

VERENIUM CORP

FORM 10-K/A (Amended Annual Report)

Filed 03/20/07 for the Period Ending 12/31/06

Address	55 CAMBRIDGE PARKWAY CAMBRIDGE, MA 02142
Telephone	617 674 5300
CIK	0001049210
Symbol	VRNMD
SIC Code	2860 - Industrial Organic Chemicals
Industry	Biotechnology & Drugs
Sector	Healthcare
Fiscal Year	12/31

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

**FORM 10-K/A
(Amendment No. 1)**

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

For the fiscal year ended December 31, 2006; or

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

Commission File Number 000-29173

DIVERSA CORPORATION

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

4955 Directors Place, San Diego, California
(Address of principal executive offices)

22-3297375
(I.R.S. Employer Identification No.)

92121
(Zip Code)

Registrant's telephone number, including area code: (858) 526-5000

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, \$0.001 par value	The NASDAQ Stock Market, LLC

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

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 Act). Yes No

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of June 30, 2006 was \$298,978,951.*

The number of shares outstanding of the Registrant's common stock was 48,350,226 as of March 1, 2007. The Registrant has no non-voting stock outstanding.

* Based on the closing price of the Registrant's common stock on the Nasdaq Global Market on June 30, 2006 of \$9.66 per share. Excludes the common stock held by executive officers, directors and stockholders whose ownership exceeded 10% of the common stock outstanding at June 30, 2006. This calculation does not reflect a determination that such persons are affiliates for any other purposes.

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (the “*Amendment*”) amends the Registrant’s Annual Report on Form 10-K for the fiscal year ended December 31, 2006, originally filed on March 16, 2007 (the “*Original Filing*”). The Registrant is filing the Amendment to revise Part I Item 3 “Legal Proceedings” and Note 6 to the Registrant’s Consolidated Financial Statements included in Part II Item 8 “Financial Statements and Supplementary Data” to include disclosure related to a patent interference proceeding which was discussed in response to other items in the Original Filing but was inadvertently omitted from Part I Item 3 and Note 6 to the Registrant’s Consolidated Financial Statements included in Part II Item 8. Part IV is also being amended to update the Exhibit Index and to add certain current dated certifications of the Registrant’s Chief Executive Officer and Chief Financial Officer under the Securities Exchange Act of 1934, as amended.

The Original Filing as amended hereby continues to speak as of the date of the Original Filing and the disclosures have not been updated to speak as of any later date. Any items in the Original Filing that are not expressly changed hereby shall be as set forth in the Original Filing. Accordingly, the Amendment should be read together with the Original Filing and the Registrant’s other filings made with the Securities and Exchange Commission. All information contained in the Amendment and the Original Filing is subject to updating and supplementing as provided in the Registrant’s subsequent periodic reports filed with the Securities and Exchange Commission.

Item 3 of Part I, Item 8 of Part II and Part IV, as amended, appear below.

ITEM 3. LEGAL PROCEEDINGS.

In December 2002, we and certain of our officers and directors were named as defendants in a class action shareholder complaint filed in the United States District Court for the Southern District of New York, now captioned *In re Diversa Corp. Initial Public Offering Sec. Litig.*, Case No. 02-CV-9699. In the amended complaint, the plaintiffs allege that we and certain of our officers and directors, and the underwriters (the “Underwriters”) of our initial public offering, or IPO, violated Sections 11 and 15 of the Securities Act of 1933, as amended, based on allegations that our registration statement and prospectus prepared in connection with our IPO failed to disclose material facts regarding the compensation to be received by, and the stock allocation practices of, the Underwriters. The complaint also contains claims for violation of Sections 10(b) and 20 of the Securities Exchange Act of 1934, as amended, based on allegations that this omission constituted a deceit on investors. The plaintiffs seek unspecified monetary damages and other relief. This action is related to *In re Initial Public Offering Sec. Litig.*, Case No. 21 MC 92, in which similar complaints were filed by plaintiffs (the “Plaintiffs”) against hundreds of other public companies (collectively, the “Issuers”) that conducted IPOs of their common stock in the late 1990s and 2000 (collectively, the “IPO Cases”). On January 7, 2003, the IPO Case against us was assigned to United States Judge Shira Scheindlin of the Southern District of New York, before whom the IPO Cases have been consolidated for pretrial purposes.

In February 2003, the Court issued a decision denying the motion to dismiss the Sections 11 and 15 claims against us and our officers and directors, and granting the motion to dismiss the Section 10(b) claim against us without leave to amend. The Court similarly dismissed the Sections 10(b) and 20 claims against two of our officers and directors without leave to amend, but denied the motion to dismiss these claims against one officer/director.

In June 2003, Issuers and Plaintiffs reached a tentative settlement agreement and entered into a memorandum of understanding providing for, among other things, a dismissal with prejudice and full release of the Issuers and their officers and directors from all further liability resulting from Plaintiffs’ claims, and the assignment to Plaintiffs of certain potential claims that the Issuers may have against the Underwriters. The tentative settlement also provides that, in the event that Plaintiffs ultimately recover less than a guaranteed sum of \$1 billion from the Underwriters in the IPO Cases and related litigation, Plaintiffs would be entitled to payment by each participating Issuer’s insurer of a pro rata share of any shortfall in the Plaintiffs’ guaranteed

recovery. In the event, for example, the Plaintiffs recover nothing in judgment against the Underwriter defendants in the IPO Cases and the Issuers' insurers therefore become liable to the Plaintiffs for an aggregate of \$1 billion pursuant to the settlement proposal, the pro rata liability of our insurers, with respect to us, would be \$5 million, assuming that 200 Issuers which approved the settlement proposal, and their insurers, were operating and financially viable as of the settlement date. We are covered by a claims-made liability insurance policy that would satisfy our insurers' pro rata liability described in this hypothetical example.

In June 2004, we executed a settlement agreement with the Plaintiffs pursuant to the terms of the memorandum of understanding. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the Court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order. On February 24, 2006, the Court dismissed litigation filed against certain underwriters in connection with the claims to be assigned to the plaintiffs under the settlement. On April 24, 2006, the Court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower Court's earlier decision certifying as class actions the six IPO Cases designated as "focus cases." The Court has ordered a stay of all proceedings in all of the IPO Cases pending the outcome of Plaintiffs' rehearing petition to the Second Circuit. Accordingly, the Court's decision on final approval of the settlement remains pending.

On September 22, 2006, we issued a letter to Valley communicating our intent to terminate Valley's exclusive distributorship for Ultra-Thin enzyme on the basis of Valley's not having met certain minimum sales requirements. On December 7, 2006, Valley filed a civil complaint in San Diego Superior Court against us, alleging breach of contract. In the complaint, Valley alleges that the Valley "Ultra-Thin"™ product was unstable and performed poorly, which caused Valley to be unable to satisfy certain contractual requirements. In the complaint, Valley seeks money damages for our alleged breach of contract, and potentially for additional damages for termination of Valley's exclusivity. We believe that the claims made by Valley have no merit, and we intend to defend ourselves vigorously. We filed an answer and cross complaint in February 2007 responding to the charges and asserting certain other charges against Valley. On March 7, 2007, we issued a letter to Valley terminating our distribution agreement with Valley, effective immediately, on the basis of Valley's not having met certain minimum purchase requirements.

On February 14, 2007, a patent interference proceeding was declared in the U.S. Patent and Trademark Office between a U.S. patent assigned to us and a pending U.S. patent application owned by Maxygen, Inc. with allowable claims directed to GeneReassembly. Maxygen seeks an entry of adverse judgment against us. A schedule for the motion phase of the interference proceeding will be discussed with the Administrative Patent Judge in April 2007. It is too early to assess the respective positions of the parties until the preliminary motions are exchanged.

We are also, from time to time, subject to legal proceedings and claims which arise in the normal course of business. In our opinion, the amount of ultimate liability with respect to these actions will not have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Diversa Corporation

We have audited the accompanying consolidated balance sheets of Diversa Corporation as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Diversa Corporation at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, Diversa Corporation changed its method of accounting for share-based payments in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004) on January 1, 2006.

The accompanying financial statements have been prepared assuming that Diversa will continue as a going concern. As discussed in Note 1 to the financial statements, Diversa has entered into a definitive merger agreement. The Company has insufficient cash and working capital to effect the merger and fund the combined business plan as contemplated, which raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Diversa Corporation's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 14, 2007 expressed an unqualified opinion on management's assessment and on the effectiveness of internal control over financial reporting.

/s/ E RNST & Y OUNG LLP

San Diego, California
March 14, 2007

DIVERSA CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands, except par value)

	December 31,	
	2006	2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 38,541	\$ 43,859
Short-term investments	13,371	21,569
Accounts receivable, net (including \$418 and \$1,657 from a related party at December 31, 2006 and 2005)	8,646	9,012
Inventories, net	4,098	2,671
Prepaid expenses and other current assets	2,378	2,325
Total current assets	67,034	79,436
Property and equipment, net	12,418	18,245
Other assets	453	388
Total assets	\$ 79,905	\$ 98,069
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 5,192	\$ 4,968
Accrued expenses	4,033	3,320
Accrued compensation	4,843	2,836
Restructuring reserve	1,908	—
Deferred revenue (including \$3,106 and \$5,931 from a related party at December 31, 2006 and 2005.)	5,395	7,535
Current portion of notes payable	5,223	7,024
Total current liabilities	26,594	25,683
Notes payable, less current portion	3,724	6,332
Deferred revenue, less current portion	783	1,250
Restructuring reserve, less current portion	5,888	—
Commitments and contingencies		
Stockholders' equity:		
Preferred stock—\$0.001 par value; 5,000 shares authorized, no shares issued and outstanding at December 31, 2006 and 2005	—	—
Common stock—\$0.001 par value; 90,000 shares authorized, 48,235 and 45,048 shares issued and outstanding at December 31, 2006 and 2005	48	45
Additional paid-in capital	372,415	358,307
Deferred compensation	—	(3,130)
Accumulated deficit	(329,486)	(290,215)
Accumulated other comprehensive loss	(61)	(203)
Total stockholders' equity	42,916	64,804
Total liabilities and stockholders' equity	\$ 79,905	\$ 98,069

See accompanying notes.

DIVERSA CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Years Ended December 31,		
	2006	2005	2004
Revenues (including related party revenues of \$22,695, \$24,305 and \$36,889 in 2006, 2005 and 2004):			
Collaborative	\$ 30,014	\$ 34,392	\$ 41,897
Grant	3,317	10,079	10,241
Product-related	15,867	9,832	5,412
Total revenue	<u>49,198</u>	<u>54,303</u>	<u>57,550</u>
Operating expenses:			
Cost of product-related revenue	12,914	10,662	3,698
Research and development	50,033	72,751	73,405
Selling, general and administrative	14,800	12,990	11,607
Amortization of acquired intangible assets	—	2,602	2,598
Restructuring charges	12,026	—	—
Asset impairment charges	—	45,745	—
Total operating expenses	<u>89,773</u>	<u>144,750</u>	<u>91,308</u>
Loss from operations	(40,575)	(90,447)	(33,758)
Other income (expense)	—	—	230
Interest income	2,307	2,011	1,767
Interest expense	(1,003)	(1,282)	(1,664)
Net loss	<u>\$(39,271)</u>	<u>\$(89,718)</u>	<u>\$(33,425)</u>
Net loss per share, basic and diluted	<u>\$ (0.85)</u>	<u>\$ (2.04)</u>	<u>\$ (0.77)</u>
Shares used in calculating net loss per share, basic and diluted	46,474	44,064	43,416

See accompanying notes.

DIVERSA CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock		Additional Paid-In Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Shares	Amount					
Balance at January 1, 2004	43,051	\$ 43	\$348,279	\$ —	\$ (167,072)	\$ 193	\$ 181,443
Net loss	—	—	—	—	(33,425)	—	(33,425)
Change in unrealized loss on available-for-sale securities	—	—	—	—	—	(530)	(530)
Comprehensive loss							(33,955)
Issuance of common stock under stock plans, net of forfeitures	679	1	3,457	—	—	—	3,458
Balance at December 31, 2004	43,730	44	351,736	—	(200,497)	(337)	150,946
Net loss	—	—	—	—	(89,718)	—	(89,718)
Change in unrealized loss on available-for-sale securities	—	—	—	—	—	134	134
Comprehensive loss	—	—	—	—	—	—	(89,584)
Issuance of common stock under stock plans, net of forfeitures	1,318	1	2,564	—	—	—	2,565
Non-cash compensation charges	—	—	142	—	—	—	142
Deferred compensation charges, net of adjustments for forfeitures	—	—	3,865	(3,865)	—	—	—
Amortization of deferred compensation, net	—	—	—	735	—	—	735
Balance at December 31, 2005	45,048	\$ 45	\$358,307	\$ (3,130)	\$ (290,215)	\$ (203)	\$ 64,804
Net loss	—	—	—	—	(39,271)	—	(39,271)
Change in unrealized loss on available-for-sale securities	—	—	—	—	—	142	142
Comprehensive loss	—	—	—	—	—	—	(39,129)
Issuance of common stock under stock plans, net of forfeitures	3,187	3	11,548	—	—	—	11,551
Reversal of deferred compensation pursuant to adoption of FASB No. 123(R)	—	—	(3,130)	3,130	—	—	—
Share-based compensation, net	—	—	5,690	—	—	—	5,690
Balance at December 31, 2006	48,235	\$ 48	\$372,415	\$ —	\$ (329,486)	\$ (61)	\$ 42,916

See accompanying notes

DIVERSA CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	2006	2005	2004
Operating activities:			
Net loss	\$ (39,271)	\$ (89,718)	\$(33,425)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	9,018	17,732	17,964
Non-cash, asset impairment charges	—	45,745	—
Non-cash, stock-based compensation	5,690	877	—
Non-cash, restructuring	226	—	—
Net loss on disposals of property and equipment	391	1,297	—
Change in operating assets and liabilities:			
Accounts receivable, net	366	(3,241)	(355)
Inventory and other current assets	(1,480)	(1,744)	(1,793)
Other assets	(65)	719	(184)
Accounts payable	224	2,773	(558)
Accrued liabilities	3,340	(1,060)	1,387
Deferred revenue	(2,607)	2,893	(5,422)
Restructuring reserve	7,796	—	—
Net cash used in operating activities	<u>(16,372)</u>	<u>(23,727)</u>	<u>(22,386)</u>
Investing activities:			
Purchases of property and equipment	(4,362)	(7,286)	(7,654)
Purchases of investments	(217,248)	(223,015)	(42,876)
Sales and maturities of investments	225,590	265,977	84,925
Net cash provided by investing activities	<u>3,980</u>	<u>35,676</u>	<u>34,395</u>
Financing activities:			
Proceeds from equipment financing	3,088	5,540	9,077
Principal payments on equipment financing obligations	(7,500)	(9,991)	(11,254)
Proceeds from sale of assets	781	—	—
Net proceeds from issuance of common stock	10,705	2,565	3,458
Net cash provided by (used in) financing activities	<u>7,074</u>	<u>(1,886)</u>	<u>1,281</u>
Net (decrease) increase in cash and cash equivalents	(5,318)	10,063	13,290
Cash and cash equivalents at beginning of year	43,859	33,796	20,506
Cash and cash equivalents at end of year	<u>\$ 38,541</u>	<u>\$ 43,859</u>	<u>\$ 33,796</u>
Supplemental disclosure of cash flow information:			
Interest paid	<u>\$ 992</u>	<u>\$ 1,205</u>	<u>\$ 1,541</u>
Supplemental disclosure of non-cash operating and financing activities:			
Restricted common stock issued to settle employee bonus liabilities	<u>\$ 620</u>	<u>\$ —</u>	<u>\$ —</u>
Restricted common stock issued to settle employee termination costs	<u>\$ 226</u>	<u>\$ —</u>	<u>\$ —</u>

See accompanying notes.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Summary of Significant Accounting Policies

The Company

Diversa Corporation is a biotechnology company, founded in 1992, that customizes enzymes for manufacturers within the alternative fuels, industrial, and health and nutrition markets to enable higher throughput, lower costs, and improved environmental outcomes.

As more fully described in the accompanying footnotes and prior filings with the Securities and Exchange Commission, on January 5, 2006 the Company announced a strategic reorganization, pursuant to which the Company has focused its resources on advancing its most promising product candidates and programs that have the greatest near-term opportunities. As part of this reorganization, the Company eliminated and/or significantly scaled back its investments in certain programs and lines of business which were not consistent with this current strategic focus. Specifically, the Company reduced or eliminated programs in fine chemicals, animal health, therapeutic antibody optimization, and small molecule drug discovery. As a result, the Company reduced its workforce by 83 employees and consolidated its facilities. In connection with the reorganization, during the fourth quarter of 2005, the Company recorded a non-cash impairment charge of \$45.7 million to write off long-lived tangible and intangible assets that the Company determined to be no longer essential to the Company's focus and determined to be impaired under current accounting rules. During the twelve months ended December 31, 2006, the Company also recorded net restructuring charges of \$12.0 million related to employee separation and facilities consolidation costs as part of this reorganization (*See Note 7—Impairment Charges and Restructuring Activities*).

Recent Strategic Events and Capital Requirements

As more fully described in *Note 3—Significant Agreements* , in December 2006, the Company entered into a new agreement with Syngenta Participations AG (“Syngenta”), a related party, which replaced a prior agreement with Syngenta. Under the terms on the new 10-year agreement, Syngenta will commit a minimum of \$16.0 million over the next two years to fund joint research and development activities, largely in defined areas of biofuels. This new agreement reduces total committed funding as compared to the prior agreement by approximately \$19.0 million over the next three years, but also gives the Company the freedom to operate in fields which were previously excluded under the prior agreement.

In January 2007, the Company announced that it would pursue opportunities for the vertically-integrated commercialization of biofuels, in particular ethanol from cellulosic biomass. To date, the Company has focused primarily on the development of novel, high-performance enzymes for cellulosic biomass feedstocks as part of its specialty enzyme business.

In February 2007, as more fully described in *Note 14—Subsequent Events* , the Company entered into a definitive merger agreement with Celunol Corp. (“Celunol”), a Delaware corporation. The merger agreement has been approved by the boards of directors of both the Company and Celunol, and is subject to shareholder approval. In February 2007, Celunol completed a significant upgrade of its pilot-scale facility in Jennings, Louisiana and, on the same Celunol-owned property, has begun construction of a 1.4 million gallons-per-year, demonstration-scale facility to produce cellulosic ethanol from sugarcane bagasse and specially-bred energy cane. Celunol expects that its demonstration-scale facility will be mechanically complete by the end of 2007.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In connection with the proposed merger, the Company is committed to funding Celunol up to \$20 million in cash prior to the close of the transaction, subject to the terms and conditions of a promissory note. In addition, substantial cash requirements will be necessary to execute the combined business plan subsequent to the closing, which is expected by the end of the second quarter of 2007.

The Company has insufficient cash and working capital to effect the merger and combined business plan as contemplated. Management believes that it will be able to obtain sufficient financing in the short-term to fund the operations of the combined entity through at least 2007; however, there is substantial doubt as to whether the Company will be able to continue as a going concern through 2007 without access to additional working capital. If the Company cannot obtain sufficient additional financing in the short-term, it may be forced to restructure or significantly curtail its operations, file for bankruptcy or cease operations. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or amounts and classification of liabilities that might be necessary should the Company be forced to take any such actions.

Basis of Consolidation

The consolidated financial statements include the financial statements of the Company and its two wholly-owned subsidiaries, which were inactive as of December 31, 2006. All significant inter-company balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers cash equivalents to be only those investments which are highly liquid, readily convertible to cash and which mature within three months from the date of purchase.

Short-term Investments

Based on the nature of the assets held by the Company and management's investment strategy, the Company's investments have been classified as available-for-sale. Management determines the appropriate classification of debt securities at the time of purchase. Securities classified as available-for-sale are carried at estimated fair value, as determined by quoted market prices, with unrealized gains and losses reported as a separate component of comprehensive income. At December 31, 2006, the Company had no investments that were classified as trading or held-to-maturity as defined by the Financial Accounting Standards Board ("FASB") Statement No. 115, "*Accounting for Certain Investments in Debt and Equity Securities* ." The amortized cost of debt securities classified as available-for-sale is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion is included in interest income. Realized gains and losses on sales of available-for-sale securities are computed based upon initial cost adjusted for any other than temporary declines in fair value and are included in interest income. The cost of securities sold is based on the specific identification method. Interest on securities classified as available-for-sale is included in interest income.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Inventories

Inventories are valued at the lower of cost or market value. Cost is substantially determined by the first-in, first-out method, and includes material, labor, and factory overhead. If necessary, the Company adjusts its inventories by an estimated allowance for excess and obsolete inventories. The determination of the need for an allowance is based on management's review of inventories on hand compared to estimated future usage and sales as well as judgments, quality control testing data, and assumptions about the likelihood of obsolescence. The Company maintained a valuation allowance of \$350,000 and \$150,000 at December 31, 2006 and 2005.

Concentration of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash, cash equivalents, and short-term investments. The Company limits its exposure to credit risk by placing its cash with high credit quality financial institutions. The Company generally invests its excess cash in U.S. Treasury and government agency obligations and investment-grade corporate securities.

The Company's accounts receivable consist of amounts due from customers for the sale of products, amount due from governmental agencies for costs incurred under funded projects, and amounts due from corporate partners under various collaboration agreements. The Company regularly assesses the need for an allowance for potentially uncollectible accounts receivable arising from its customers' inability to make required payments. The Company has a limited number of accounts receivable and uses the specific identification method as a basis for determining this estimate. Historically, losses related to uncollectible accounts receivable have been minimal. The Company maintained an allowance for doubtful accounts of \$229,000 at December 31, 2006, and had no allowance for doubtful accounts at December 31, 2005.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets (generally three to five years) using the straight-line method. Amortization of leasehold improvements is computed over the shorter of the lease term or the estimated useful life of the related assets. For the years ended December 31, 2006, 2005, and 2004, the Company recorded depreciation expense of \$9.0 million, \$12.5 million and \$12.8 million, which includes the depreciation of assets under capital leases.

Acquired Intangible Assets

In accordance with Accounting Principles Board Opinion ("APB") No. 17, "*Accounting for Intangible Assets*," the Company's intangible assets, which all fall into one intangible asset class, are recorded at cost and are amortized over their estimated useful lives, which range from seven to fifteen years. For purposes of evaluating impairment of the acquired intangible assets, the Company compares the carrying values and estimated future cash flows of both the acquired assets and the Company's internally developed technologies on a combined basis. In connection with the Company's strategic reorganization, the Company determined, based on an analysis of estimated future cash flows, that the acquired intangible assets were fully impaired as of December 31, 2005, and recorded an impairment charge totaling \$43.5 million to write off the value of these assets (*See Note 7—Impairment Charges and Restructuring Activities*).

Impairment of Long-Lived Assets

In accordance with FASB No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*," if indicators of impairment exist, the Company assesses the recoverability of the affected long-lived assets by determining whether the carrying value of such assets can be recovered through undiscounted future operating

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

cash flows. If impairment is indicated, the Company measures the amount of such impairment by comparing the carrying value of the asset to the present value of the expected future cash flows associated with the use of the asset. In connection with the Company's strategic reorganization, the Company determined, based on an analysis of estimated future cash flows, that the Company's property and equipment carrying values were impaired as of December 31, 2005, and recorded an impairment charge totaling \$2.2 million to write down the value of these assets to their net realizable value (*See Note 7—Impairment Charges and Restructuring Activities*).

Fair Value of Financial Instruments

Financial instruments, including cash and cash equivalents, short-term investments, accounts receivable, accounts payable, and accrued liabilities, are carried at cost, which management believes approximates fair value because of the short-term maturity of these instruments. The carrying amounts of debt obligations approximate their respective fair values as they bear terms that are comparable to those available under current market conditions.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin ("SAB") No. 104, " *Revenue Recognition* " and Emerging Issues Task Force ("EITF") Issue No. 00-21, " *Accounting for Revenue Arrangements with Multiple Deliverables* ."

Under SAB No. 104 revenue is recognized when the following criteria have been met: i) persuasive evidence of an arrangement exists; ii) services have been rendered or product has been delivered; iii) price to the customer is fixed and determinable; and iv) collection of the underlying receivable is reasonably assured.

Billings to customers or payments received from customers are included in deferred revenue on the balance sheet until all revenue recognition criteria are met.

Revenue Arrangements with Multiple Deliverables

The Company sometimes enters into revenue arrangements that contain multiple deliverables. The Company recognizes revenue from such arrangements entered into subsequent to June 30, 2003 in accordance with EITF No. 00-21. This issue addresses the timing and method of revenue recognition for revenue arrangements that include the delivery of more than one product or service. In these cases, the Company recognizes revenue from each element of the arrangement as long as separate value for each element can be determined, the Company has completed its obligation to deliver or perform on that element, and collection of the resulting receivable is reasonably assured.

Collaborative Revenue

The Company recognizes revenue from research funding under collaboration agreements when earned on a "proportional performance" basis as research hours are incurred. The Company performs services as specified in each respective agreement on a best-efforts basis, and is reimbursed based on labor hours incurred on each contract. The Company initially defers revenue for any amounts billed or payments received in advance of the services being performed and recognize revenue pursuant to the related pattern of performance, based on total labor hours incurred relative to total labor hours estimated under the contract.

The Company recognizes fees received to initiate research projects over the life of the project. The Company recognizes fees received for exclusivity in a field over the period of exclusivity.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company recognizes milestone payments when earned, as evidenced by written acknowledgement from the collaborator, provided that (i) the milestone event is substantive and its achievability was not reasonably assured at the inception of the agreement, (ii) the milestone represents the culmination of an earnings process, (iii) the milestone payment is non-refundable and (iv) the Company's past research and development services, as well as its ongoing commitment to provide research and development services under the collaboration, are charged at fees that are comparable to the fees that the Company customarily charges for similar research and development services.

Product-Related Revenue

The Company recognizes product-related revenue at the time of shipment to the customer provided all other revenue recognition criteria have been met. The Company recognizes revenue on product sales through third-party distribution agreements, if the distributor has a right of return, in accordance with the provisions set forth in Financial Accounting Standards Board Statement ("FASB") No. 48, "*Revenue Recognition When Right of Return Exists*." Under FASB No. 48, the Company recognizes product revenues upon shipment to distributors, provided that (i) the price is substantially fixed and determinable at the time of sale; (ii) the distributor's obligation to pay the Company is not contingent upon resale of the products; (iii) title and risk of loss passes to the distributor at time of shipment; (iv) the distributor has economic substance apart from that provided by the Company; (v) the Company has no significant obligation to the distributor to bring about resale of the products; and (vi) future returns can be reasonably estimated. For any sales that do not meet all of the above criteria, revenue is deferred until all such criteria have been met.

The Company recognizes product-related profit-sharing revenue during the quarter in which such revenue is earned, based on estimates provided by the Company's profit-sharing partner. These estimates are adjusted for actual results in the subsequent quarter. Profit-sharing revenue is included in product-related revenue in the statement of operations.

Grant Revenue

The Company recognizes revenue from grants as related costs are incurred, as long as such costs are within the funding limits specified by the underlying grant agreements.

Deferred Revenue

As of December 31, 2006, the Company had \$6.2 million in deferred revenue, of which \$1.2 million was related to product sales, and \$5.0 million was related to funding from collaborative partners.

Research and Development

Research and development expenses, including direct and allocated expenses, consist of independent research and development costs, as well as costs associated with sponsored research and development. Research and development costs are expensed as incurred.

Cost of Product-Related Revenue

Cost of product-related revenue includes both internal and third-party fixed and variable costs including materials and supplies, labor, facilities and other overhead costs associated with its product-related revenues. The Company expenses the cost of idle manufacturing capacity to cost of product-related revenue as incurred.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Income Taxes

Current income tax expense (benefit) is the amount of income taxes expected to be payable (receivable) for the current year. A deferred income tax asset or liability is computed for the expected future impact of differences between the financial reporting and tax bases of assets and liabilities, as well as the expected future tax benefit to be derived from tax loss and credit carry-forwards. Deferred income tax expense is generally the net change during the year in the deferred income tax assets and liabilities. Valuation allowances are established unless, based upon the available evidence, it is more likely than not that the deferred tax assets will be realized. The effect of tax rate changes is reflected in income tax expense (benefit) during the period in which such changes are enacted. The Company has provided a full valuation allowance against any deferred tax assets.

Comprehensive Loss

Comprehensive loss is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources, including unrealized gains and losses on marketable securities. The Company presents comprehensive loss in its Consolidated Statements of Stockholders' Equity.

Net Loss per Share

Basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding during the period. During the year ended December 31, 2006 and 2005, the Company issued approximately 1,035,000 and 726,000 restricted shares to employees, of which 1,118,000 shares and 560,000 shares were unvested. For purposes of the computation of net loss per share, these unvested shares are considered contingently returnable shares under FASB No. 128, "Earnings Per Share," and are not considered outstanding common shares for purposes of computing net loss per share until all necessary conditions are met that no longer cause the shares to be contingently returnable. The impact of these unvested shares on weighted average shares outstanding has been excluded for purposes of computing net loss per share.

The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share data):

	<u>Years Ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
Weighted average shares outstanding during the period	47,503	44,589	43,416
Less: Weighted average unvested restricted shares outstanding	(1,029)	(525)	—
Weighted average shares used in computing basic and diluted net loss per share	<u>46,474</u>	<u>44,064</u>	<u>43,416</u>
Net loss	<u>\$(39,271)</u>	<u>\$(89,718)</u>	<u>\$(33,425)</u>
Net loss per share, basic and diluted	<u>\$ (0.85)</u>	<u>\$ (2.04)</u>	<u>\$ (0.77)</u>

The Company has excluded all outstanding stock options and warrants from the calculation of diluted net loss per share because all such securities are anti-dilutive for all applicable periods presented. The total number of shares excluded from the calculations of diluted net loss per share, prior to application of the treasury stock method for options and warrants, was 5.0 million, 8.9 million, and 9.8 million for the years ended December 31, 2006, 2005, and 2004. Such securities, had they been dilutive, would have been included in the computation of diluted earnings per share.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Segment Reporting

Through December 31, 2006, the Company operated in only one segment. Accordingly, no segment disclosures have been included in the accompanying notes to the consolidated financial statements.

Reclassification

Certain prior year amounts have been reclassified to conform to the current year presentation.

Effect of New Accounting Standards

In July 2006, the Financial Accounting Standards Board issued Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*” (“FIN 48”), which clarifies the accounting for uncertainty in tax positions. FIN 48 requires recognition in the financial statements of the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions are effective for our first quarter 2007 financial statements with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to the opening balance of retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its consolidated financial statements but does not expect the impact to be material.

In September 2006, the FASB issued FASB No. 157, “Fair Value Measurements.” FASB No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FASB No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the impact that SFAS No. 157 will have on its consolidated financial statements.

In February 2007, the FASB issued FASB No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an Amendment of FASB Statement No. 115*. This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. Most of the provisions in FASB No. 159 are elective; however, the amendment to FASB No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, applies to all entities with available-for-sale and trading securities. The fair value option established by FASB No. 159 permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity will report unrealized gains and losses on items for which the fair value option has been elected in earnings (or another performance indicator if the business entity does not report earnings) at each subsequent reporting date. The fair value option: (a) may be applied instrument by instrument, with a few exceptions, such as investments otherwise accounted for by the equity method; (b) is irrevocable (unless a new election date occurs); and (c) is applied only to entire instruments and not to portions of instruments. FASB No. 159 is effective as of the beginning of an entity’s first fiscal year that begins after November 15, 2007. The Company does not expect the adoption of FASB No. 159 to have a material impact on its consolidated financial statements.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. Balance Sheet Details

Short-term investments consist of the following (in thousands):

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Market Value</u>
December 31, 2006				
Corporate debt securities	\$ 12,414	\$ 2	\$ (66)	\$ 12,350
Mortgage-backed securities	1,018	3	—	1,021
	<u>\$ 13,432</u>	<u>\$ 5</u>	<u>\$ (66)</u>	<u>\$ 13,371</u>
December 31, 2005				
Corporate debt securities	\$ 12,214	\$ 12	\$ (132)	\$ 12,094
U.S. Government and agency obligations	8,032		(78)	7,954
Mortgage-backed securities	1,526	—	(5)	1,521
	<u>\$ 21,772</u>	<u>\$ 12</u>	<u>\$ (215)</u>	<u>\$ 21,569</u>

The estimated fair value of available for sale securities, by contractual maturity is as follows at December 31:

	<u>2006</u>		<u>2005</u>	
	<u>Amortized Cost</u>	<u>Market Value</u>	<u>Amortized Cost</u>	<u>Market Value</u>
Due in one year or less	\$ 4,453	\$ 4,452	\$ 11,914	\$ 11,830
Due between one and two years	8,979	8,919	9,858	9,739
	<u>\$ 13,432</u>	<u>\$ 13,371</u>	<u>\$ 21,772</u>	<u>\$ 21,569</u>

At December 31, 2006, all of the Company's investments mature within two years with an average maturity of approximately eight months.

The Company evaluates the realizable value of its short-term investments. When assessing short-term investments for other-than-temporary declines in value, the Company considers such factors as how significant the decline in value is as a percentage of the original cost and how long the market value of the investment has been below its original cost. If events and circumstances indicate that a decline in the value of these assets has occurred, and is other than temporary, the Company records a charge to investment income (expense). The Company has not incurred any such charges for the years ended December 31, 2006, 2005, or 2004.

Investments considered to be temporarily impaired at December 31, 2006 are as follows:

	<u>Number of Investments</u>	<u>Less than 12 Months of Temporary Impairment</u>		<u>Greater Than 12 Months of Temporary Impairment</u>		<u>Total Temporary Impairment</u>	
		<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
Corporate debt securities	15	\$ 3,257	\$ (4)	\$ 5,747	\$ (61)	\$ 9,004	\$ (65)
U.S. Government and agency obligations	1	400	(1)	—	—	400	(1)
	<u>16</u>	<u>\$ 3,657</u>	<u>\$ (5)</u>	<u>\$ 5,747</u>	<u>\$ (61)</u>	<u>\$ 9,404</u>	<u>\$ (66)</u>

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Gross realized gains from the sale of cash equivalents and marketable securities were \$3,000, zero, and \$60,000, for the years ended December 31, 2006, 2005, and 2004. Gross realized losses from the sale of cash equivalents and marketable securities were \$12,000, \$140,000 and \$186,000 for the years ended December 31, 2006, 2005, and 2004.

Accounts receivable consist of the following (in thousands):

	December 31,	
	2006	2005
Trade, net of allowance for doubtful accounts	\$5,486	\$3,382
Grants	1,553	1,181
Collaborators	1,607	4,411
Other	—	38
	<u>\$8,646</u>	<u>\$9,012</u>

Inventory consists of the following (in thousands):

	December 31,	
	2006	2005
Inventory:		
Raw Materials	\$ 811	\$ 544
Work in Process	27	106
Finished Goods	3,260	2,021
	<u>\$4,098</u>	<u>\$2,671</u>

Other current assets consist of the following (in thousands):

	December 31,	
	2006	2005
Prepaid expenses	\$2,331	\$1,504
Other receivables	47	821
	<u>\$2,378</u>	<u>\$2,325</u>

Property and equipment consist of the following (in thousands):

	December 31,	
	2006	2005
Laboratory equipment	\$ 46,311	\$ 46,832
Computer equipment	11,919	13,695
Leasehold improvements	7,114	7,235
Furniture and fixtures	4,274	5,392
	69,618	73,154
Reserve for asset impairment	(1,271)	(1,530)
Accumulated depreciation and amortization:	(55,929)	(53,379)
	<u>\$ 12,418</u>	<u>\$ 18,245</u>

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Depreciation of property, plant and equipment is provided on the straight-line method over estimated useful lives as follows:

Laboratory equipment	5 years
Computer equipment	3 years
Furniture and fixtures	5 years

Leasehold improvements are depreciated using the shorter of the estimated useful life or remaining lease term.

In connection with the Company's strategic reorganization, the Company determined, based on an analysis of estimated future cash flows, that the acquired intangible assets were fully impaired as of December 31, 2005, and recorded an impairment charge totaling \$43.5 million to write off the net carrying value of these assets (See Note 7—Impairment Charges and Restructuring Activities). Amortization expense for acquired intangible assets for each of the years ended December 31, 2005 and 2004 was approximately \$5.2 million, of which approximately \$2.6 million was recorded as a reduction of revenue as it related to the research collaboration.

Accrued expenses consists of the following (in thousands):

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Outside services	\$1,496	\$1,213
Professional fees	720	764
Other	1,817	1,343
	<u>\$4,033</u>	<u>\$3,320</u>

Accrued compensation consists of the following (in thousands):

	<u>December 31,</u>	
	<u>2006</u>	<u>2005</u>
Vacation	993	1,320
Other employee costs	601	619
Bonuses	3,249	897
	<u>\$4,843</u>	<u>\$2,836</u>

3. Significant Agreements

The Company has a number of strategic alliances and relationships, the more significant of which include the following:

Research and Development Collaborations

Syngenta

The following summarizes the Company's relationship with Syngenta AG, and its affiliates (collectively, "Syngenta"), a related party (*see Note 5—Related Party Transactions*):

In 1999, the Company entered into a strategic alliance with Syngenta. In conjunction with the transaction, Syngenta Biotechnology purchased 5,555,556 shares of Series E convertible preferred stock (which converted to

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

common shares upon completion of the Company's initial public offering), paid a technology access fee, and provided project research funding to the Company, for aggregate total proceeds of \$12.5 million.

Also in 1999, the Company formed a five-year strategic alliance with Syngenta. Through a contract joint venture, named Zymetrics, Inc., the Company and Syngenta jointly pursued opportunities in the field of animal feed and agricultural product processing. Under the agreement, Syngenta received exclusive, worldwide rights in the field of animal feed and project exclusive, worldwide rights in the field of agricultural product processing. Syngenta agreed to pay \$20.0 million for the rights granted under the original agreement, which expired in 2004. In May 2004, the Company entered into an agreement with Syngenta that continued the development and commercialization of novel animal feed enzymes beyond the five-year initial term of the 1999 Zymetrics joint venture agreement.

During 2003, the Company completed a series of transactions with Syngenta and its wholly-owned subsidiary, the Torrey Mesa Research Institute ("TMRI"). Under the transactions, the companies formed an extensive research collaboration whereby the Company was entitled to receive a minimum of \$118.0 million in research and development funding over the initial seven-year term of the related research collaboration agreement. The Company also purchased certain property and equipment from TMRI and assumed certain miscellaneous liabilities under equipment maintenance contracts.

Upon closing, the Company issued to Syngenta and TMRI a total of 6,034,983 shares of common stock and a warrant to purchase 1,293,211 shares of common stock at \$22.00 per share that is exercisable for ten years starting in 2008. The total value of the acquisition was approximately \$74.0 million, of which \$54.9 million was allocated to certain intangible assets. In December 2005, in connection with its strategic reorganization, the Company recorded an impairment charge related to the write-down of the carrying values of assets and technologies acquired as part of the acquisition (*See Note 7—Impairment Charges and Restructuring Activities*).

In December 2006, the Company entered into a new 10-year research and development partnership with Syngenta which replaced the 2003 agreement and is focused on the discovery and development of enzymes to economically convert pre-treated cellulosic biomass to mixed sugars—a critical step in the process of biofuel production. Under the terms of the new agreement, Syngenta will commit a minimum of \$16.0 million over the next two years to fund joint research and development activities, largely in defined areas of biofuels. In addition, the Company will be entitled to development- and commercialization-related milestone payments as well as royalties on any products that are commercialized by Syngenta. This new license and research agreement allows us to independently develop and commercialize fermentation-based enzyme combinations from our proprietary platform, and we are free to pursue opportunities for the integrated commercialization of biofuels. Syngenta will have the rights to market and sell plant-expressed, or transgenic, enzyme products developed under the collaboration in the fields of animal feed or biofuels. The Company has also licensed its existing collection of enzymes for plant expression to Syngenta within these two fields.

As a result of the restructuring of the Syngenta agreement, the Company's minimum guaranteed collaborative revenue will be reduced by approximately \$19.0 million over the next 3 years, with \$12.0 million of this reduction occurring in 2007.

The Company also has a manufacturing agreement with an affiliate of Syngenta to supply commercial quantities of Quantum phytase at a fixed price, determined by a negotiated formula that is subject to adjustment during the term of the agreement. In addition, the Company is entitled to receive royalties from Syngenta on sales of Quantum phytase.

Total revenue recognized under the Syngenta agreements was \$22.7 million, \$24.3 million, and \$36.9 million for the years ended December 31, 2006, 2005, and 2004.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

DuPont Bio-Based Materials

In 2003, the Company entered into a six-year alliance with DuPont Bio-Based Materials (“DuPont”). This multi-year program is being co-funded by the U.S. Department of Energy (“DOE”), and is focused on the development of an integrated corn-based biorefinery (“ICBR”) for the production of ethanol and other value-added chemical products from corn biomass. The program includes within its consortium the National Renewable Energy Lab, or NREL, which is part of the DOE. The Company’s objective under the program is to discover, optimize, and manufacture a “cocktail” of enzymes that can efficiently convert the different components of an entire corn plant, including the stalk, into simple sugars that can then be used to make ethanol and other products. The Company has received research funding, as well as milestone payments, and is entitled to additional milestone payments as well as royalties on any new products developed under the agreement that incorporate the Company’s technologies.

In 2005, the Company announced that the performance of the enzymes developed under the ICBR program with DuPont substantially exceeded the initial targets set by the Department of Energy, triggering a milestone payment to the Company of approximately \$500,000. DuPont has the right to exclusively license a selected number of enzymes comprising this cocktail for use in converting biomass to fuels and/or other chemicals, in exchange for the payment to the Company of up-front license fees and running royalties on sales of these enzymes or DuPont’s revenues from licensing technologies to third parties that include one or more enzymes the Company may have licensed to DuPont.

Revenue recognized under the DuPont ICBR program was \$1.5 million, \$3.0 million and \$2.4 million for the years ended December 31, 2006, 2005 and 2004.

DSM

In 2003, the Company entered into a collaborative agreement with DSM Pharma Chemicals to discover and develop biocatalytic solutions designed to simplify and lower the cost of a variety of chemical transformations. Under the terms of the agreement, DSM will identify targeted chemical conversions, the Company will work to develop appropriate biocatalysts, and DSM will scale-up these processes to manufacture pharmaceutical intermediates and active ingredients. The Company will receive research payments and is entitled to milestones and royalties on products commercialized by DSM.

In 2006, the Company entered into a research and development agreement with DSM New Business Development B.V. pursuant to which DSM paid the Company an up-front fee for a one-year license to certain biomolecules. The Company is also entitled to receive royalties on products commercialized by DSM under the agreement.

Revenue recognized under the DSM agreements was \$0.3 million, \$0.5 million and \$1.0 million for the years ended December 31, 2006, 2005 and 2004.

Cargill Health and Food Technologies

In 2005, the Company signed a collaboration agreement with Cargill Health and Food Technologies to discover and develop novel enzymes for the cost-effective production of a proprietary Cargill product. Under the terms of the agreement, the Company received upfront payments and research funding, and is entitled to receive milestone payments, license fees, and royalties on products that may be developed under the agreement. Revenue recognized under the Cargill collaboration was \$1.4 million and \$2.1 million for the years ended December 31, 2006 and 2005.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Merck & Co., Inc.

In December 2004, the Company entered into an agreement with Merck & Co., Inc. to collaborate on the development of therapeutic antibodies for a key target by applying its proprietary MedEv™ platform. Under the terms of the agreement, the Company received an upfront payment and received research funding. In mid-2005, the two parties amended this agreement to provide for additional research and development activities as well as terms for additional research funding, milestone payments, and royalties. Revenue recognized under the Merck agreement was \$0.5 million and \$2.2 million for the years ended December 31, 2006 and 2005.

BASF

In December 2005, the Company entered into a master collaboration agreement with BASF under which the Company is responsible for the discovery and optimization of new enzymes, and BASF is responsible for process and product development and commercialization. Under the agreement, the Company has received technology access fees and research support payments, and is entitled to receive milestone payments and royalties based on sales of products resulting from the collaboration. Revenue recognized under the BASF agreement was \$2.3 million for the years ended December 31, 2006. The Company recognized no revenue from the BASF agreement in 2005.

Bunge Oils, Inc.

In February 2006, the Company entered into an agreement with Bunge Oils, Inc. to discover and develop novel enzymes optimized for the production of edible oil products with enhanced nutritional or health benefits. This agreement was an extension of a 2005 agreement. Under the terms of the agreement, the Company is responsible for discovering, optimizing, and manufacturing enzymes, and Bunge is responsible for commercializing oils using new enzyme-enabled processes. Under the terms of the agreement, the Company has received an upfront technology access fee and will receive full research funding for enzyme discovery and development activities under the project. Under the terms of the agreement, the Company is also eligible to receive milestone payments for successful enzyme development activities as well as royalties on any products that are commercialized. Revenue recognized under the Bunge agreements was \$2.2 million and \$0.7 million for the years ended December 31, 2006 and 2005.

Government Grants and Contracts

The Company has received grants and contracts from a number of government agencies, including the U.S. Department of Defense, the U.S. Department of Energy, and the National Institutes of Health. Revenue related to government grants and contracts was \$3.3 million, \$10.1 million, and \$10.2 million for the years ended December 31, 2006, 2005, and 2004.

Manufacturing, Supply and Distribution Agreements

Valley Research, inc

In 2005, the Company signed, and later amended, a distribution agreement with Valley Research, inc. (“Valley”) covering the Ultra-Thin alpha amylase enzyme and potentially additional enzyme products. Under the amended agreement, the Company appointed Valley as its exclusive distributor in the United States for Ultra-Thin enzyme for ethanol and high fructose corn sweetener applications, subject to certain limitations, and subject to certain conditions required to be met for such exclusivity to be maintained. Valley must purchase certain minimum dollar amounts of Ultra-Thin enzyme from the Company during each year of the agreement in order to maintain exclusivity. The term of this distribution agreement regarding Ultra-Thin enzyme is for a period of

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

five years following regulatory approval of such enzyme by the FDA's Center for Veterinary Medicine, which approval was obtained on February 24, 2006.

The Company has deferred revenue on its 2006 sales of this product to Valley, as it does not believe that, given its limited commercial experience with this product and Valley, all criteria for recognizing revenue related to its 2006 sales to Valley have been met. Specifically, the Company plans to continue to defer revenue on sales to Valley until its has established to the Company's satisfaction that payment for the product is not dependent on Valley's sales of the product to its customers.

As more fully described in *Note 6—Litigation*, the Company and Valley are currently in a legal dispute over alleged breach of contract on the part of both parties.

Danisco Animal Nutrition

In May 1996, the Company entered into a collaboration agreement with Danisco Animal Nutrition (formerly Finnfeeds International Ltd) to jointly identify and develop a novel phytase enzyme that when used as an additive in animal feed applications allows higher utilization of phytic acid phosphates from the feed, thereby increasing its nutritional value. The addition of phytase to animal feed reduces the need for inorganic phosphorus supplementation and lowers the level of harmful phosphates that are introduced to the environment through animal waste, resulting in inorganic phosphate cost savings and a significant reduction in environmental pollution. Following the completion of the initial objectives of the agreement with Danisco, in December 1998, the Company entered into a license agreement with Danisco to commercialize an enzyme developed under the collaboration agreement. Under the terms of the license agreement, the Company granted Danisco an exclusive license to manufacture, use, and sell the developed enzyme. In consideration for the license, the Company is paid a profit share equal to 50% of the cumulative profits generated by Danisco on such sales. The Company also has a manufacturing agreement with Danisco to supply commercial quantities of Phyzyme XP at the Company's cost to manufacture such quantities. In March 2003, the FDA approved Phyzyme XP Animal Feed Enzyme, which the Company developed in collaboration with Danisco. In September 2006, the EU Commission granted permanent authorization for the use of Phyzyme XP in broiler poultry feed in Europe.

Revenue recognized from transactions with Danisco, including contract manufacturing performed on behalf of Danisco, was \$8.9 million, \$5.2 million, and \$2.0 million for the years ended December 31, 2006, 2005, and 2004.

License Agreements

Xoma Ltd.

In 2003, the Company signed a license and product development agreement with Xoma Ltd. Under the terms of the agreement, the Company received a license to use Xoma's antibody expression technology for developing antibody products independently and with collaborators, and an option to a license for the production of antibodies under the Xoma patents. The Company paid an initial license fee of \$2.0 million, which was initially capitalized and was being amortized over the estimated useful life of seven years. Under the agreement, the Company may also be required to pay future milestones and royalties. As of December 31, 2005, in connection with the Company's strategic reorganization, the Company assessed the carrying value of this license on its balance sheet and determined that it was impaired. As a result, the Company has written off the carrying value of the license on its balance sheet as of December 31, 2005 (*See Note 7—Impairment Charges and Restructuring Activities*).

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Terragen Discovery, Inc.

In November 1999, the Company signed a license agreement with Terragen Discovery Inc., or Terragen, under which the Company and Terragen agreed to cross license certain technologies. Under the terms of the agreement, the Company made an initial payment of \$2.5 million in 1999 and agreed to make annual payments of \$0.1 million to Terragen to maintain the patent rights over the remaining patent life. The Company capitalized the initial payment as an intangible asset, which through December 31, 2005 was amortized over the sixteen year patent life. As of December 31, 2005, in connection with the Company's strategic reorganization, the Company assessed the carrying values of this license on its balance sheet and determined that it was impaired. As a result, the Company has written off the carrying value of the license on its balance sheet as of December 31, 2005 (*See Note 7—Impairment Charges and Restructuring Activities*).

Other Agreements

The Company has signed various agreements with research institutions, as well as other commercial entities. Generally, these agreements call for the Company to pay research support, cost reimbursement, and, in some cases, subsequent royalty payments in the event a product is commercialized. The financial impact of these agreements on the Company is not significant.

4. Debt

The Company has entered into various equipment financing line of credit agreements with lenders to finance equipment purchases. Under the terms of the credit agreements, equipment purchases are structured as notes and are to be repaid over periods ranging from 36 to 48 months at interest rates ranging from 6.99% to 10.43%. The notes are secured by the related equipment.

On September 30, 2005, the Company entered into a \$14.6 million Loan and Security Agreement (the "Bank Agreement") with a commercial bank (the "Bank"). The Bank Agreement provides for a one-year credit facility for up to \$10.0 million in financing for qualified equipment purchases in the United States and Mexico (the "Equipment Advances") and a \$4.6 million letter of credit sub-facility (the "Letter of Credit Sublimit"). The Bank Agreement was amended in October 2006 to increase the Letter of Credit Sublimit to \$4.7 million. Borrowings under the Equipment Advances are structured as promissory notes which are secured by qualified equipment purchases and repaid over 36 to 48 months, depending on the location of the equipment financed. Borrowings will bear interest at the Bank's prime rate (8.25% at December 31, 2006) plus 0.75%. On September 30, 2006, the Company's draw-down period under the Equipment Advances expired.

At December 31, 2006, there was approximately \$3.7 million in outstanding borrowings under the Equipment Advances and a letter of credit for approximately \$4.7 million under the Letter of Credit Sublimit, as required under the Company's facilities leases (*See Note 6—Commitments and Contingencies*).

The Bank Agreement contains standard affirmative and negative covenants and restrictions on actions by the Company including, but not limited to, activity related to the Company's common stock repurchases, liens, investments, indebtedness, and fundamental changes in, or dispositions of, the Company's assets. Certain of these actions may be taken by the Company with the consent of the Bank. In addition, the Company is required to meet certain financial covenants, primarily a minimum balance of unrestricted cash, cash equivalents, and investments in marketable securities of \$25.0 million, including \$15.0 million maintained in accounts at the Bank or its affiliates.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of December 31, 2006 the Company was in compliance with all debt covenants under its various financing agreements; however, the Company could be at risk of non compliance with its covenants under the Bank Agreement if it is unable to raise additional capital during 2007 (See Note 1—Recent Strategic Events and Capital Requirements) . The Bank Agreement also provides for an event of default upon the occurrence of a material adverse effect on i) the business operations, condition (financial or otherwise) or prospects of the Company, ii) the ability of the Company to repay its obligations due to the bank or otherwise perform its obligations under the Bank Agreement, or iii) the Company’s interest in, or the value of, perfection or priority of the bank’s security interest in the collateral. In the event of non compliance or a material adverse effect, the Company would be required to cash-secure its existing obligations under the Bank Agreement (\$8.4 million at December 31, 2006).

At December 31, 2006, the Company’s future minimum payments under the equipment financing arrangements are as follows (in thousands):

Year ending December 31:	
2007	\$ 5,766
2008	2,865
2009	1,022
2010	<u>89</u>
Total future minimum payments	9,742
Less amounts representing interest	<u>(795)</u>
Total future minimum principal payments	8,947
Less current portion of debt obligations	<u>(5,223)</u>
Non-current portion of debt obligations	<u>\$ 3,724</u>

5. Related Party Transactions

Syngenta AG

The Company has had an ongoing research collaboration with Syngenta, a greater-than 10% owner of the Company’s outstanding common stock since 1999. (See Note 3—Significant Agreements).

The Company recognized revenue from Syngenta and its affiliates of \$22.7 million, \$24.3 million, and \$36.9 million for the years ended December 31, 2006, 2005, and 2004. Accounts receivable due from Syngenta were \$0.4 million and \$1.7 million, and deferred revenue associated with Syngenta was \$3.1 million and \$5.9 million, at December 31, 2006 and 2005.

In connection with the research collaboration with Syngenta, the Company received \$0.3 million and \$0.5 million in rental cost reimbursements from Syngenta during the year ended December 31, 2006 and 2005, which was recorded as a reduction in rent expense (See Note 6—Leases).

Notes Receivable from Officers

In February 2000, the Company initiated a loan program for six employees to pay personal tax liabilities resulting from the failure to file Form 83(b) elections with the Internal Revenue Service related to those employees’ exercise of incentive and non-qualified stock options during 1999. This failure to timely file the Form 83(b) elections exposed the employees to significant personal tax liabilities. The Company agreed to loan the employees up to \$1.6 million in full recourse promissory notes. As of December 31, 2005, the Company had

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

a remaining loan balance from three individuals aggregating \$0.6 million, which amounts are included in other current assets on the accompanying balance sheet. The notes bore interest at 4.94%, and were repaid in full as they came due in April 2006.

6. Commitments and Contingencies

Leases

At December 31, 2006, the Company's minimum commitments under non-cancelable operating leases were as follows (in thousands):

	Operating Leases
Year ending December 31:	
2007	\$ 4,837
2008	4,990
2009	5,176
2010	5,339
Thereafter	31,405
Total minimum lease payments	<u>\$51,747</u>

In November 2000, the Company relocated its San Diego operations to a 75,000 square foot facility. In April 2002, the Company occupied an additional 60,000 square foot research and development facility adjacent to its existing office. The operating leases for the Company's two facilities expire in November 2015 and March 2017.

For the years ended December 31, 2006, 2005, and 2003 rent and administrative service expense under operating leases was approximately \$3.9 million, \$4.6 million, and \$4.9 million, net of rental income and restructuring charges. As more fully described in *Note 7—Impairment and Restructuring Activities*, the Company recorded a restructuring charge and related restructuring liability based on space vacated in its 60,000 square foot facility during 2006. As of December 31, 2006, approximately 75% of this space was idle. Accordingly, the rent payments of approximately \$1.1 million related to the idle space are not included in rent expense, but rather recorded against the restructuring reserve as paid.

During 2006 and 2005, the Company received \$0.3 million and \$0.5 million of rent reimbursement from Syngenta, a related party (*See Note 5—Related Party Transactions*).

Under the terms of its facilities leases, the Company is required to maintain an irrevocable standby letter of credit from a bank in lieu of a cash security deposit. The amount of the letter of credit is based upon certain financial covenants requiring minimum market capitalization or working capital. As of December 1, 2006, the amount of the letter of credit required was \$4.7 million, which has been issued under the Company's Bank Agreement (*See Note 4—Debt*). Amounts outstanding under the letter of credit are unsecured, and are subject to an annual fee of 1.25%.

During 2002, the Company entered into a manufacturing agreement with Fermic, S.A. de C.V. ("Fermic"), a fermentation and synthesis plant located in Mexico City, to provide the Company with the capacity to produce commercial quantities of certain enzyme products. Based on actual and projected increased product requirements, the agreement was amended in 2004 to provide for additional capacity to be installed over the succeeding four year period. Under the terms of the agreement, the Company can cancel the committed

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

purchases with thirty months' notice provided that the term of the agreement, including the termination notice period, aggregates four years. Pursuant to the agreement with Fermic, the Company is also obligated to reimburse monthly costs related to manufacturing activities. These costs scale up as the projected manufacturing volume increases. As of December 31, 2006, the Company had minimum commitments to Fermic under this agreement of approximately \$24.7 million over the next three years. In addition, under the terms of the agreement, the Company is required to purchase certain equipment required for fermentation and downstream processing of the products. Through December 31, 2006, the Company had incurred costs of approximately \$13.4 million for equipment related to this agreement. During 2007, the Company anticipates spending as much as \$3.0 million in additional equipment costs related to the manufacturing agreement. As the Company continues to develop its commercial manufacturing platforms, it will be required to purchase additional capital equipment under this agreement.

The Company relies on Fermic as its sole-source manufacturer for large volumes of commercial enzymes.

Litigation

Class Action Shareholder Lawsuit

In June 2004, we executed a settlement agreement with the Plaintiffs pursuant to the terms of the memorandum of understanding. On February 15, 2005, the Court issued a decision certifying a class action for settlement purposes and granting preliminary approval of the settlement subject to modification of certain bar orders contemplated by the settlement. On August 31, 2005, the Court reaffirmed class certification and preliminary approval of the modified settlement in a comprehensive Order. On February 24, 2006, the Court dismissed litigation filed against certain underwriters in connection with the claims to be assigned to the plaintiffs under the settlement. On April 24, 2006, the Court held a Final Fairness Hearing to determine whether to grant final approval of the settlement. On December 5, 2006, the Second Circuit Court of Appeals vacated the lower Court's earlier decision certifying as class actions the six IPO Cases designated as "focus cases." The Court has ordered a stay of all proceedings in all of the IPO Cases pending the outcome of Plaintiffs' rehearing petition to the Second Circuit. Accordingly, the Court's decision on final approval of the settlement remains pending. The Company is covered by a claims-made liability insurance policy which it believes will satisfy any potential liability of the Company under this settlement. Due to the inherent uncertainties of litigation and assignment of claims against the Underwriters, and because the settlement has not yet been finally approved by the Court, the ultimate outcome of this matter cannot be predicted. In accordance with FASB No. 5, "*Accounting for Contingencies*" the Company believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

Valley Research, inc.

On September 22, 2006, the Company issued a letter to Valley which communicated the Company's intent to exercise certain rights under the distribution agreement between the Company and Valley (see *Note 3—Significant Agreements*). Specifically, the Company stated that it terminated Valley's exclusivity on the basis of certain minimum sales requirements not having been met as of August 24, 2006, as provided by the distribution agreement.

On December 7, 2006, Valley filed a civil complaint in San Diego Superior Court against the Company, alleging breach of contract. In the complaint, Valley alleges that the Valley "Ultra-Thin"™ product was unstable and performed poorly, which caused Valley to be unable to satisfy certain contractual requirements. In the complaint, Valley seeks money damages for alleged breach of contract by the Company and potentially for additional damages for termination of Valley's exclusivity. The Company believes that the claims made by Valley have no merit, and intends to defend itself vigorously.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

On January 8, 2007 the Company filed a cross-complaint in San Diego Superior Court against Valley, alleging breach of contract, breach of the implied covenant of good faith and fair dealing, and violation of the California Business and Professional Code. In its cross-complaint, the Company seeks payment in full of outstanding invoices due from Valley. Pursuant to a letter dated March 7, 2007, Diversa Corporation, a Delaware corporation, terminated that certain Distribution Agreement, dated January 1, 2005, and the Amendment thereto dated August 1, 2005 (the “*Agreement*”), between Diversa and Valley covering the enzyme Diversa currently markets under the Fuelzyme-LF label .

Under the Agreement, Valley was previously Diversa’s exclusive distributor in the United States for the Valley “Ultra-Thin” enzyme for ethanol and high fructose corn sweetener applications, subject to certain limitations, and subject to certain conditions required to be met for such exclusivity to be maintained. On September 22, 2006, Diversa terminated Valley’s exclusivity on the basis of certain minimum sales requirements not having been met as of August 24, 2006, as provided by the Agreement. The term of the Agreement was set to expire on February 24, 2011. Diversa’s termination of the Agreement was based on, among other things, Valley’s failure to meet certain minimum purchase requirements for the Valley “Ultra-Thin” enzyme. Specifically, Valley failed to purchase a minimum of \$2,600,000 worth of the Valley “Ultra-Thin” enzyme from Diversa within one year of the U.S. Food and Drug Administration’s Center for Veterinary Medicine’s approval of the Valley “Ultra-Thin” enzyme. Pursuant to the Agreement, the termination was effective immediately upon Valley’s receipt of notice from Diversa of its intention to terminate the Agreement.

In accordance with FASB No. 5, “*Accounting for Contingencies*” the Company believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

Patent Interference Proceeding

On February 14, 2007, a patent interference proceeding was declared in the U.S. Patent and Trademark Office between a U.S. patent assigned to Diversa and a pending U.S. patent application owned by a third party with allowable claims directed to GeneReassembly. The third party seeks an entry of adverse judgment against Diversa. A schedule for the motion phase of the interference proceeding will be discussed with the Administrative Patent Judge in April 2007. It is too early to assess the respective positions of the parties until the preliminary motions are exchanged. In accordance with FASB No. 5 “*Accounting for Contingencies*” the Company believes any contingent liability related to this claim is not probable or estimable and therefore no amounts have been accrued in regards to this matter.

The Company is also, from time to time, subject to legal proceedings and claims which arise in the normal course of business. In management’s opinion, the amount of ultimate liability with respect to these actions will not have a material adverse effect on the Company’s consolidated financial position, results of operations, or cash flows.

7. Impairment Charges and Restructuring Activities

During the fourth quarter of 2005, the Company recorded a \$45.7 million impairment charge for activities resulting from management’s strategic decision to reorganize and refocus the Company’s resources to advance its most promising product candidates and programs that have the greatest near-term opportunities, and discontinued development of a number products and programs, primarily related to fine chemicals, animal health, therapeutic antibody optimization, and small molecule drug discovery. The Company wrote-off the carrying values of tangible and intangible assets considered non-essential to the Company’s current focus, or otherwise deemed impaired under the provisions set forth by FASB No. 144, “*Accounting for the Impairment or Disposal of Long-Lived Assets* .”

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

These charges are summarized below (in thousands):

	<u>Year Ended December 31, 2005</u>
Write-off of intangible assets acquired in connection with fiscal 2003 transactions with Syngenta	\$ 40,622
Excess or idle equipment costs	2,237
Write-off of intellectual property licenses	2,886
Total	<u>\$ 45,745</u>

The Company commenced several cost containment measures in January 2006, including a reduction in workforce by 83 employees, the majority of whom were research and development personnel, and the consolidation of its facilities. Pursuant to FASB No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," the Company recorded net charges of \$12.0 million during the year ended December 31, 2006 related to these activities.

The following table sets forth the activity in the restructuring reserves for the year ended December 31, 2006 (in thousands):

	<u>Facility Consolidation Costs</u>	<u>Employee Separation Costs</u>	<u>Other Costs</u>	<u>Total</u>
Balance at January 1, 2006	\$ —	\$ —	\$—	\$ —
Accrued and expensed	8,356	2,607	60	11,023
Charged against accrual	(1,563)	(2,607)	(60)	(4,230)
Adjustments and revisions	1,003	—	—	1,003
Balance at December 31, 2006	<u>\$ 7,796</u>	<u>\$ —</u>	<u>\$—</u>	<u>\$ 7,796</u>

During the first quarter of 2006, the Company completed the employee termination activities under this restructuring, and no further payments or expenses related to employee separation are anticipated under this program. The facility consolidation costs are based on estimates, representing the discounted cash flow of lease payments (net of anticipated sublease income) on the vacated space through its contractual lease term in 2016. The Company recorded a \$0.3 million reversal of charges during the quarter ended June 30, 2006 and additional charges of \$0.8 and \$0.5 million during the quarters ended September 30 and December 31, 2006, reflecting revisions in estimates for the remaining net facilities consolidation costs. The Company may revise these estimates in future periods, which could give rise to additional charges or adjustments.

8. Concentration of Business Risk

During the years ended December 31, 2006, 2005, and 2004, the Company had collaborative research agreements that accounted for 61%, 63%, and 73% of total revenue. Including revenue generated from the DuPont ICBR program (See Note 3—Significant Agreements), the Company derived, directly or indirectly, approximately 10%, 24%, and 22%, of its revenue from agencies of the United States Government in 2006, 2005, and 2004.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A relatively small number of customers and collaboration partners historically have accounted for a significant percentage of the Company's revenue. Revenue from significant customers and / or collaboration partners as a percentage of total revenue was as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Customer A	46%	45%	64%
Customer B	18%	10%	4%

Accounts receivable from four significant customers comprised approximately 27%, 22%, 12%, and 11% of accounts receivable at December 31, 2006. Accounts receivable from four significant customers comprised approximately 21%, 18%, 15%, and 12% of accounts receivable at December 31, 2005. Accounts receivable derived directly or indirectly from agencies of the U.S. Government, including accounts receivable from DuPont (*See Note 3—Significant Agreements*), comprised 19% and 13% of total accounts receivable at December 31, 2006 and 2005.

Revenue by geographic area was as follows (in thousands):

	<u>For the years ended December 31,</u>		
	<u>2006</u>	<u>2005</u>	<u>2004</u>
North America	\$13,593	\$20,119	\$16,378
South America	3,806	1,583	1,302
Europe	31,783	32,001	39,870
Asia	16	600	—
	<u>\$49,198</u>	<u>\$54,303</u>	<u>\$57,550</u>

For the years ended December 31, 2006, 2005 and 2004 more than 70% of the Company's product-related revenue has come from one focus area, Health and Nutrition.

9. Stockholders' Equity

Shareholder Rights Plan

On December 13, 2000, the Board of Directors of the Company approved the adoption of a shareholder rights plan (the "Rights Plan"). Under the Rights Plan, the Board of Directors declared a dividend of one right to purchase one one-hundredth of a share of Series A junior participating preferred stock (a "Right") for each share of Company common stock outstanding as of December 22, 2000. The exercise price of each Right is \$125.00.

Initially, the Rights trade with the Company's common stock and are not separately transferable. However, subject to certain exceptions, the Rights will become exercisable (i) at such time that a person (or group of affiliated persons) acquires beneficial ownership of 15% or more of the outstanding Company common stock (an "Acquiring Person") or (ii) on the tenth business day after a person or entity commences, or expresses an intention to commence, a tender or exchange offer that would result in such person acquiring 15% or more of the outstanding Company common stock. In December 2002, in connection with the Company's entering into a series of agreements with Syngenta and Torrey Mesa Research Institute, the Company amended the Rights Plan to provide that, with respect to Syngenta and its affiliates and associates, the threshold will be 22% rather than 15% for the aggregate beneficial ownership of the Company's common stock that their holdings may not exceed without the Rights becoming exercisable.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In the event a person becomes an Acquiring Person, each Right held by all persons other than the Acquiring Person will become the right to acquire one share of Company common stock at a price equal to 50% of the then-current market value of the Company common stock. Furthermore, in the event an Acquiring Person effects a merger of the Company, each Right will entitle the holder thereof to purchase one share of common stock of the Acquiring Person or the Acquiring Person's ultimate parent at a price equal to 50% of the then-current market value of the Acquiring Person's or the Acquiring Person's ultimate parent's common stock.

The Board of Directors can redeem the Rights at any time prior to a person becoming an Acquiring Person at a redemption price of \$0.01 per Right. In addition, the Board of Directors may, after any time a person becomes an Acquiring Person, exchange each Right for one share of common stock of the Company. The Rights will expire on December 12, 2010 if not redeemed prior to such date.

10. Equity Incentive Plans and Warrants

Non-Employee Directors' Stock Option Plans

2005 Non-Employee Directors' Equity Incentive Plan

In March 2005, the Board of Directors of the Company ("Board") adopted the Company's 2005 Non-Employee Directors' Equity Incentive Plan ("Directors' Plan"), and reserved a total of 600,000 shares for issuance thereunder. The number of shares available for issuance under the Directors' Plan will automatically increase on the first trading day of each calendar year, beginning with the 2006 calendar year and continuing through and including calendar year 2015, by an amount equal to the excess of (i) the number of shares subject to stock awards granted during the preceding calendar year, over (ii) the number of shares added back to the share reserve during the preceding calendar year pursuant to expirations, terminations, cancellations forfeitures and repurchases of previously granted awards. However this automatic annual increase shall not exceed 250,000 shares in any calendar year.

The Board adopted the Directors' Plan as the primary equity incentive program for the Company's non-employee directors in order to secure and retain the services of such individuals, and to provide incentives for such persons to exert maximum efforts for the success of the Company. The Directors' Plan replaced the 1999 Non-Employee Directors' Stock Option Plan. As of December 31, 2006, there were approximately 330,000 shares outstanding under the Directors' Plan and approximately 312,000 shares outstanding under the 1999 Non-Employee Directors' Stock Option Plan.

Employee Stock Option and Stock Purchase Plans

1999 Employee Stock Purchase Plan

In December 1999, the Board of Directors adopted the 1999 Employee Stock Purchase Plan (the "Purchase Plan"). As of December 31, 2006, a total of 1,784,000 shares of the Company's common stock have been reserved for issuance under the Purchase Plan. The Purchase Plan permits eligible employees to purchase common stock at a discount, but only through payroll deductions, during defined offering periods. The price at which stock is purchased under the Purchase Plan is equal to 85% of the fair market value of the common stock on the first or last day of the offering period, whichever is lower. The Purchase Plan provides for annual increases of shares available for issuance under the Purchase Plan.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

1997 Equity Incentive Plan

In August 1997, the Company adopted the 1997 Equity Incentive Plan (the “1997 Plan”), which provides for the granting of incentive or non-statutory stock options, stock bonuses, and rights to purchase restricted stock to employees, directors, and consultants as administered by the Board of Directors. Unless terminated sooner by the Board of Directors, the 1997 Plan will terminate in August 2007.

The incentive and non-statutory stock options are granted with an exercise price of not less than 100% and 85%, respectively, of the estimated fair value of the underlying common stock as determined by the Board of Directors. The 1997 Plan allows the purchase of restricted stock at a price that is not less than 85% of the estimated fair value of the Company’s common stock as determined by the Board of Directors.

Options granted under the 1997 Plan vest over periods ranging up to four years and are exercisable over periods not exceeding ten years. As of December 31, 2006, the aggregate number of shares which may be awarded under the 1997 Plan is approximately 12,983,000, with approximately 4,076,000 available for grant.

Accounting for Share-Based Compensation

In January 2006 the Company adopted FASB No. 123(R), “*Share-Based Payment*,” which is a revision of FASB No. 123, “*Accounting for Share-based Compensation*.” FASB No. 123(R) supersedes APB No. 25 and amends FASB No. 95, “*Statement of Cash Flows*.” Generally, the approach in FASB No. 123(R) is similar to the approach described in FASB No. 123. However, FASB No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure, which has previously been used by the Company, is no longer an alternative.

The Company adopted the fair value recognition provisions of FASB No. 123(R), using the modified prospective transition method. Under this transition method, compensation expense includes options vesting for i) share-based payments granted prior to, but not vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of FASB No. 123; ii) share-based payments granted after December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB No. 123(R); and iii) shares issued under the ESPP after December 31, 2005, based on calculations of fair value which are similar to how stock option valuations are made. Because this transition method was selected, results of prior periods have not been restated.

Prior to January 1, 2006, the Company accounted for share-based employee compensation plans using the intrinsic value method of accounting in accordance with Accounting Principles Board Opinion (“APB”) No. 25, “*Accounting for Stock Issued to Employees*,” and its related interpretations. Under the provisions of APB 25, no compensation expense was recognized with respect to purchases of the Company’s common stock under the ESPP or when stock options were granted with exercise prices equal to or greater than market value on the date of grant.

All of the Company’s equity incentive plans are considered to be compensatory plans under FASB No. 123(R).

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The Company recognized \$5.7 million (\$0.12 per share) and \$0.9 million (\$0.02 per share) in share-based compensation expense for its share-based awards for years ended December 31, 2006 and 2005. These charges had no impact on the Company's reported cash flows. Share-based compensation expense was allocated among the following expense categories (in thousands):

	YEAR ENDED DECEMBER 31,	
	2006	2005
Research and development	\$3,611	\$476
Selling, general and administrative	2,079	401
	<u>\$5,690</u>	<u>\$877</u>

During 2005, the Company issued approximately 726,000 shares of restricted stock to employees and, pursuant to FASB No. 123, recorded net expense of \$0.8 million related to the amortization of deferred stock-based compensation during the year ended December 31, 2005. The Company also recorded a non-cash share-based compensation charge of approximately \$0.1 million during the fourth quarter of 2005 related to the acceleration of vesting on approximately 28,000 restricted shares granted to its former Chief Executive Officer. Under the modified prospective method of transition under FASB No. 123(R), the Company is not required to restate its prior period financial statements to reflect expensing of share-based compensation under the new standard. Therefore, the results for the year ended December 31, 2006 are not comparable to 2005.

The Company has determined its share-based compensation expense under FASB No. 123(R) for the year ended December 31, 2006 as follows:

Valuation of Stock Options

Share-based compensation related to stock options includes both the amortization of the fair value of options granted prior to January 1, 2006, determined using the multiple option approach under the Black-Scholes-Merton ("BSM") valuation model, as well as the amortization of the fair value of options granted after December 31, 2005, determined using the single option approach under the BSM valuation model. The fair value of options determined under FASB No. 123(R) is amortized to expense over the vesting periods of the underlying options, generally four years.

The fair value of stock option awards for the twelve months ended December 31, 2006 was estimated on the date of grant using the assumptions in the following table. The expected volatility in this model is based on the historical volatility of the Company's stock. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time awards are granted, based on maturities which approximate the expected life of the options. The expected life of the options granted is estimated using the historical exercise behavior of employees. The expected dividend rate takes into account the absence of any historical dividends paid by the Company and management's intention to retain all earnings for future operations and expansion.

Average Risk-Free Interest Rate	Dividend Yield	Average Volatility Factor	Average Option Life
4.5%	0%	0.61	Five years

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Valuation of ESPP Awards

Share-based compensation related to awards issued under the ESPP after December 31, 2005 are based on calculations of fair value under the BSM valuation model which are similar to how stock option valuations are made. The fair value of ESPP awards determined under FASB No. 123(R) is amortized to expense over the vesting periods of the underlying awards, ranging from six months to two years. For the twelve months ended December 31, 2006, the fair value was based on the following assumptions.

Average Risk-Free Interest Rate	Dividend Yield	Average Volatility Factor	Option Life
3.7%	0%	0.53	Six months to two years

Valuation of Non-Restricted and Restricted Stock Awards

The fair value of non-restricted and restricted stock awards is equal to the closing market price of the Company's common stock at the date of grant. The fair value of non-restricted awards is charged to share-based compensation upon grant. The fair value of restricted awards is amortized to share-based compensation expense over the vesting period of the underlying awards, ranging from two years to four years.

Forfeiture Rate for Options and Restricted Stock Awards

The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods on a cumulative basis in the period the estimated forfeiture rate changes for all share-based awards. The Company considered its historical experience of pre-vesting option forfeitures as the basis to arrive at its estimated pre-vesting option forfeiture rate of 5% per year for the year ended December 31, 2006 for all share-based awards.

Unrecognized Share-Based Compensation Expense

As of December 31, 2006, there was approximately \$6.0 million of total unrecognized compensation expense related to nonvested share-based compensation arrangements granted under the equity incentive plans. This expense is expected to be recognized over a weighted-average period of 1.4 years as follows:

	<u>(in thousands)</u>
Fiscal Year 2007	3,795
Fiscal Year 2008	1,772
Fiscal Year 2009	409
Fiscal Year 2010	21
	<u>\$ 5,997</u>

During the fourth quarter of fiscal 2005, the Company accelerated the vesting of unvested stock options awarded to all employees and officers under its stock option plans that had exercise prices greater than \$10.00. The unvested options to purchase approximately 710,000 shares became fully vested as of December 8, 2005 as a result of the acceleration. These stock options would have all become fully vested before or during 2008. The Company accelerated these options because the options had exercise prices significantly in excess of the then current market value (\$5.25 at December 8, 2005), and thus were not fully achieving their original objectives of incentive compensation and employee retention. The acceleration eliminated future compensation expense that would have been recognized in the statements of operations with respect to these options with the implementation of FASB No. 123(R). The future expense eliminated as a result of the acceleration of the vesting of these options was approximately \$1.1 million.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Prior Year Pro Forma Disclosure of Share-Based Compensation Expense

Had the Company determined compensation expense based on fair value in accordance with FASB No. 123, “*Accounting for Stock Based Compensation*,” net loss and net loss per common share would have been as follows:

	<u>Year Ended December 31,</u>	
	<u>2005</u>	<u>2004</u>
Net loss, as reported	\$ (89,718)	\$ (33,425)
Add: Stock-based compensation expense included in reported net loss	877	—
Deduct: Total stock-based compensation expense determined under fair value based method for all awards	<u>(7,531)</u>	<u>(8,420)</u>
Pro forma net loss	<u>\$ (96,372)</u>	<u>\$ (41,845)</u>
Basic and diluted net loss per share, as reported	\$ (2.04)	\$ (0.77)
Pro forma basic and diluted net loss per share	\$ (2.19)	\$ (0.96)

Equity Incentive Awards Activity

Stock Options

Information with respect to all of the Company’s stock option plans is as follows (in thousands, except per share data):

	<u>Shares</u>	<u>Weighted-Average Exercise Price Per Share</u>	<u>Aggregate Intrinsic Value</u>
Balance at January 1, 2004	6,927	\$ 10.42	
Granted	2,802	\$ 9.80	
Exercised	(323)	\$ 4.11	
Cancelled	(944)	\$ 10.42	
Balance at December 31, 2004	8,462	\$ 10.45	
Granted	658	\$ 6.58	
Exercised	(366)	\$ 2.34	
Cancelled	(1,215)	\$ 11.51	
Balance at December 31, 2005	7,539	\$ 10.34	
Granted	220	\$ 9.12	
Exercised	(2,006)	\$ 4.78	
Cancelled	(2,096)	\$ 13.32	
Balance at December 31, 2006	<u>3,657</u>	\$ 11.60	\$ 6,345

The grant date fair value of options granted during the year ended December 31, 2006, as determined by the BSM valuation model, was \$4.83 per share. The total intrinsic value of options exercised during the year ended December 31, 2006 was \$7.4 million, or \$3.69 per share.

At December 31, 2006, options to purchase 3,133,124 shares with an aggregate intrinsic value of approximately \$4,744,000 were exercisable, and approximately 4,553,571 shares remain available for grant.

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A further detail of the options outstanding as of December 31, 2006 is set forth as follows (in thousands, except per share data):

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>	<u>Weighted- Average Remaining Life in Years</u>	<u>Weighted- Average Exercise Price Per Share</u>	<u>Options Exercisable</u>	<u>Weighted- Average Exercise Price</u>	<u>Per Share of Options Exercisable</u>
\$ 0.42 – \$ 7.76	917	6.6	\$ 6.47	727	\$ 6.66	\$ 6.66
\$ 7.79 – \$10.05	1,601	7.1	\$ 9.45	1,289	\$ 9.59	\$ 9.59
\$10.12 – \$26.98	923	4.9	\$ 15.83	901	\$ 15.95	\$ 15.95
\$27.00 – \$88.63	216	3.6	\$ 31.27	216	\$ 31.27	\$ 31.27
\$ 0.42 – \$88.63	<u>3,657</u>	6.2	\$ 11.60	<u>3,133</u>	\$ 12.23	\$ 12.23

Non-Restricted and Restricted Share Awards

Information with respect to all of the Company's non-restricted and restricted share awards is as follows (in thousands, except per share data):

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value Per Share</u>
Nonvested awards outstanding at January 1, 2005	—	\$ —
Granted	726	\$ 6.59
Vested	(28)	\$ 7.00
Forfeited and cancelled	(138)	\$ 7.00
Nonvested awards outstanding at December 31, 2005	560	\$ 6.47
Granted	1,036	\$ 6.44
Vested	(315)	\$ 6.85
Forfeited and cancelled	(163)	\$ 6.61
Nonvested awards outstanding at December 31, 2006	<u>1,118</u>	<u>\$ 6.31</u>

Warrants

In connection with the closing of a series of transactions with Syngenta Participations AG in February 2003, the Company issued to Syngenta a warrant to purchase 1,293,00 shares of common stock at \$22 per share that is exercisable for ten years starting in 2008.

Common Stock Reserved for Future Issuance

At December 31, 2006, the Company has reserved shares of common stock for future issuance as follows (in thousands):

Employee Stock Purchase Plan	271
Equity Incentive Plans	4,554
Warrants	1,293
	<u>6,118</u>

DIVERSA CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

11. Benefit Plan

The Company has a 401(k) plan which allows participants to defer a portion of their income through contributions. Such deferrals are fully vested and are not taxable to the participant until distributed from the plan upon termination, retirement, permanent disability, or death. The Company matches a portion of the employee contributions and may, at its discretion, make additional contributions. The Company made cash contributions of approximately \$0.4 million during the year ended December 31, 2006 and \$0.7 million during each of the years ended December 31, 2005 and 2004.

12. Income Taxes

The reconciliation of income tax computed at the Federal statutory tax rate to the benefit for income taxes is as follows:

	December 31,		
	2006	2005	2004
	(\$ in thousands)		
Tax at statutory rate	\$(13,744)	\$(31,401)	\$(11,699)
State taxes, net of Federal benefit	(2,256)	(5,155)	(1,921)
Change in valuation allowance	12,044	35,953	11,888
SFAS 123R ISO Expense	1,155		
Permanent Differences & Other	2,801	603	1,732
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

Significant components of the Company's deferred tax assets are shown below. A valuation allowance of \$128.7 million and \$116.9 million has been recognized to offset the deferred tax assets at December 31, 2006 and 2005 as realization of such assets is uncertain. The following table sets forth the detail of the Company's deferred taxes (in thousands):

	As of December 31,	
	2006	2005
Deferred tax assets:		
Net operating loss carryforwards	\$ 82,316	\$ 72,101
Federal and state tax credits	8,298	8,203
Deferred revenue	2,517	3,580
Depreciation and amortization	22,347	23,718
Allowance and accrued liabilities	3,421	2,242
Stock Option Expense	1,164	
Capitalized research and development	8,855	7,030
Total deferred tax assets	128,918	116,874
Valuation allowance	(128,918)	(116,874)
Net deferred tax assets	<u>\$ —</u>	<u>\$ —</u>

At December 31, 2006, the Company has federal and California net operating loss carry-forwards of approximately \$233.5 million and \$48.0 million, respectively. The federal net operating loss carry-forwards will begin to expire in 2011 unless utilized. The California net operating loss carry-forwards will begin to expire in 2007 unless utilized. The Company also has federal research credits of approximately \$5.2 million which begin to expire in 2011, California research credits of approximately \$4.0 million which will carryover indefinitely, and California manufacturer's investment credits of approximately \$0.7 million, which will begin to expire in 2010.

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

A portion of the deferred tax assets include a future tax benefit related to stock option deductions, which, if recognized, will be allocated to additional paid-in capital.

Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of the Company's net operating loss and credit carry-forwards may be limited due to cumulative changes in ownership of more than 50%.

As a result of the adoption of SFAS 123R, the company recognizes excess tax benefits associated with the exercise of stock options directly to stockholders' equity only when realized. Accordingly, deferred tax assets are not recognized for net operating loss carryforwards resulting from excess tax benefits occurring from January 1, 2006 onward. At December 31, 2006, deferred tax assets do not include \$2.2 million of excess tax benefits from share based compensation.

13. Selected Quarterly Data (Unaudited)

The following tables set forth certain unaudited quarterly information for each of the eight fiscal quarters in the two year period ended December 31, 2006. This quarterly information has been prepared on a consistent basis with the audited consolidated financial statements and, in the opinion of management, includes all adjustments which management believes are necessary for a fair presentation of the information for the periods presented. Our quarterly operating results may fluctuate significantly as a result of a variety of factors, and operating results for any quarter are not necessarily indicative of results for a full fiscal year or future quarters.

<u>2006 Quarter Ended</u>	<u>Dec. 31</u>	<u>Sep. 30</u>	<u>June 30</u>	<u>Mar. 31</u>
	(in thousands, except per share data)			
Total revenue	\$ 14,778	\$ 14,312	\$ 10,598	\$ 9,510
Operating expenses (1)	21,272	18,678	18,686	31,137
Net loss	(6,123)	(3,975)	(7,772)	(21,401)
Basic and diluted net loss per common share	(0.13)	(0.08)	(0.17)	(0.47)
<u>2005 Quarter Ended</u>	<u>Dec. 31</u>	<u>Sep. 30</u>	<u>June 30</u>	<u>Mar. 31</u>
	(in thousands, except per share data)			
Total revenue	\$ 14,516	\$ 12,773	\$ 14,185	\$ 12,829
Operating expenses (2)	69,527	24,872	25,396	24,955
Net loss	(54,688)	(12,067)	(10,977)	(11,986)
Basic and diluted net loss per common share	(1.23)	(0.27)	(0.25)	(0.27)

(1) Includes restructuring charges of \$12.0 million, of which \$11.0 million was recorded in the first quarter of 2006.

(2) Includes a non-cash asset impairment charge of \$45.7 million during the fourth quarter of 2005

14. Subsequent Events

Proposed Merger Transaction with Celunol Corp

On February 12, 2007, the Company entered into a definitive merger agreement with Celunol Corp., a Delaware corporation, pursuant to which the parties agreed to a merger transaction involving the merger of a wholly-owned subsidiary of the Company into Celunol, with Celunol continuing as the surviving corporation and a wholly-owned subsidiary of the Company. The merger agreement has been approved by the boards of directors of both the Company and Celunol.

Management believes that the combined company will be the first within the cellulosic ethanol industry to possess integrated end-to-end capabilities in pre-treatment, novel enzyme development, fermentation,

DIVERSA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

engineering, and project development. It will seek to build a global enterprise as a leading producer of cellulosic ethanol and as a strategic partner in bio-refineries around the world. The combined company will be headquartered in Cambridge, Massachusetts and have research and operations facilities in San Diego, California; Jennings, Louisiana; and Gainesville, Florida.

In February 2007, Celunol completed a significant upgrade of its pilot-scale facility in Jennings, Louisiana and, on the same Celunol-owned property, has begun construction of a 1.4 million gallons-per-year, demonstration-scale facility to produce cellulosic ethanol from sugarcane bagasse and specially-bred energy cane. Celunol expects that its demonstration-scale facility will be mechanically complete by the end of 2007.

Under the terms of the merger agreement, upon completion of the merger, and subject to certain adjustments, Celunol's securityholders will receive an aggregate of 15 million shares of stock, options and warrants in the Company, collectively representing approximately 24% of the outstanding equity of the combined organization following the completion of the merger. In conjunction with the merger, the Company is committed to fund up to \$20 million in cash to fund Celunol's operations through the close of the merger, subject to the terms and conditions of a promissory note.

The Company expects the transaction, which will be accounted for as a purchase, to close in the second quarter of 2007, subject to the satisfaction of certain customary closing conditions, including the approval of the stockholders of both companies. Diversa will require the approval of a majority of the total shares of Diversa common stock voting at the annual stockholders' meeting to approve the issuance of Diversa common stock in connection with the merger. Celunol will require the approval of (a) a majority of the total voting shares represented by Celunol common stock and preferred stock, voting as a single class, and (b) a majority of the total voting shares represented by Celunol preferred stock, voting as a single class, to approve the merger.

The Company plans to file a registration statement on Form S-4 in March 2007 in connection with the proposed merger.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a)(1) Index to Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm	3
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Consolidated Statements of Operations	5
Consolidated Statements of Stockholders' Equity	6
Consolidated Statements of Cash Flows	7
Notes to Consolidated Financial Statements	8

(a)(2) Financial Statement Schedules: All schedules have been omitted because they are not applicable or required, or the information required to be set forth therein is included in the Consolidated Financial Statements or notes thereto included in Item 8 ("Financial Statements and Supplementary Data").

(a)(3) Index to Exhibits—See (b) below.

(b) Exhibits

<u>Exhibit Number</u>	<u>Description of Exhibit</u>
2.1	Transaction Agreement dated as of December 3, 2002 among Syngenta Participations AG, Torrey Mesa Research Institute and the Company.(6)
2.2	Agreement and Plan of Merger and Reorganization, dated as of February 12, 2007, by and among the Company, Concord Merger Sub, Inc., Celunol Corp., and William Lese.(15)
2.3	Form of Voting Agreement, dated as of February 12, 2007, by and among the Company and certain stockholders of Celunol Corp.(15)
2.4	Form of Voting Agreement, dated as of February 12, 2007, by and among Celunol Corp. and certain stockholders of the Company.(15)
2.5	Form of Lock-up Agreement by and between the Company and certain stockholders of Celunol Corp.(15)
2.6	Form of Lock-up Agreement by and between the Company and certain stockholders of the Company.(15)
3.1	Amended and Restated Certificate of Incorporation.(1)
3.2	Certificate of Amendment of Restated Certificate of Incorporation.(17)
3.3	Amended and Restated Bylaws.(1)
4.1	Form of Common Stock Certificate of the Company.(2)
4.2	Rights Agreement by and between the Company and American Stock Transfer and Trust Company, as Rights Agent, dated as of December 13, 2000 (including the Form of Certificate of Designation of Series A Junior Participating Preferred Stock attached thereto as Exhibit A, the Form of Right Certificate attached thereto as Exhibit B, and the Summary of Rights to Purchase Preferred Shares attached thereto as Exhibit C).(3)

Exhibit Number	Description of Exhibit
4.3	Amendment to Rights Agreement by and between the Company and American Stock Transfer and Trust Company, as Rights Agent, dated as of December 2, 2002.(7)
4.4	The Company's Certificate of Designation of Series A Junior Participating Preferred Stock.(3)
4.5	Form of Warrant issued by the Company to Syngenta Participations AG.(6)
4.6	Registration Rights Agreement dated as of December 3, 2002 among Syngenta Participations AG, Torrey Mesa Research Institute, Syngenta Seeds AG and the Company.(6)
4.7†	Registration Rights Agreement dated as of July 18, 2003 by and between GlaxoGroup Limited and Diversa Corporation.(8)
4.8	Second Amendment to Rights Agreement by and between the Company and American Stock Transfer and Trust Company, as Rights Agent, dated as of February 12, 2007.(15)
4.9	Reference is made to Exhibits 3.1 and 3.2.
10.1	Form of Indemnity Agreement entered into between the Company and its directors and executive officers.(2)
10.2*	1994 Employee Incentive and Non-Qualified Stock Option Plan, as amended.(2)
10.3*	Form of Stock Option Agreement under the 1994 Employee Incentive and Non-Qualified Stock Option Plan.(2)
10.4*	1997 Equity Incentive Plan.(2)
10.5*	Form of Stock Option Grant Notice and Stock Option Agreement under the 1997 Equity Incentive Plan.(2)
10.6*	1999 Non-Employee Directors' Stock Option Plan.(2)
10.7*	Form of Stock Option Grant Notice and Related Stock Option Agreement under the 1999 Non-Employee Directors' Stock Option Plan.(2)
10.8*	2005 Non-Employee Directors' Equity Incentive Plan.(4)
10.9*	1999 Employee Stock Purchase Plan.(2)
10.10†	Amended and Restated Stockholders' Agreement by and among the Company and the Stockholders identified therein, dated January 25, 1999.(2)
10.11†	License Agreement by and between the Company and Finnfeeds International Limited (now Danisco Animal Nutrition), dated December 1, 1998.(2)
10.12*	Employment Offer Letter to Patrick Simms, dated February 3, 1997.(2)
10.13*	Employment Offer Letter to William H. Baum, dated July 31, 1997.(2)
10.14	Lease Agreement, dated February 11, 2000, by and between the Company and KR—Gateway Partners, LLC.(1)
10.15	Lease Agreement, dated February 11, 2000, by and between the Company and KR—Gateway Partners, LLC.(1)
10.16†	Amended and Restated Research Collaboration Agreement dated as of January 3, 2003 between the Company and Syngenta Participations AG. (6)
10.17†	License Agreement dated December 29, 2003 by and between Xoma Ireland Limited and the Company. (9)

Exhibit Number	Description of Exhibit
10.18†	Transition Agreement dated May 28, 2004 by and between the Company, Zymetrics, Inc., Syngenta Seeds AG, and Syngenta Participations AG. (10)
10.19†	Amendment to Amended and Restated Research Collaboration Agreement dated May 28, 2004 between the Company and Syngenta Participations AG. (10)
10.20*	Employment Offer Letter, dated November 11, 2004, between the Company and Anthony E. Altig. (11)
10.21*	Employment Offer Letter, dated March 31, 2005, between the Company and Jeffrey G. Black. (12)
10.22	Loan and Security Agreement by and between the Company and Comerica Bank dated September 30, 2005. (13)
10.23†	Distribution Agreement dated January 1, 2005 by and between Valley Research, inc. and the Company. (14)
10.24†	Amendment to Distribution Agreement by and between Valley Research, inc. and the Company, effective as of August 1, 2005. (14)
10.25	Employment Offer Letter, dated November 10, 2005, between the Company and Edward Shonsey. (16)
10.26††	License and Research Agreement by and between Syngenta Participations AG and the Company, effective December 31, 2006. (17)
10.27	Letter Agreement, dated February 12, 2007, by the Company and Carlos A. Riva. (15)
10.28	Promissory Note, dated February 12, 2007, by Celunol Corp. for the benefit of the Company. (15)
23.1+	Consent of Independent Registered Public Accounting Firm.
24.1	Power of Attorney.(17)
31.1+	Certification of Chief Executive Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities and Exchange Act of 1934, as amended.
31.2+	Certification of Chief Financial Officer pursuant to Rules 13a-14(a) and 15d-14(a) promulgated under the Securities and Exchange Act of 1934, as amended.
32.1+	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2+	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Indicates management or compensatory plan or arrangement.

- (1) Filed as an exhibit to the Company's Quarterly Report Form 10-Q for the quarter ended March 31, 2000, filed with the Securities and Exchange Commission on May 12, 2000, and incorporated herein by reference.
- (2) Filed as an exhibit to the Company's Registration Statement on Form S-1 (No. 333-92853) filed with the Securities and Exchange Commission, as amended, and incorporated herein by reference.
- (3) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on December 15, 2000, and incorporated herein by reference.
- (4) Filed as an exhibit to the Company's Proxy Statement on Form 14-A filed with the Securities and Exchange Commission on April 15, 2005, and incorporated herein by reference.
- (5) Filed as part of the Company's Definitive Proxy Statement on Schedule 14A (File No. 000-29173) filed on April 6, 2001, and incorporated herein by reference.
- (6) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on January 6, 2003, and incorporated herein by reference.

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- (7) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on December 4, 2002, and incorporated herein by reference.
 - (8) Filed as an exhibit to the Company's Quarterly Report Form 10-Q for the quarter ended June 30, 2003, filed with the Securities and Exchange Commission on August 14, 2003, and incorporated herein by reference.
 - (9) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on March 12, 2004, and incorporated herein by reference.
 - (10) Filed as an exhibit to the Company's Quarterly Report Form 10-Q for the quarter ended June 30, 2004, filed with the Securities and Exchange Commission on August 6, 2004, and incorporated herein by reference.
 - (11) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on November 18, 2004 and incorporated herein by reference.
 - (12) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on April 26, 2005 and incorporated herein by reference.
 - (13) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on October 6, 2005 and incorporated herein by reference.
 - (14) Filed as an exhibit to the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 16, 2006 and incorporated herein by reference.
 - (15) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on February 12, 2007 and incorporated herein by reference.
 - (16) Filed as an exhibit to the Company's Current Report on Form 8-K, filed with the Securities and Exchange Commission on November 15, 2005 and incorporated herein by reference.
 - (17) Filed as an exhibit to the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 16, 2007 and incorporated herein by reference.
- † Confidential treatment has been granted with respect to portions of this exhibit. A complete copy of the agreement, including the redacted terms, has been separately filed with the Securities and Exchange Commission.
- †† Confidential treatment has been requested with respect to portions of this exhibit. A complete copy of the agreement, including the redacted terms, has been separately filed with the Securities and Exchange Commission.
- + Filed herewith.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements (Form S-8 Nos. 333-107171, 333-75396 and 333-31056) pertaining to the 1994 Employee Incentive and Non-Qualified Stock Option Plan, the 1997 Equity Incentive Plan, the 1999 Non-Employee Directors' Stock Option Plan, and the 1999 Employee Stock Purchase Plan of Diversa Corporation of our reports dated March 14, 2007, with respect to the consolidated financial statements of Diversa Corporation, Diversa Corporation management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of Diversa Corporation, included in this Annual Report (Form 10-K/A) for the year ended December 31, 2006.

/s/ E RNST & Y OUNG LLP

San Diego, California
March 14, 2007

CERTIFICATION
Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934,
as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Edward T. Shonsey, certify that:

1. I have reviewed this Annual Report on Form 10-K/A for the year ended December 31, 2006 of Diversa Corporation.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 20, 2007

/s/ E DWARD T. S HONSEY
Edward T. Shonsey
Chief Executive Officer

CERTIFICATION
Pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934,
as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Anthony E. Altig, certify that:

1. I have reviewed this Annual Report on Form 10-K/A for the year ended December 31, 2006 of Diversa Corporation.
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 20, 2007

/s/ ANTHONY E. ALTIG

Anthony E. Altig
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Diversa Corporation (the "Company") on Form 10-K/A for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on or about the date hereof (the "Report"), I, Edward T. Shonsey, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge, that:

- (1) the Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Report and results of operations of the Company for the period covered by the Report.

Date: March 20, 2007

/s/ EDWARD T. SHONSEY

Edward T. Shonsey
Chief Executive Officer

This certification shall not be deemed "filed" for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, or otherwise subject to the liability of Section 18 of the Exchange Act. Such certification shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report of Diversa Corporation (the "Company") on Form 10-K/A for the period ended December 31, 2006, as filed with the Securities and Exchange Commission on or about the date hereof (the "Report"), I, Anthony E. Altig, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge, that:

- (1) the Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Report and results of operations of the Company for the period covered by the Report.

Date: March 20, 2007

/s/ ANTHONY E. ALTIG

Anthony E. Altig
Chief Financial Officer

This certification shall not be deemed "filed" for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, or the Exchange Act, or otherwise subject to the liability of Section 18 of the Exchange Act. Such certification shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.