2007 and 2006, respectively.

Our business strategy moving forward is to use any revenues generated by our Home and Garden Business to support our operations while we explore whether there may be opportunities to realize potential value from our remaining business assets, primarily our tax loss carryforwards. As described below, we engaged legal professionals to validate the underlying assumptions related to our tax loss carryforwards and analyze and provide advice on the options that may be available to preserve and maximize the potential use of our deferred tax assets, as well as on potential limitations and risks of such utilization strategy. We expect this to be an expensive and time consuming process, and we may not generate revenue from our Home and Garden Business or otherwise attract capital to support the process for its duration.

### *Loss on impairment of equipment and leasehold improvements*

We periodically review the carrying values of our property and equipment to determine whether such assets have been impaired. An impairment loss must be recorded pursuant to SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, when the undiscounted net cash flows expected to be realized from the use of such assets are less than their carrying value. The determination of expected undiscounted net cash flows requires us to make many estimates, projections and assumptions, including the lives of the assets, future sales and expense levels, additional capital investments or expenditures necessary to maintain the assets, industry market trends and general and industry economic conditions. Our property and equipment consisted primarily of assets used to manufacture and sell our products and assets used in our research and administration. For the purpose of assessing asset impairment, we have grouped all of these assets together in one asset group because our administration and research support our manufacturing and sales activities and do not have a separate identifiable cash flow.

In the first half of 2006, we continued to incur losses from operations and actual sales and growth rates for the first half of 2006 were significantly lower than expected. In reviewing our assets for impairment in connection with the preparation of the Company's financial statements for the quarter ended June 30, 2006, we compared the carrying value of such assets to updated undiscounted cash flows expected from the use of this asset group. As a result of continuing operating losses and lower sales and growth rates in the first half of 2006 compared to forecasts,

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the carrying value of the group of assets exceeded undiscounted cash flows expected from the use of this asset group. Consequently, the Company concluded on July 31, 2006 that a charge for impairment to its equipment and leasehold improvements was required and a \$4,880,516 impairment loss was recognized at June 30, 2006. We estimated the fair value of equipment using an orderly liquidation method and no fair value was attributed to leasehold improvements. The impairment charge will not result in future cash expenditures.

### *Gain on sale of investment*

In the first quarter of 2006, we sold a minority stock investment for \$100,000 that resulted in a gain of \$99,884.

### *Interest Income*

Interest income consists primarily of earnings on our cash and cash equivalents. Interest income increased \$28,545 from \$55,558 in the second quarter of 2006 to \$84,103 in the same quarter of 2007. Interest income increased \$31,392 from \$116,672 in the first half of 2006 to \$148,064 in the same period of this year. The change was due to a higher average cash balance available for investment in the six months ended June 30, 2007 compared to the same period in 2006.

### *Income Taxes*

We have generated a net loss from operations for each period since we began doing business. As of December 31, 2006, we had accumulated approximately \$115,800,000 of net operating loss carryforwards for U.S. Federal income tax purposes, which expire between 2009 and 2026, and net operating loss carryforwards in 19 U.S. states that range from approximately \$12,500,000 to approximately \$2,000 per state and expire between 2007 and 2026. Our total U.S. general business credit carryforwards were approximately \$1,400,000 and expire between 2013 and

2026. We have also accumulated approximately \$1,400,000 of net operating loss carryforwards in Mexico that expire between 2011 and 2016 and approximately \$7,000,000 million in France, of which approximately \$4,200,000 expires in 2007 and 2008 and approximately \$2,800,000 does not expire. We have provided a valuation allowance against our net deferred tax assets because of the significant uncertainty surrounding our ability to realize value on such assets.

Our business strategy is to use any revenue generated by our Home and Garden Business to support our continued operations while we explore whether there may be opportunities to realize potential value from our remaining business assets, primarily our tax loss carryforwards. The strategy is extremely speculative and subject to a large number of risks and uncertainties including those set forth under the heading "Risk Factors" in our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2007. We have conducted only limited preliminary analysis of our ability to utilize our tax loss carryforwards and have drawn no final conclusions about the viability of this strategy. We have not developed any specific plan as to whether, how or within what time frame we might pursue or implement this strategy. In order to confirm whether there are opportunities to realize potential value from our tax loss carryforwards, we engaged legal professionals to validate the underlying assumptions related to our tax loss carryforwards and analyze and provide advice on the options that may be available to preserve and maximize the potential use of our tax loss carryforwards, as well as on potential limitations and risks of such utilization strategy. This will be an expensive and time consuming process, and we may not generate revenue from our Home and Garden Business or otherwise attract capital to support the process for its duration.

In the event we were to undergo an ownership change as defined in Section 382 of the Code, our net tax loss and general business credit carryforwards generated prior to the ownership change would be subject to annual limitations, which could reduce, eliminate, or defer the utilization of these losses. Based upon an analysis of past changes in our ownership, we believe the Company may have experienced ownership changes (as defined under Section 382) on March 20, 1996 and October 2, 2000 that may result in limitations on our future ability to use tax loss carryforwards generated prior to those dates. We do not believe that the sale to PHC resulted in another ownership change that would further limit our future ability to use tax loss carryforwards generated after October 2, 2000 because it was a sale of assets. However, we cannot assure you that the IRS or some other taxing authority may not disagree with our position and contend that we have already experienced other such ownership changes. In such case, our ability to use our tax loss carryforwards to offset future taxable income would be severely limited. If the sale of assets to PHC were deemed to result in an ownership change as defined in Section 382 of the Code, our tax loss carryforwards available to offset future taxable income could be severely limited and the tax loss carryforwards may expire as a result of the limitation. If an ownership change is not deemed to occur as a result of the sale to PHC,

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

there is still the potential for an ownership change to occur under Section 382 as a result of future changes in stock ownership. Net operating loss carryforwards may expire if we do not generate sufficient income to utilize the losses before their normal expiration.

Generally, an ownership change occurs if one or more shareholders, each of whom owns 5% or more in value of a corporation's stock, increase their aggregate percentage ownership by more than 50% over the lowest percentage of stock owned by such shareholders at any time during the preceding three-year period. For example, if a single shareholder owning 10% of our stock acquired an additional 50.1% of our stock in a three-year period, a change of ownership would occur. Similarly, if ten persons, none of whom owned our stock, each acquired slightly over 5% of our stock within a three-year period (so that such persons own, in the aggregate, more than 50%) an ownership change would occur. Ownership of stock is determined by certain constructive ownership rules which can attribute ownership of stock owned by entities (such as estates, trusts, corporations, and partnerships) to the ultimate indirect owner.

For purposes of this rule, all holders who each own less than 5% of a corporation's stock are generally treated together as one (or, in certain cases, more than one) 5% shareholder. Transactions in the public markets among shareholders owning less than 5% of the equity securities generally are not included in the calculation. Special rules can result in the treatment of options (including warrants) or other similar interests as having been exercised if such treatment would result in an ownership change.

As we explore whether there may be opportunities to utilize our tax loss carryforwards, due to the importance of avoiding a future ownership change under the tax laws, we will be limited in our ability to issue additional stock in the future to provide capital for our business. We would only be able to issue such additional stock in a manner that would not cause an ownership change, for purposes of these rules, and thus our ability to access the equity markets could be restricted.

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Finally, in addition to Section 382, certain other statutory provisions and common law doctrine could limit our opportunities to realize potential value from, or otherwise adversely affect our ability to preserve and utilize, our tax loss carryforwards.

The use of our tax loss carryforwards is subject to uncertainty because it is dependent upon the amount of taxable income we generate. We have no assurance that we will have sufficient taxable income in future years to use the tax loss carryforwards before they expire. We believe that our ability to achieve profitability may depend in substantial part on our ability to identify and acquire suitable acquisitions on favorable terms, so that we can increase our revenues and generate new income. We may seek additional capital from time to time, including through the sale of stock or other securities, which may result in dilution to existing shareholders. In addition, as noted above, the provisions of the Code and certain applicable IRS regulations will limit the number of shares of stock we can sell from time to time without causing a limitation on our ability to use our tax loss carryforwards to reduce our future tax obligations.

### **Liquidity and Capital Resources**

Our operating expenditures have been significant since our inception. We currently anticipate that our operating expenses in 2007, although substantially less than our operating expenses in 2006, will significantly exceed net Home and Garden Product sales and that net losses and working capital requirements will consume a material amount of our cash resources in 2007. Our future capital requirements will depend on the success of our Home and Garden Business and our ability to successfully implement our strategy of realizing potential value from our remaining business assets, primarily our tax loss carryforwards. We have no current intention to make substantial investments to grow our Home and Garden Business. We believe that the balance of our cash and cash equivalents at June 30, 2007 will be sufficient to meet our anticipated cash needs for net losses, working capital and capital expenditures for more than the next 12 months, although there can be no assurance in this regard.

At June 30, 2007, our cash and cash equivalents totaled \$6,004,702, an increase of \$1,819,477 from the balance of \$4,185,225 at December 31, 2006. In the first quarter of 2007, we received \$1,396,824 in net proceeds (after transaction costs incurred after January 1, 2007) from the sale of the Harpin Protein Technology to PHC and on June 6, 2007 we collected \$506,250 from PHC as a partial payment of the promissory note. We expect to collect the remaining principal and interest of the promissory note on December 28, 2007. Prior to October 2000, we financed our operations primarily through the private sale of our equity securities, resulting in net proceeds of approximately \$36,500,000 through September 30, 2000. In October 2000, we received approximately \$91,500,000 in net proceeds from the initial public offering of 2,223,333 shares of our common stock. We plan to finance our operations in 2007

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## **EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

### **NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

using existing cash and cash equivalents. Our business strategy of exploring whether there may be opportunities to utilize our remaining business assets, including our tax loss carryforwards, will, due to the importance of avoiding a future ownership change under the tax laws, limit us in our ability to issue additional stock to provide capital for our business.

The sale of our Harpin Protein Technology had the following effects on our cash used in operations and cash resources in the first half of 2007:

Cash and cash equivalents increased by \$1,500,000 on February 28, 2007. This increase was offset by the payment of transaction costs totaling \$103,176 incurred and recorded in the first three months of 2007 (approximately \$320,000 was incurred and recorded in selling, general and administrative expense in 2006). Cash and cash equivalents also increased and other long-term assets decreased by \$287,879 for the release of restricted cash and return of deposit by the facility lease landlord. On June 6, 2007, cash and cash equivalents increased and note receivable decreased by \$506,250 as a result of collecting a portion of the note receivable from PHC.

Current inventory decreased by \$1,895,978 for inventory sold to PHC. We also sold \$261,820 of finished goods to PHC under our Independent Distribution Agreement with PHC. The remaining inventory consists primarily of raw materials and finished goods used for our Home and Garden Business.

Other current assets decreased by \$63,750 for equipment classified as held for sale and sold to PHC.

Property and equipment decreased by \$647,962 for assets sold to PHC.



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Current accrued liabilities decreased by \$59,625 due to PHC's assumption of these liabilities.

Other long-term liabilities decreased to zero at February 28, 2007 due to PHC's assumption of our office and manufacturing facility lease liabilities recorded for rent expense in excess of rent payments totaling \$73,131 and asset retirement obligation of \$287,857 and our \$100,000 liability to CRF.

Product sales, cost of goods sold, research and development and selling, general and administrative expense are expected to decrease significantly in 2007 compared to 2006.

Additionally, future minimum lease payments under the non-cancelable office and manufacturing facility lease totaling \$184,970 in 2007, \$229,424 in 2008 and \$238,366 in 2009 were assumed by PHC as of February 28, 2007. We currently have no contractual obligations associated with capital and operating lease obligations.

Net cash used in operations decreased by \$1,640,987 from \$1,706,923 in the first six months of 2006 to \$65,936 in the same period of 2007. Net cash used in operations in the first six months of 2007 resulted primarily from a net loss of \$374,346 offset by net fluctuations in various asset and liability balances totaling \$303,741. We expect that net cash used in operations will continue to be significant.

We conduct our operations in two primary functional currencies: the U.S. dollar and the euro. Historically, neither fluctuations in foreign exchange rates nor changes in foreign economic conditions have had a significant impact on our financial condition or results of operations. We currently do not hedge our foreign currency exposures and are, therefore, subject to the risk of exchange rate fluctuations. We may invoice our international customers in U.S. dollars and euros, as the case may be. We are exposed to foreign exchange rate fluctuations as the financial results of foreign subsidiaries are translated into U.S. dollars in consolidation. As of February 28, 2007, the cumulative translation adjustment related to our European subsidiary totaling \$103,470 was reclassified from accumulated other comprehensive income and reported as part of the gain on sale of Harpin Protein Technology as this subsidiary was substantially liquidated as a result of the sale to PHC. Foreign exchange rate fluctuations did not have a material impact on our financial statements in the six months ended June 30, 2006.

### *Employment Agreement*

On July 25, 2007, we entered into an employment agreement with Bradley S. Powell, our President and Chief Financial Officer. Under the terms of the employment agreement, we agreed to pay Mr. Powell an annual base salary initially set at \$205,000, and a lump sum amount payable upon execution of the employment agreement equal to the retroactive application of his annual base salary to December 15, 2006, the date on which he became our President. Mr. Powell may receive, at the Compensation Committee's sole discretion, a bonus upon completion of an acquisition, merger or consolidation to which the Company is a party. Mr. Powell is also entitled to participate,

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

subject to and in accordance with applicable eligibility requirements, in fringe benefit programs provided to our other employees. The employment agreement includes noncompetition and nonsolicitation provisions that apply to Mr. Powell during his employment and for a period of 18 months thereafter, and includes customary nondisclosure and inventions assignment provisions.

The employment agreement extinguished Mr. Powell's change-in-control agreement, dated August 16, 2000, and severance agreement, dated January 28, 2002, in exchange for supplemental payments totaling \$356,145. The supplemental payments are payable in installments as follows: one-half on execution of the employment agreement; one-quarter on September 30, 2007; and one-quarter on January 1, 2008. Any remaining unpaid supplemental payment shall not be made in the event Mr. Powell's employment is terminated by us for cause, as defined in the agreement, or if Mr. Powell voluntarily terminates his employment for any reason. If Mr. Powell's employment is terminated by the Company without cause or as a result of his death or total disability, as defined in the agreement, any remaining unpaid supplemental payment shall be accelerated and paid on the date of termination and Mr. Powell's unvested stock options would accelerate and become fully vested and exercisable.

### **Critical Accounting Policies, Estimates and Judgments**

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Our critical accounting policies are more fully described in Note 1 to our consolidated financial statements included in our most recent Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 30, 2007. Certain of our accounting policies require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these judgments are subject to an inherent degree of uncertainty. These judgments are based on historical experience, terms of existing contracts, commonly accepted industry practices, information provided by our customers and other assumptions that we believe are reasonable under the circumstances. Our estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the condensed consolidated financial statements in the period in which they are determined to be necessary. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates include:

### *Revenue Recognition*

Prior to the sale of our Harpin Protein Technology assets on February 28, 2007, we sold the majority of our products to independent, third-party distributors in the agricultural and horticultural markets. We sell the majority of our Home and Garden Products to independent, third-party distributors and directly to consumers over the internet in the Home and Garden Markets. Our arrangements with those distributors provide no price protection or product-return rights. We recognize revenue from product sales, net of sales allowances, when product is delivered to our distributors and all of our significant obligations have been satisfied, unless acceptance provisions or other contingencies or arrangements exist, including whether collection is reasonably assured. If acceptance provisions or contingencies exist, revenue is recognized after such provisions or contingencies have been satisfied. As part of the analysis of whether all of our significant obligations have been satisfied or situations where acceptance provisions or other contingencies or arrangements exist, we consider the following elements, among others: sales terms and arrangements, including customer payment terms, historical experience and current incentive programs.

Sales allowances represent allowances granted to independent distributors for sales and marketing support and are based on the terms of the distribution agreements or other arrangements. Sales allowances are estimated and accrued when the related product sales are recognized or when services are provided and are paid in accordance with the terms of the then-current distributor program agreements or other arrangements.

We also record, at the time revenue is recognized, a liability for warranty claims based on a percentage of sales. The warranty accrual percentage and warranty liability are reviewed periodically and adjusted as necessary, based on historical experience, the results of product quality testing and future expectations. Changes in our estimate of the warranty liability are recorded in cost of goods sold.

### *Accounts and Note Receivable and Allowance for Doubtful Accounts*

Accounts receivable balances are reported net of customer-specific related sales allowances. In determining the adequacy of the allowance for doubtful accounts, we consider a number of factors, including the age of outstanding invoices, customer payment trends, the financial condition of our customers, historical bad debts and current economic trends. Based upon our analysis of outstanding accounts and note receivable at June 30, 2007, no allowance for doubtful accounts was recorded. Changes in the factors above or other factors could result in a significant charge.

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

#### *Inventory Valuation and Classification*

Our inventory is valued at the lower of cost or market on an average cost basis. We regularly review inventory balances to determine whether a write-down is necessary. We consider various factors in making this determination, including recent sales history, including bulk sales, and predicted trends, industry market conditions, general economic conditions, the age of our inventory and recent quality control data. Changes in the factors above or other factors could result in significant inventory cost reductions and write-offs.

As of December 31, 2006, we reviewed assets for impairment in connection with the sale of our Harpin Protein Technology to PHC by comparing the carrying value at February 28, 2007 of assets sold to consideration received from PHC and recorded liabilities assumed by PHC. Based on this review, the carrying value of inventory sold to PHC exceeded the consideration received from PHC and recorded liabilities assumed by PHC. Accordingly, we recorded a \$452,347 charge for impairment to inventory as of December 31, 2006.

We also review our inventory to determine inventory classification. Inventory expected to be utilized in the next twelve-month period is classified as current and inventory expected to be utilized beyond that period is classified as non-current. In determining the classification of inventory, we consider a number of factors, including historical sales experience and trends, existing distributor inventory, expansion into new

markets, introduction of new products and estimates of future sales growth.

#### *Valuation of Property and Equipment*

We periodically review the carrying values of our property and equipment to determine whether such assets have been impaired. An impairment loss must be recorded pursuant to SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, when the undiscounted net cash flows expected to be realized from the use of such assets are less than their carrying value. The determination of undiscounted net cash flows expected requires us to make many estimates, projections and assumptions, including the lives of the assets, future sales and expense levels, additional capital investments or expenditures necessary to maintain the assets, industry market trends and general and industry economic conditions. Prior to the sale of our Harpin Protein Technology assets on February 28, 2007, our property and equipment consisted primarily of assets used to manufacture and sell our products and assets used in our research and administration. For the purpose of assessing asset impairment, we grouped all of these assets together in one asset group because our administration and research support our manufacturing and sales activities and do not have a separate identifiable cash flow. Equipment and leasehold improvements are stated at estimated fair value as a result of asset impairment charges recorded at June 30, 2006.

#### *Stock-Based Compensation*

We account for stock-based compensation in accordance with the fair value recognition provisions of SFAS 123R. We use the Black-Scholes-Merton option-pricing model which requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them ( expected term ), the estimated volatility of our common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements. Changes in the subjective assumptions can materially affect the estimate of fair value of stock-based compensation and consequently, the related amount recognized in the condensed consolidated statements of operations.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We do not currently hold any derivative instruments, and we do not engage in hedging activities. Also, we do not have any outstanding variable-rate debt and currently do not enter into any material transactions denominated in foreign currency. Because of the relatively short-term average maturity of our investment funds, such investments are sensitive to interest rate movements and we do not expect interest rate fluctuations to significantly affect our results of operations. Our direct exposure to interest rate and foreign exchange rate fluctuation is currently not material to our results of operations. We believe that the market risk arising from the financial instruments we hold is not material.

### **Item 4. Controls and Procedures**

Our President and Chief Financial Officer has carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of

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## **EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

### **NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the fiscal quarter covered by this report. Based on that evaluation, our President and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of the end of such quarter. There have been no changes in our internal control over financial reporting during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1A. Risk Factors**

Except as described below, there have not been any material changes during the quarter ended June 30, 2007 to the risk factors set forth in Part I, Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2006 filed with the SEC on March 30, 2007.

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On July 25, 2007, we entered into an employment agreement with Bradley S. Powell, our President and Chief Financial Officer, that extinguished Mr. Powell's existing change-in-control agreement and severance agreement in exchange for supplemental payments totaling \$356,145. The terms of the employment agreement are described above in this Form 10-Q. As a result of the termination of the change-in-control agreement and the severance agreement, the risk factor in the 10-K titled "Our liquidity and financial condition could be materially impaired if we are required to pay any severance amounts to Mr. Powell under his employment agreement and/or change in control agreement" is no longer applicable.

The following additional risk factor is applicable:

### **Our rights plan could discourage a change in control and harm the rights of our common shareholders**

On June 4, 2007, our Board of Directors adopted a shareholder rights plan and declared a dividend distribution of one preferred share purchase right on each outstanding share of our common stock. Each share of our outstanding common stock is now associated with one right to acquire one one-hundredth (1/100) of a share of our Series R Participating Cumulative Preferred Stock, without par value, at a purchase price of \$12.00.

The rights only become exercisable in certain limited circumstances on the distribution date, which is the earlier of: (1) the close of business on the tenth business day after a public announcement that a person has acquired beneficial ownership of 5% or, in the case of any person or group that owned beneficially 5% or more of our outstanding shares of common stock on June 1, 2007, 13% (or 18% in the case of SF Holding Corp., an existing investor that owns in excess of 16% of our outstanding shares) or more of our outstanding shares of common stock (such percentage of our outstanding shares is referred to as the "Requisite Percentage"); and (2) a date that our Board of Directors designates following the commencement of, or first public disclosure of an intent to commence, a tender or exchange offer for outstanding shares of common stock that could result in the offeror becoming the beneficial owner of the Requisite Percentage or more of our outstanding shares of common stock. Prior to the earlier of June 1, 2017, the expiration date of the rights, and a person becoming the beneficial owner of the Requisite Percentage or more of our outstanding shares of common stock, the rights are redeemable by us at a price of \$0.0025 per right. If the rights are not redeemed, each right will then entitle the holder to purchase for the purchase price common stock having the value of twice the then-current purchase price. After a person becomes the beneficial owner of the Requisite Percentage or more of our outstanding shares of common stock, but before a person becomes the beneficial owner of more than 50% of these shares, our Board of Directors may elect to exchange each preferred share purchase right, other than those that have become null and void and nontransferable as described above, for shares of common stock, without payment of the purchase price. The exchange rate in this situation would be one-half of the number of shares of common stock that would otherwise be issuable at that time upon the exercise of one preferred share purchase right.

The principal purpose of the preferred share purchase rights is to protect the utilization of our net operating tax loss carryforwards, which could be jeopardized in the event that any investor accumulates a large position in our stock. However, some provisions in the rights plan may have the effect of discouraging a third party from making an acquisition proposal for us and may thereby inhibit a change in control. For example, such provisions may deter tender offers for shares of common stock, which offers may be attractive to shareholders, or deter purchases of large

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## EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES

### NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

blocks of common stock, thereby limiting the opportunity for shareholders to receive a premium for their shares of common stock over the then-prevailing market prices.

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

The 2007 annual meeting of shareholders of Eden Bioscience Corporation was held on May 24, 2007. At the annual meeting, our shareholders were asked to elect three directors to our Board of Directors. The following directors were elected to serve for terms expiring at the 2010 Annual Meeting, or until the directors' earlier retirement, resignation or removal:

	<u>Votes For</u>	<u>Votes Withheld</u>
<u>Class III Directors:</u>		
Rhett R. Atkins	7,643,564	67,029
Jon E. M. Jacoby	7,656,624	53,969

