EDEN BIOSCIENCE CORP
Form 10-Q
November 06, 2003

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# FORM 10-Q

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(Mark One)
[X] **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended September 30, 2003**

**or**

[ ] **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the transition period from ____________ to ____________ .**

**Commission File Number 0-31499**

# EDEN Bioscience Corporation

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Washington** | **91-1649604** |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

**3830 Monte Villa Parkway, Suite 100**
**Bothell, Washington 98021-6942**
(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 [X] No [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes [ ] No [X]

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

| **Class** | **Outstanding as of November 5, 2003** |
|---|---|
| Common Stock, $.0025 Par Value | 24,361,990 |

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**EDEN Bioscience Corporation**

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**PART I FINANCIAL INFORMATION**

**Item 1. Unaudited Financial Statements**

**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(Unaudited)**

ASSETS

| | September 30, 2003 | December 31, 2002 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ 21,893,061 | $ 30,729,828 |
| Accounts receivable | 43,182 | 218,529 |
| Inventory | 2,123,747 | 2,216,420 |
| Other current assets | 541,548 | 770,136 |
| Total current assets | 24,601,538 | 33,934,913 |
| Property and equipment, net | 16,800,320 | 18,410,909 |
| Other assets | 1,637,658 | 1,647,304 |
| Total assets | $ 43,039,516 | $ 53,993,126 |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | September 30, 2003 | December 31, 2002 |
|---|---|---|
| Current liabilities: | | |
| Accounts payable | $ 264,580 | $ 361,801 |
| Accrued liabilities | 1,154,804 | 3,627,571 |
| Current portion of accrued loss on facility subleases | 492,629 | 292,482 |
| Current portion of capital lease obligations | 19,938 | 95,426 |
| Total current liabilities | 1,931,951 | 4,377,280 |
| Accrued loss on facility subleases, net of current portion | 2,497,604 | 2,613,651 |
| Capital lease obligations, net of current portion | 16,156 | 29,592 |
| Other long-term liabilities | 677,925 | 378,816 |
| Total liabilities | 5,123,636 | 7,399,339 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Preferred stock, $.01 par value, 10,000,000 shares authorized; no shares issued and outstanding at September 30, 2003 and December 31, 2002 | -- | -- |
| Common stock, $.0025 par value, 100,000,000 shares authorized; issued and outstanding shares - 24,354,322 shares at September 30, 2003; 24,307,495 shares at December 31, 2002 | 60,886 | 60,769 |
| Additional paid-in capital | 132,513,643 | 132,466,906 |
| Cumulative translation adjustment | (84,724) | (78,842) |
| Accumulated deficit | (94,573,925) | (85,855,046) |
| Total shareholders' equity | 37,915,880 | 46,593,787 |
| Total liabilities and shareholders' equity | $ 43,039,516 | $ 53,993,126 |

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

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Product sales, net of sales allowances | $ 102,533 | $ 59,884 | $ 1,498,057 | $ 1,687,420 |
| Operating expenses: | | | | |
| Cost of goods sold | 307,766 | 373,591 | 1,513,761 | 2,106,892 |
| Research and development | 982,983 | 2,535,579 | 4,013,389 | 8,157,002 |
| Selling, general and administrative | 1,406,321 | 1,965,629 | 4,852,024 | 6,842,039 |
| Total operating expenses | 2,697,070 | 4,874,799 | 10,379,174 | 17,105,933 |
| Loss from operations | (2,594,537) | (4,814,915) | (8,881,117) | (15,418,513) |
| Other income (expense): | | | | |
| Interest income | 62,411 | 170,347 | 233,862 | 582,994 |
| Interest expense | (1,393) | (7,940) | (8,116) | (31,390) |
| Total other income | 61,018 | 162,407 | 225,746 | 551,604 |
| Loss before income taxes and cumulative effect of adoption of SFAS No. 143 | (2,533,519) | (4,652,508) | (8,655,371) | (14,866,909) |
| Provision for income taxes | -- | -- | -- | -- |
| Loss before cumulative effect of adoption of SFAS No. 143 | (2,533,519) | (4,652,508) | (8,655,371) | (14,866,909) |
| Cumulative effect of adoption of SFAS No. 143 | -- | -- | (63,508) | -- |
| Net Loss | $ (2,533,519) | $ (4,652,508) | $ (8,718,879) | $ (14,866,909) |
| Basic and diluted net loss per share: | | | | |
| Loss before cumulative effect of adoption of SFAS No. 143 | $ (0.10) | $ (0.19) | $ (0.36) | $ (0.61) |
| Cumulative effect of adoption of SFAS No. 143 | -- | -- | -- | -- |
| Net loss | $ (0.10) | $ (0.19) | $ (0.36) | $ (0.61) |
| Weighted average shares outstanding used to compute net loss per share | 24,354,322 | 24,254,210 | 24,334,770 | 24,219,932 |
| Pro forma amounts assuming retroactive application of SFAS No. 143: | | | | |
| Net loss | $ (2,533,519) | $ (4,660,773) | $ (8,655,371) | $ (14,891,295) |
| Basic and diluted net loss per share | $ (0.10) | $ (0.19) | $ (0.36) | $ (0.61) |

*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**

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2003 | 2002 |
| Cash flows from operating activities: | | |
| Net loss | $ (8,718,879) | $ (14,866,909) |
| Adjustments to reconcile net loss to cash used in operating activities: | | |
| Depreciation and amortization | 1,656,035 | 1,981,489 |
| Amortization of stock option compensation expense | -- | 7,605 |
| Loss on disposal of fixed assets | 63,642 | 39,360 |
| Deferred rent payable | 107,682 | 102,969 |
| Accretion expense | 15,357 | -- |
| Cumulative effect of adoption of SFAS No. 143 | 63,508 | -- |
| Changes in assets and liabilities: | | |
| Accounts receivable | 177,338 | (73,444) |
| Inventory | 102,492 | 75,551 |
| Other assets | 236,021 | 414,591 |
| Accounts payable | (99,250) | (650,370) |
| Accrued liabilities | (2,482,528) | (217,555) |
| Accrued loss on facility subleases | 84,100 | -- |
| Other long-term liabilities | -- | (32,500) |
| Net cash used in operating activities | (8,794,482) | (13,219,213) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (209,525) | (204,615) |
| Proceeds from disposal of equipment | 200,556 | 24,473 |
| Net cash provided used in investing activities | (8,969) | (180,142) |
| Cash flows from financing activities: | | |
| Reduction in capital lease obligations | (88,924) | (172,665) |
| Proceeds from issuance of common stock | 46,854 | 115,981 |
| Net cash used in financing activities | (42,070) | (56,684) |
| Effect of foreign currency exchange rates on cash and cash equivalents | 8,754 | 7,654 |
| Net decrease in cash and cash equivalents | (8,836,767) | (13,448,385) |
| Cash and cash equivalents at beginning of period | 30,729,828 | 48,327,022 |
| Cash and cash equivalents at end of period | $ 21,893,061 | $ 34,878,637 |
| Supplemental disclosures: | | |
| Cash paid for interest | $ 8,116 | $ 31,390 |
| Depreciation charges capitalized into inventory | -- | 208,225 |

*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 (the Company ) was incorporated in the State of Washington on July 18, 1994. The Company is a plant technology company focused on developing, manufacturing and marketing innovative, natural protein-based products for agriculture and began sales of its initial product, Messenger®, in August 2000.

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with 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 footnotes required by generally accepted accounting principles for complete financial statements. The balance sheet at December 31, 2002 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the financial statements and notes for the year ended December 31, 2002 included in the Company s Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 27, 2003.

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 months and nine months ended September 30, 2003 are not necessarily indicative of the results expected for the full fiscal year or for any future period.

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

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 depreciable lives of property and equipment, expense accruals and provisions for sales allowances, warranty claims, inventory valuation, asset impairments, bad debts and asset retirement obligations. Such estimates and assumptions are based on historical experience, where applicable, and other assumptions. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the consolidated financial statements in the period in which they are determined to be necessary. Actual results could differ from these estimates.

***Property and Equipment***

Equipment and leasehold improvements are 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, units-of-production and accelerated methods, which allocate costs over their estimated useful lives of two to 20 years. Equipment leased under capital leases is depreciated over the shorter of its estimated useful life or lease term, which ranges between three to five years. Leasehold improvements are depreciated over the shorter of their estimated useful lives or lease terms, which range between two to ten years.

On January 1, 2003, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 143, Accounting for Asset Retirement Obligations, which provides the accounting requirements for retirement obligations associated with tangible long-lived assets. This statement requires companies to record the fair value of a liability for an asset retirement obligation in the period in which it is incurred.

***Revenue***

The Company recognizes revenue from product sales, net of sales allowances, when product is shipped to its distributors and all significant obligations of the Company have been satisfied, unless acceptance provisions or other contingencies exist. If acceptance provisions or contingencies exist, revenue is deferred and recognized later if such provisions or contingencies are satisfied. Distributors do not have price protection or product-return rights. Accounts receivable are presented net of sales allowances. The Company provides an allowance for warranty claims based on

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

historical experience, the results of product quality testing and future 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, product warehousing and delivery and information exchange and are estimated based on the terms of the distribution agreements currently in place. Sales allowances are accrued when the related product sales are recognized and are paid in accordance with the terms of the then-current distributor program agreements. Distributor program agreements expire annually, generally on December 31. Prior to 2003, sales allowances were paid when the distributors sold the product and reported the sales data to the Company, generally on a quarterly basis. The Company expects that sales allowances related to 2003 sales will be paid in 2003 and early 2004, upon submission by distributors of annual sales data. Gross product sales and sales allowances are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Gross product sales | $ 105,409 | $ 65,239 | $ 1,435,295 | $ 2,166,160 |
| Sales allowances | (2,876) | (5,355) | (63,539) | (478,740) |
| Elimination of previously recorded sales allowance liabilities | -- | -- | 126,301 | -- |
| Product sales, net of sales allowances | $ 102,533 | $ 59,884 | $ 1,498,057 | $ 1,687,420 |

Net product sales for the nine months ended September 30, 2003 includes the elimination of $126,301 of sales allowance liabilities recognized in prior quarters that will not be paid because of changes in distributor programs implemented in 2003 and actual amounts earned by distributors being less than amounts previously estimated.

***Recent Accounting Pronouncements***

SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities (effective January 1, 2003), replaces Emerging Issues Task Force Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring). SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and states that an entity s commitment to an exit plan, by itself, does not create a present obligation that meets the definition of a liability. SFAS No. 146 also establishes that fair value is the objective for initial measurement of the liability. The adoption of SFAS No. 146 is not expected to have a material impact on the Company s consolidated results of operations, financial position or cash flows.

In November 2002, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 45 ( FIN 45 ), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34. FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. FIN 45 also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of FIN 45 are applicable to guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of interim and annual periods ended after December 15, 2002. The disclosure modifications required for interim and annual periods ended after December 15, 2002 are included in the notes to these unaudited condensed consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an Amendment of FASB Statement No. 123. SFAS No. 148 amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of Statement No. 123 to require more prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ended after December 15, 2002 and are included in the notes to these unaudited condensed consolidated financial statements.

***Net Loss Per Share***

Basic net loss per share is calculated as the net loss divided by the weighted average number of common shares outstanding during the period. Diluted net loss per share is calculated as the net loss divided by the sum of the

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

weighted average number of common shares outstanding during the period plus the additional common shares that would have been issued had all dilutive warrants and options been exercised, less shares that would be repurchased with the proceeds from such exercises (treasury stock method). The effect of including outstanding options and warrants is antidilutive for all periods presented. Therefore, options and warrants have been excluded from the calculation of diluted net loss per share and consist of the following:

| | As of September 30, | |
|---|---|---|
| | 2003 | 2002 |
| Options to purchase common stock | 2,463,201 | 2,124,452 |
| Warrants to purchase common stock | 232,217 | 260,805 |

***Comprehensive Loss***

The following table summarizes the Company s comprehensive loss:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Net loss | $ (2,533,519) | $ (4,652,508) | $ (8,718,879) | $ (14,866,909) |
| Cumulative translation adjustment | (1,895) | (16,941) | (5,882) | (27,497) |
| Total comprehensive loss | $ (2,535,414) | $ (4,669,449) | $ (8,724,761) | $ (14,894,406) |

***Stock Compensation***

The Company has elected to apply the disclosure-only provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Accordingly, the Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. The following table illustrates the effect on net loss and loss per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Net loss, as reported | $ (2,533,519) | $ (4,652,508) | $ (8,718,879) | $ (14,866,909) |
| Add: Amortization of stock option compensation expense | -- | 2,535 | -- | 7,605 |
| Deduct: Total stock-based employee compensation expense under fair value based method | (367,265) | (534,894) | (1,288,122) | (1,420,713) |
| Pro forma net loss | $ (2,900,784) | $ (5,184,867) | $ (10,007,001) | $ (16,280,017) |
| Loss per share: | | | | |
| Basic and diluted - as reported | $ (0.10) | $ (0.19) | $ (0.36) | $ (0.61) |
| Basic and diluted - pro forma | $ (0.12) | $ (0.21) | $ (0.41) | $ (0.67) |

***Reclassifications***

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year.

**2. Inventory**

Inventory, at average cost, consists of the following:

| | September 30, 2003 | December 31, 2002 |
|---|---|---|
| Raw materials | $ 870,587 | $ 856,108 |
| Work in process | 238,292 | 291,118 |
| Finished goods | 1,014,868 | 1,069,194 |
| Total inventory | $ 2,123,747 | $ 2,216,420 |

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

**3. Property and Equipment**

Property and equipment, at cost, consists of the following:

| | September 30, 2003 | December 31, 2002 |
|---|---|---|
| Equipment | $ 12,690,166 | $ 12,759,251 |
| Equipment under capital leases | 219,012 | 478,565 |
| Leasehold improvements | 11,563,408 | 11,415,694 |
| | 24,472,586 | 24,653,510 |
| Less accumulated depreciation and amortization | (7,190,901) | (6,242,601) |
| Net property and equipment | $ 17,281,685 | $ 18,410,909 |

The Company recorded depreciation and amortization of $495,966 and $676,862 for the three months ended September 30, 2003 and 2002, respectively, and $1,656,035 and $2,189,714 for the nine months ended September 30, 2003 and 2002, respectively.

**4. Accrued Liabilities**

Accrued liabilities consist of the following:

| | September 30, 2003 | December 31, 2002 |
|---|---|---|
| Compensation and benefits | $ 311,412 | $ 751,540 |
| Warranty | 228,021 | 331,059 |
| Research and development field trial expenses | 202,201 | 604,068 |
| Sales allowances and marketing expenses | 193,462 | 1,170,657 |
| Facility costs | 139,678 | 426,889 |
| Other | 80,030 | 343,358 |
| Total accrued liabilities | $ 1,154,804 | $ 3,627,571 |

**5. Warranty Liability**

The Company records, at the time revenues are recognized, a liability for warranty claims based on a percentage of sales. The warranty accrual percentage, which has ranged between zero and five percent, and warranty liability are reviewed periodically and adjusted as necessary, based on historical experience, the results of product quality testing and future expectations. The following table summarizes changes to the Company s warranty liability during the nine months ended September 30, 2003:

| | |
|---|---|
| Balance at December 31, 2002 | $ 331,059 |
| Payments and other settlements | (41,071) |
| Accruals, net of changes in estimate of liability | (61,967) |
| Balance at September 30, 2003 | $ 228,021 |

**6. Stock Options and Warrants**

The following table summarizes stock option activity since December 31, 2002:

| | Number of Options |
|---|---|
| Balance at December 31, 2002 | 1,868,452 |
| Options granted | 1,153,000 |
| Options cancelled | (526,051) |
| Options exercised | (32,200) |
| Balance at September 30, 2003 | 2,463,201 |

On June 17, 2002, the Company offered to exchange certain outstanding options to purchase shares of its common stock granted to its then-current U.S. employees and officers (other than its Chief Financial Officer and then-Interim President) for new options to be granted under the 2000 Stock Incentive Plan on a date that was at least six months and one day after the date on which the Company cancelled the tendered options. The offer was made pursuant to a tender offer that expired on July 17, 2002. Employees who participated in the offer were required to

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

tender all stock options granted to them in October and November 2001, other than any options that may have been granted during that period expressly in connection with a promotion, with an exercise price of $7.00 per share for cancellation without replacement. On July 17, 2002, options to purchase 788,900 shares of the Company s common stock (representing approximately 56% of the shares subject to options eligible for participation in the offer) were tendered for cancellation, of which options to purchase 584,200 shares were tendered for exchange and options to purchase 204,700 shares were tendered for cancellation without replacement. On January 21, 2003, the Company granted new options to purchase 558,700 shares of its common stock. Each new option has an exercise price of $1.64 per share (the fair market value of the Company s common stock on the date of grant) and vests over four years at a rate of 25% on each anniversary of the vesting start date of the tendered option that it replaced.

As of September 30, 2003, the Company had warrants outstanding to purchase 232,217 shares of its common stock. No warrants to purchase shares of the Company s common stock were issued during the nine-month period ended September 30, 2003.

**7. 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 September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Customer A | $ 53,800 | $ -- | $ 363,200 | $ -- |
| Customer B | -- | ** | 182,400 | ** |
| Customer C | -- | -- | 167,600 | ** |
| Customer D | -- | 27,700 | ** | ** |
| Customer E | -- | -- | -- | 195,000 |
| Customer F | ** | -- | ** | 191,200 |
| Customer G | -- | -- | -- | 164,700 |
| Customer H | 20,500 | -- | ** | ** |
| Customer I | -- | 21,900 | -- | ** |
| Customer J | -- | 7,400 | -- | ** |

** Less than ten percent.

**8. Restructuring Charges and Other Costs**

The Company recorded aggregate restructuring costs of $160,082 in the nine months ended September 30, 2003 and $534,769 in the year ended December 31, 2002 for severance and other costs associated with workforce reductions that occurred during those periods. The following table summarizes changes to the Company s restructuring charge liability during the nine months ended September 30, 2003:

| | |
|---|---|
| Balance at December 31, 2002 | $ 56,534 |
| Accrual for additional restructuring charges | 160,082 |
| Payments and other reductions | (216,616) |
| Balance at September 30, 2003 | $ -- |

**9. Asset Retirement Obligation**

As of January 1, 2003, the Company adopted SFAS No. 143, Accounting for Asset Retirement Obligations, by recording an asset and liability in the amount of $129,093 related to asset retirement obligations the Company has at the expiration or earlier termination of its manufacturing facility lease. The lease expires on December 31, 2006, at which time the Company may extend the lease for three additional years. The Company has not restricted any assets for purposes of settling this asset retirement obligation. As of January 1, 2003, the Company also recorded a $63,508 charge for the cumulative effect of adopting SFAS No. 143, which consists of cumulative accretion of $34,821 and depreciation of $28,687 related to periods prior to January 1, 2003. Following is a reconciliation of the beginning and ending aggregate carrying value of the asset retirement obligation liability:

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**EDEN BIOSCIENCE CORPORATION AND SUBSIDIARIES**

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

| | |
|---|---|
| Initial measurement of obligation | $ 129,093 |
| Accretion expense for periods prior to January 1, 2003 | 34,821 |
| Accretion expense for the nine months ended September 30, 2003 | 15,357 |
| Balance at September 30, 2003 | $ 179,271 |

Pro forma net losses for the years ended December 31, 2002 and 2001, assuming retroactive application of SFAS No. 143, would be as follows:

| | Year Ended December 31, | |
|---|---|---|
| | **2002** | **2001** |
| Net loss, as reported | $ (23,505,567) | $ (23,714,967) |
| Accretion and depreciation expense | (32,792) | (30,716) |
| Pro forma net loss, assuming retroactive application of SFAS No. 143 | $ (23,538,359) | $ (23,745,683) |

The pro forma balance of the asset retirement obligation liability, assuming that SFAS No. 143 had been adopted prior to the quarter ended September 30, 2002 (the earliest period presented), would be $163,913 at December 31, 2002, $159,093 at September 30, 2002 and $145,465 at December 31, 2001.

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

*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 2002 audited financial statements and notes thereto included in our Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 27, 2003.*

*This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. We use words such as anticipate, believe, expect, future and intend, 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 factors described below and under the caption Factors That May Affect Our Business, Future Operating Results and Financial Condition set forth at the end of this Item 2. You should not place undue reliance on these 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. We undertake no obligation to publicly release 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 are a plant technology company focused on developing, manufacturing and marketing innovative natural protein-based products for agriculture. We have a fundamentally new, patented and proprietary technology that we believe enhances plant health and improves crop production and plant protection. We believe our technology and products provide growers with valuable benefits by increasing crop yields, quality and shelf-life, improving the plant s ability to withstand diseases and other environmental stresses and enhancing the utilization of foliar nutrients.

We have incurred significant operating losses since inception. We incurred net losses of $23.5 million in 2002 and $23.7 million in 2001. As of September 30, 2003, we had an accumulated deficit of $94.6 million. We incurred net losses of $8.7 million and $14.9 million for the nine months ended September 30, 2003 and 2002, respectively. Total operating expenses were $10.4 million for the nine months ended September 30, 2003, a decrease of $6.7 million from $17.1 million in the nine months ended September 30, 2002. We expect to incur significant additional net losses as we proceed with the commercialization of Messenger, Messenger STS and Employ and the development of new products and technologies.

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**Results of Operations**

*Three Months and Nine Months Ended September 30, 2003 and 2002*

*Revenues*

We generated our first product sales in August 2000. Product sales to date have resulted from sales of Messenger, primarily to distributors in the United States. Revenues from product sales are recognized when (a) the product is delivered to independent distributors or other customers, (b) we have satisfied all of our significant obligations and (c) any acceptance provisions or other contingencies have been satisfied. We do not offer product-return rights. Product sales are reported net of applicable sales allowances, as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Gross product sales | $ 105,409 | $ 65,239 | $ 1,435,295 | $ 2,166,160 |
| Sales allowances | (2,876) | (5,355) | (63,539) | (478,740) |
| Elimination of previously recorded sales allowance liabilities | -- | -- | 126,301 | -- |
| Product sales, net of sales allowances | $ 102,533 | $ 59,884 | $ 1,498,057 | $ 1,687,420 |

Gross product sales for the third quarter of 2003 totaled $105,000, an increase of $40,000 (62%) from $65,000 in the comparable quarter of 2002. Gross product sales for the first nine months of 2003 totaled $1.4 million, a decrease of $731,000 (33%) from $2.2 million for the same period in 2002. Sales in the first nine months of 2003 were made to 30 distributors, three of which accounted for an aggregate of 48% of net product sales. Sales in the first nine months of 2002 were made to 24 distributors, three of which accounted for an aggregate of 33% of net product sales. Sales in the quarters ended September 30, 2003 and 2002 continued to be negatively impacted by high levels of inventory held by distributors, the continuing challenges of commercializing a fundamentally new technology and product and the lagging U.S. economy. We expect these conditions to continue at least for the remainder of this year, which we expect will adversely impact our commercialization efforts and sales of Messenger and our two new products.

Sales to consumers in the home and garden market in the United States totaled $50,000 in the nine months ended September 30, 2003, or 3% of net product sales for the period. No sales to consumers in the home and garden market were recorded in the nine months ended September 30, 2002. We do not expect sales in this market to be significant in the remainder of 2003.

Foreign sales to customers in Europe and Central America totaled $28,000 in the nine months ended September 30, 2003, or 2% of net product sales for the period. No foreign sales were recorded in the nine months ended September 30, 2002. We do not expect foreign sales to be significant in the remainder of 2003.

In the first nine months of 2003, we shipped 377,000 ounces of Messenger to our distributors, compared to 477,000 ounces in the first nine months of 2002, a decrease of 100,000 ounces (21%). Based on information received from distributors, we estimate that our distributors sold approximately 75,000 ounces to growers in the third quarter of 2003, a decrease of approximately 68,000 ounces (48%) from approximately 143,000 ounces in the third quarter of 2002. For the first nine months of 2003, we estimate that our distributors sold approximately 497,000 ounces to growers, a decrease of approximately 114,000 ounces (19%) from approximately 611,000 ounces in the first nine months of 2002. We estimate that inventory held by distributors at September 30, 2003 was approximately 515,000 ounces, which we believe is high. We do not expect distributors that hold significant inventories of Messenger to place additional orders for Messenger until their current inventories are reduced and, therefore, we expect sales to distributors in the remainder of this year to be minor. One of our primary objectives in 2003 and 2004 is to continue working with distributors to significantly reduce their inventories of Messenger.

In February 2003, we negotiated with one of our distributors a compromise settlement whereby we paid $250,000 to settle unpaid accrued sales allowances and an uncollected account receivable. As part of the settlement agreement and mutual release, we accepted approximately 232,000 ounces of Messenger from that distributor. We do not anticipate entering into any additional such agreements.

During third quarter 2003, we conducted an in-depth analysis of Messenger s pricing and performance in comparison to that of other key products used by growers. This study suggests that the most significant factor in explaining the slow adoption rate of Messenger is the relationship of our price to other similarly priced chemical and

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non-chemical inputs. In September, with the cooperation of our retailers, we instituted a buy one, get one free program at the grower level that runs through the end of the year. This program provides us the opportunity to observe the effect of lower pricing in certain target markets this fall. We plan to use the information obtained from our pricing study, grower and distributor feedback, and the fall promotion to make final pricing decisions for the 2004 season. We will be introducing a new and improved formulation of Messenger early next year, trade named Messenger STS, and we expect that it will be priced significantly below the current price of Messenger. This will allow us to price toward the median crop input cost in our targeted crops and expand the attractiveness of our offer in other crops. We will also be introducing a new product, trade named Employ, for use in nutritional applications in the fourth quarter of this year.

Once we determine our 2004 pricing, we will work with our distributors to reduce the average cost of their existing Messenger inventories. We expect to accomplish this through delivery of our existing and future products to distributors in the first quarter of 2004. We expect that some of this product will be delivered at no cost to distributors and we do not, therefore, expect to recognize any revenues in relation to such product. This will substantially increase channel inventory in the immediate term but will, we believe, significantly improve our growth rate and our sales to distributors over the medium term.

Due to the growing seasons of our targeted crops, we expect grower usage of our products to be highly seasonal. Based on the recommended application timing in our targeted crops and information received from our distributors, we expect the second quarter of each year to be the most significant period of use. Our 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 amount of our products in distributors inventories.

*Sales Allowances*

Sales allowances represent allowances granted to independent distributors for sales and marketing support, product warehousing and delivery and information exchange and are estimated based on the terms of the distribution agreements. Sales allowances are accrued when the related product sales are recognized and are paid in accordance with the terms of the then-current distributor program agreements. Distributor program agreements expire annually, generally on December 31. Prior to 2003, sales allowances were paid when the distributors sold the product and reported the sales data to the Company, generally on a quarterly basis. Previously accrued sales allowances totaling approximately $546,000 related to Messenger inventory held by distributors at December 31, 2002 were paid in the first quarter of 2003. We expect that sales allowances related to 2003 sales will be paid in 2003 and early 2004, upon submission by distributors of annual sales data.

Beginning in 2003, we made several changes to our distributor program. We reduced both the cost of Messenger to our distributors and the sales allowance they will receive, thereby lowering the necessary working capital investment by distributors who maintain inventories of Messenger. As a result of these changes, sales allowances related to gross sales during the three months ended September 30, 2003 totaled $3,000 (3% of gross product sales), compared to $5,000 (8% of gross product sales) in the comparable period of 2002. Sales allowances related to gross sales during the nine months ended September 30, 2003 totaled $64,000 (4% of gross product sales), compared to $479,000 (22% of gross product sales) in the same period in 2002. We expect sales allowances to average between three and five percent of gross product sales for the remainder of 2003. Estimated sales allowance liabilities recognized in prior years totaling $126,000 will not be paid because of changes in distributor programs implemented in 2003 and actual amounts earned by distributors being less than amounts previously estimated.

*Cost of Goods Sold*

Cost of goods sold consists primarily of the cost of Messenger sold to distributors, idle capacity charges, inventory cost reductions and write-offs and the cost of Messenger used for promotional purposes. Cost of goods sold was $308,000 in the third quarter of 2003, compared to $374,000 in the third quarter of 2002. This decrease was primarily due to a reduction in the estimated warranty liability. For the first nine months of 2003, cost of goods sold was $1.5 million, compared to $2.1 million for the same period in 2002. This decrease resulted primarily from lower product sales in 2003 compared to 2002, a reduction in the estimated warranty liability and a reduction in Messenger used for promotional purposes. We expect to continue incurring idle capacity charges in the future.

Our inventory includes approximately 504,000 ounces of Messenger that was manufactured more than two years ago. In addition, we estimate that distributors own approximately 515,000 ounces of Messenger that was manufactured more than two years ago. Due to the age of this inventory, we are conducting limited re-testing of

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Messenger samples produced in 2000 and 2001. During the first nine months of 2003, we voluntarily recalled and replaced approximately 10,000 ounces of Messenger owned by distributors that our limited re-testing indicated had degraded below our quality control standards. If our limited re-testing program indicates that additional material has degraded below our quality standards, we may have to record inventory write-downs and replace any such product owned by distributors or growers.

*Research and Development Expenses*

Research and development expenses consist primarily of personnel, field trial, laboratory, regulatory, patent and facility expenses. Research and development expenses decreased $1.5 million (60%) from $2.5 million in the third quarter of 2002 to $983,000 in the same quarter of this year. For the first nine months of 2003, research and development costs were $4.0 million, a decrease of $4.2 million (51%) from $8.2 million in the same period last year. This decrease was primarily due to lower spending on personnel costs, field trials, facility costs (including depreciation) and travel. Research and development costs in the quarter ended September 30, 2003 were approximately 35% lower than average research and development costs in the first and second quarters of 2003, primarily as a result of the staff reduction that occurred during second quarter 2003.

*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 $559,000 (28%) from $2.0 million in the third quarter of 2002 to $1.4 million in the same quarter of 2003. For the first nine months of 2003, selling, general and administrative expenses were $4.9 million, a decrease of $1.9 million (28%) from $6.8 million in the same period last year. The majority of this decrease occurred in the United States and resulted primarily from reductions in personnel, advertising and marketing costs. Compared to average costs in the first and second quarters of 2003, company-wide selling, general and administrative costs in the third quarter of this year were lower by approximately 18%.

In April 2003, we subleased to a third party approximately 7,300 square feet of additional office space in our headquarters in Bothell, Washington. Due to declines in the real estate market, the rent we will receive is less than the rent we will pay on the subleased space. As a result, we recorded in selling, general and administrative expenses a $235,000 loss on the sublease in April 2003. In September 2003, we recorded an additional loss of approximately $134,000 on this sublease as a result of a reduction in the amount of rental income expected to be received over the term of the sublease.

*Interest Income*

Interest income consists of earnings on our cash and cash equivalents. Interest income decreased $108,000 (64%) from $170,000 in the third quarter of 2002 to $62,000 in the same quarter of this year. For the first nine months of 2003, interest income was $234,000, down $349,000 (60%) from $583,000 in the same period last year. This decrease was due primarily to significantly lower average cash balances available for investment in the current year and interest rate reductions that occurred in the past year.

*Interest Expense*

Interest expense consists of interest we pay on capital leases used to finance certain equipment purchases. Interest expense decreased $7,000 from $8,000 in the third quarter of 2002 to $1,000 in the same quarter of this year. For the first nine months of 2003, interest expense was $8,000, down $23,000 from $31,000 in the same period last year. This decrease was due to reduced leasing activity and lower average principal balances as we pay down our existing capital lease obligations.

*Income Taxes*

We have generated a net loss from operations in each period since we began doing business. As of December 31, 2002, we had accumulated approximately $78.8 million of net operating loss carryforwards for federal income tax purposes. These carryforwards expire between 2009 and 2022. Our foreign tax net operating loss carryforwards totaled $6.7 million at December 31, 2002 and expire in 2006 and 2007. The annual use of these net operating loss carryforwards may be limited in the event of a cumulative change in ownership of more than

50%.

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**Liquidity and Capital Resources**

At September 30, 2003, our cash and cash equivalents totaled $21.9 million, a decrease of $8.8 million from the $30.7 million balance at December 31, 2002. Prior to October 2000, we financed our operations primarily through the private sale of our equity securities, which resulted in net proceeds of approximately $36.5 million through September 30, 2000. In October 2000, we received approximately $91.5 million in net proceeds from the initial public offering of 6,670,000 shares of our common stock. To a lesser extent, we have financed our equipment purchases through lease financings.

Net cash used in operations decreased $4.4 million (33%) from $13.2 million in the first nine months of 2002 to $8.8 million in the same period of 2003. Net cash used in operations in the first nine months of 2003 resulted primarily from a net loss of $7.0 million, after adding back depreciation expense of $1.7 million, and fluctuations in various asset and liability balances totaling $2.0 million. We expect that net cash used in operations will continue to be significant.

Investing activities used cash of $9,000 in the first nine months of 2003 and $180,000 in the first nine months of 2002. This reduction is due primarily to proceeds from the disposal of equipment in 2003. Net cash used in financing activities decreased $15,000 (26%) from $57,000 in the first nine months of 2002 to $42,000 in the same period of 2003. The primary use of funds in 2003 was to pay down principal on our outstanding capital leases, offset by proceeds of $47,000 from the issuance of shares of our common stock.

We conduct our operations in three primary functional currencies: the U.S. dollar, the European Union euro and the Mexican peso. 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, euros and Mexican pesos, 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. Foreign exchange rate fluctuations did not have a material impact on our financial results in the three-month or nine-month periods ended September 30, 2003 or 2002.

The following are our contractual obligations as of September 30, 2003: