

PURE BIOSCIENCE  
Form 10-K  
October 13, 2009

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended July 31, 2009 or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file No. 0-21019

PURE BIOSCIENCE  
(Exact name of registrant as specified in charter)

California  
(State or other jurisdiction of  
incorporation or organization)

33-0530289  
(IRS Employer  
Identification No.)

1725 Gillespie Way  
El Cajon, California 92020  
(Address of principal executive office, including zip code)

(619) 596-8600  
(Registrant's telephone number, including area code)

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

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, no par value

Indicate by check mark whether 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 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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company (as defined in Rule 12b-2 of the Act). See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if a smaller reporting company) Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes  No

As of October 9, 2009, the registrant had 34,126,148 shares of its common stock, no par value, issued and outstanding.

The aggregate market value of the registrant's voting stock held by non-affiliates, as of the last day of the registrant's second quarter of the fiscal year ended July 31, 2009, was approximately \$72,332,800 (computed on the basis of the last trade of the common stock on the NASDAQ Capital Market on January 30, 2009).

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Documents Incorporated by Reference

Portions of the registrant's Definitive Proxy Statement to be filed with the Securities and Exchange Commission ("SEC") pursuant to Regulation 14A in connection with the Annual Meeting of Shareholders to be held on or about January 20, 2010 are incorporated herein by reference into Part III of this Annual Report. Such Definitive Proxy Statement will be filed with the Commission not later than 120 days after July 31, 2009.

As used in this 10-K, the terms "we", "us", "our" and "the Company" refer to PURE Bioscience, a California corporation, and its subsidiaries, on a consolidated basis, unless otherwise stated.

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## PART I

### CAUTIONARY STATEMENT

This Annual Report contains forward-looking statements regarding our business, financial condition, results of operations and prospects. Words such as “expects,” “anticipates,” “intends,” “plans,” “believes,” “seeks,” “estimates” and similar expressions or variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Annual Report. Additionally, statements concerning future matters such as the development of new products, sales levels, expense levels and other statements regarding matters that are not historical are forward-looking statements.

Although forward-looking statements in this Annual Report reflect the good faith judgment of our management, such statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties and actual results and outcomes may differ materially from the results and outcomes discussed in or anticipated by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include without limitation those discussed under the heading “Risk Factors” in Item 1A, as well as those discussed elsewhere in this Annual Report. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report. We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report. Readers are urged to carefully review and consider the various disclosures made in this Annual Report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations and prospects.

#### Item 1. Business

##### Overview

PURE Bioscience (sometimes referred to herein as the “Company,” “we”, “us” or “our”) was incorporated in the state of California on August 24, 1992. We began as a provider of pharmaceutical water purification products for the pharmacy market. In 2000, we commenced investments in the development of novel bioscience technologies, and subsequent to the May 2005 sale of our Water Treatment Division we have been exclusively focused on the development and commercialization of our current and future bioscience products.

We are expanding into markets with broad potential by developing new, proprietary bioscience products based upon our patented silver ion antimicrobial technologies. We are developing technology-based bioscience products, including our silver dihydrogen citrate-based antimicrobials, which we believe can provide novel, non-toxic solutions to numerous global health challenges and represent innovative advances in diverse markets. We believe that our technologies are in a position to contribute significantly to today’s global trend toward industrial and consumer use of environmentally friendly products, while providing competitive advantages in efficacy and safety.

##### Bioscience Technologies

Our flagship bioscience technology is a patented, aqueous antimicrobial called silver dihydrogen citrate (“SDC”). A new molecular entity, SDC is an electrolytically generated source of stabilized ionic silver that can serve as the basis for a broad range of products in diverse markets. SDC liquid is colorless, odorless, tasteless, non-caustic and formulates well with other compounds. As a platform technology, our SDC-based antimicrobial is distinguished from competitors in the marketplace because of its superior efficacy combined with reduced toxicity. We are producing and plan to expand the production of pre-formulated, ready-to-use products for private label distribution, as well as varying strengths of SDC concentrate as an additive or raw material for inclusion in other companies’ products, including as an active pharmaceutical ingredient. In addition to SDC, we have obtained patent protection for ionic silver-based

molecular entities utilizing 14 organic acids other than citric acid.

We also own certain rights to a patent-pending pesticide technology, Triglycylboride which, like SDC, provides effective results without human toxicity and is an alternative to traditional poisons. Triglycylboride has been formulated into the products RoachX and AntX, however these products are not currently being actively marketed or developed.

#### Principal Products and Markets

Silver Dihydrogen Citrate. SDC is an electrolytically generated source of stabilized ionic silver that can serve as the basis for a broad range of products in diverse markets. Colorless, odorless, tasteless and non-caustic, the aqueous SDC formulates well with other compounds. We produce and have begun to market, through our distributors, pre-formulated, ready-to-use product for private label distribution, as well as varying strengths of SDC concentrate as an additive or raw material for inclusion in other companies' products.

We currently have U.S. Environmental Protection Agency ("EPA") registration for our 2400-parts per million (ppm) technical grade SDC concentrate (trade name Axenohl) as well as for our Axen and Axen30 hard surface disinfectant products for commercial, industrial and consumer applications including restaurants, homes and medical facilities. In August 2009, we obtained EPA registration for an SDC-based sanitizer for food contact surfaces. The new sanitizer was registered under the trade name Axen50 for sanitization of food contact surfaces and equipment in environments such as farms, food processing plants, schools, hospitals, restaurants and homes.

Our Axen30 EPA registration includes claims such as a 30-second kill time on standard indicator bacteria, a 24 hour residual kill on standard indicator bacteria, a 2-minute kill time on some resistant strains of bacteria, a 10-minute kill time on fungi, a 30-second kill time on HIV Type I, and a 3 to 10-minute kill time on other viruses. These claims distinguish the efficacy of Axen30 from many of the leading commercial and consumer products currently on the market, while maintaining lower toxicity ratings. Based on the EPA toxicity categorization of antimicrobial products that ranges from Category I (high toxicity) down to Category IV, Axen30, with its combination of the biocidal properties of ionic silver and citric acid, is an EPA Category IV antimicrobial for which precautionary labeling statements are normally not required. This compares with Category II warning statements for most leading brands of antimicrobial products.

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The tests conducted to obtain the EPA registration were performed by nationally recognized independent laboratories including Nelson Laboratories of Salt Lake City, Utah and AppTec ATS of St. Paul, Minnesota, under AOAC protocol and GLP regulations in accordance with EPA regulations. Specific Axen test results include:

- 30-Second Kill Time At 30 ppm, Axen demonstrated a 30-second, 99.9999% kill of standard indicator organisms including *Staphylococcus aureus* ATCC 6538, *Pseudomonas aeruginosa* ATCC 15442 and *Salmonella choleraesuis* ATCC 10708. Each is regarded as ever present in nearly every person's life and is also a frequent human pathogen.
- Residual Kill Activity The residual activity of Axen was tested at 0, 1, 6, and 24 hours after application to a hard surface against standard indicator organisms (*Staphylococcus aureus* ATCC 6538, *Pseudomonas aeruginosa* ATCC 15442 and *Salmonella choleraesuis* ATCC 10708). Quantitative residual results at 24 hours after initial application show a 99.99% reduction in all three bacteria tested.
- Bacteria Additional testing of Axen against Methicillin Resistant *Staphylococcus aureus* ATCC 700698 (MRSA), Vancomycin Resistant *Enterococcus faecium* ATCC 700221 (VRE) and *Escherichia coli* OH157 ATCC 43888 demonstrated a 99.9999% kill in 2 minutes. These specific bacteria are especially problematic in hospitals because of their resistance to antibiotics. Further, Axen showed a 99.9999% kill in 30-seconds against *Listeria monocytogenes* ATCC 19111. Food processing operations are challenged to keep this bacterium under control. In November 2007, we obtained expanded EPA-registered claims to include claims against two additional resistant strains of *Staphylococcus*, Community Associated MRSA (CA-MRSA) and Community Associated PVL Positive MRSA (CA-MRSA, PVL Positive), eliminating both organisms in just two minutes. Also added to the expanded label are two-minute kill claims on *Campylobacter jejuni* and *Acinetobacter baumannii*.
- Fungus Axen demonstrated a 99.9999% kill in 10 minutes of the common athlete's foot fungus, *Trichophyton mentagrophytes* ATCC 9533. This data allows us to add a fungicidal claim to Axen's hard surface disinfectant label.
- Viruses Axen also demonstrated 99.9999% virucidal efficacy against HIV Type 1 in 30 seconds, Herpes simplex virus type 1 in one minute, and Influenza A virus ATCC VR-544, Rhinovirus type R 37 ATCC VR-1147, Strain 151-1 and Poliovirus type 2 ATCC VR-1022, Strain Lansing in 10 minutes. After review and registration by the EPA, this data allows us to add these virucidal claims to Axen's hard surface disinfectant label. The recently expanded EPA-registered viral efficacy claims include a three-minute kill against Human Corona virus and Rotavirus and a ten-minute kill against Norovirus and Avian Influenza A.

We have received EPA registration to expand claims for our Axen30 hard surface disinfectant to include use on hard surfaces in childcare facilities, restaurants, homes and medical facilities. Expanded use claims for our Axen30 disinfectant also include children's toys, toy boxes, play tables and activity centers, jungle gyms, playpens, child car seats, strollers and diaper changing tables. The EPA's registration of such sensitive use sites emphasizes the "least-toxic" characteristics of Axen30 while expanding its versatility in the professional and consumer disinfection markets. With our partners, we are investigating market opportunities for products in the childcare segment which includes daycare centers, preschools, schools, gymnasiums and children's activity centers.

We expect the new Axen50 sanitizer approval to open new markets for our technology, as food borne illnesses create significant health and economic problems in the U.S. and internationally. The Axen50 registration will enable our distributors to apply for state registrations to sell both new food surface sanitizers and to add the new food contact sanitization claims to existing disinfectant product registration claims. Additionally, we expect that this registration will help add to our product offerings additional direct food contact applications of SDC-based formulations as antimicrobial processing aids, predominantly through the U.S. Department of Agriculture.

When requested by our partners, we may utilize our expertise to source, assemble and build SDC blending systems for sale to our distributors. These systems allow our distributors to blend our SDC concentrate into lower concentrations, thereby significantly reducing the cost of shipping products, particularly for overseas markets. No information regarding the method of making SDC is passed to our distributors as in all of our third party agreements we are, and intend to continue to be, the sole manufacturer and sole source of SDC concentrate.

We plan to pursue additional EPA and U.S. Food and Drug Administration (“FDA”) regulatory approvals for other applications. In September 2003, we entered into an agreement with Therapeutics, Incorporated (“Therapeutics”), a drug development company based in La Jolla, California, for the development and commercialization of certain FDA-regulated SDC-based products (the “Therapeutics Agreement”). Products under development in our collaboration with Therapeutics included women’s health products, acne products, products for treatment of dermatophytoses such as tinea pedis (athlete's foot), onychomycosis (nail fungus), and antimicrobial skin wash products, beginning with a hand sanitizer. In December 2006, Therapeutics submitted an Investigational New Drug (IND) application to the FDA for an SDC-based hand sanitizer, to enable initiation of the first clinical trial of a product containing SDC as an active pharmaceutical ingredient. After reviewing the submission the FDA determined that the product testing in man may begin as proposed. Multiple hand sanitizer formulations containing SDC have been tested for safety and efficacy in proof of concept studies.

In July 2008, we added a new development and licensing partner for SDC-based products for human use, FTA Therapeutics, LLC (“FTA”). To facilitate the contract with FTA, we structured an agreement in which Therapeutics transferred its development and license rights for FDA-regulated SDC-based products, including the in-process IND for a skin sanitizer, back to us. We purchased from Therapeutics all data and other materials generated by Therapeutics related to the licenses being returned. We intend to subsequently license development rights for these indications to multiple third parties, the first being FTA.

FTA has begun formulation and clinical projects for FDA-regulated dermatology products containing SDC. Under our agreement with FTA, FTA will fund and direct all development activities and FDA regulatory filings. In July 2009, the Cleveland Clinic, which has one of the largest biomedical engineering departments in the United States, acquired an equity stake in FTA and will work with FTA on their SDC development projects.

Our SDC technology also shows promise as a broad-spectrum antimicrobial for multiple other medical indications, including wound and burn care, as well as for dental and veterinary indications, for which we are actively seeking development partners.

In September 2007, we announced that we had developed a new SDC-based antimicrobial product that provides what we believe to be the first 24-hour residual protection against norovirus. The highly concentrated product is designed to be mixed with water at the point of use to create a low toxicity hard surface antimicrobial. In 2007, we commissioned an independent, third-party study entitled "Residual Virucidal Efficacy of a Disinfectant for Use on Inanimate Environmental Surfaces Utilizing Feline Calicivirus as a Surrogate Virus for Norovirus." The study was conducted by the nation's leading third party microbiology and virology testing laboratory in accordance with EPA Good Laboratory Practice regulations. The testing laboratory modified an existing EPA protocol for testing bacterial residual efficacy to a protocol that appropriately evaluated the residual efficacy of our new formulation against the Feline Calicivirus. Our new disinfectant demonstrated greater than 99.9999% reduction in viral titer of Feline Calicivirus after 12 hours and at least a 99.98% reduction after 24 hours. We intend to initially market the product through distributor relationships to the cruise ship industry under the name Cruise Control, subject to significant testing and evaluation of the product by potential purchasers.

In July 2008, we suspended the development and marketing efforts for our Triglycylboride boric acid-based pesticides in order to focus on the development of our SDC and related technologies. If we decide not to make additional future investments in the Triglycylboride technology ourselves, we may pursue alternatives such as selling or licensing our rights to the technology, however the value of the technology, if any, is unknown at this time.

#### Customers

We rely on third parties to market and distribute our products. Our partners and distributors are marketing our novel antimicrobial silver ion technology to industrial and consumer markets, however these products have not yet been widely accepted into the marketplace.

We sell, or plan to sell, SDC in a variety of concentrations and formulations. We sell SDC concentrate to certain partners who in turn (i) resell the concentrate as an active ingredient or preservative in other companies' products; (ii) blend the product into hard surface disinfectant products for sale to retail, commercial and institutional customers; and/or (iii) develop novel formulations under a license granted by us. In addition, we sell both bulk and individually bottled hard surface disinfectant products to distributors that in turn sell the product to retail, commercial and institutional customers.

We have a strategic agreement with Ciba, under which we have granted Ciba the right to resell our SDC concentrate within the global personal care, household and institutional markets. During the year ended July 31, 2009 ("Fiscal 2009") Ciba was acquired by BASF, a chemical company with global annual revenues in 2008 of approximately \$90 billion. All contractual rights under our agreements with Ciba have been assigned to BASF, and the integration of Ciba into BASF is complete (for all subsequent references to the strategic relationship in this Annual Report, we will refer to our partner as "BASF"). BASF's customers include many global, well established corporations with powerful existing brands. In February 2009, the first name brand personal care products containing SDC as the active ingredient were launched in Europe by a customer of BASF. We expect other such product launches in future periods through our agreement with BASF.

In July 2008, we entered into an agreement with FTA Therapeutics, LLC for the development of FDA-regulated dermatology products containing SDC. Under the agreement, FTA will fund and direct all development activities and



FDA regulatory filings. We would receive payments on the achievement of certain milestones for each licensed indication; royalties on commercial sales of any products developed and sold under the agreement; and a transfer price for any SDC Active Pharmaceutical Ingredient manufactured by us for incorporation into products developed and sold under the agreement.

We have entered into distribution agreements with multiple distributors in the United States to market our EPA-approved hard surface disinfectant under their own labels, and a number of such products have recently been launched, or we expect to be launched in future periods. As our disinfectant contains a novel, patented molecule, the market adoption of such products can take significantly longer than for a reformulation of a product under an existing brand name. However, we are hopeful that our distributors will successfully achieve market acceptance of our products as a result of the novel selling points of SDC, such as its broad spectrum efficacy, low toxicity and lack of evidence of pathogenic resistance.

During Fiscal 2009, we signed a distribution agreement with BioTech Medical LLC, a U.S.-based division of privately-held Suarez Corporation Industries, a leading international marketing company. This agreement allows BioTech Medical LLC the non-exclusive right to market our Axen30 hard surface disinfectant and our Cruise Control concentrated product globally, with the exception of Brazil. Additionally, we have a strategic agreement with Rockline Industries for the development of wet wipes containing our SDC technology, which Rockline would market if successful product development and EPA approval were achieved.

To date, with the exception of BASF, BioTech Medical LLC and Rockline, our partners have been, and are, small distributors to whom we have granted primarily non-exclusive rights to market our EPA approved Axen30 hard surface disinfectant, which is sold under multiple brand names owned by the distributors. However, we continue to develop new products and formulations utilizing our SDC technology. Potential products may include cleaner disinfectants, field dilutable disinfectants and sanitizers, hospital grade disinfectants and sporicides, cold process sterilants, and medical device applications. If we are successful in developing any such new formulations and obtaining regulatory approvals, we expect be able to attract additional established partners and distributors of our technology.

In August 2009, we obtained EPA registration for an SDC-based sanitizer for food contact surfaces. This registration will enable applications for state registrations to sell both new food surface sanitizers and to add the new food contact sanitization claims to existing disinfectant product registration claims. We also have other pending EPA applications, for additional uses and for new formulations. For example, SDC is currently in various trials by third parties in the transportation and agriculture industries, both of which we consider to be significant market opportunities. While we cannot predict the timing or scale of any of these opportunities, and we are competing in highly competitive markets, we believe that our SDC technology has significant advantages over existing technologies. With the additional food contact claims, and additionally if we are successful in gaining approvals for additional uses and for new formulations, we expect to be able to attract new, well capitalized partners and distributors.

During Fiscal 2009, we signed a number of distribution agreements for the distribution of Axen30 as a hard surface disinfectant, including, among others, agreements with Global Endeavor for India; Harmony Bioscience, Inc. worldwide excluding Brazil, Markus Group Ltd. for Thailand, Indonesia Australia, New Zealand and Vietnam; PT Kurnia Sarana Abadi for Indonesia; and Sterifide Laboratories Inc. for the United States.

During Fiscal 2009, sales to each of the three following customers comprised 10% or more of our revenues: CIBA/BASF, PureGreen LLC, a U.S. sub-registrant and distributor of our hard surface disinfectant products, and Eco-Safe Solutions Inc., also a U.S. sub-registrant and distributor of our hard surface disinfectant products.

During Fiscal 2009, 98% of sales were made to U.S. domestic customers. The balance of future revenues by territory is unknown at this time, however we expect the United States market to continue to be our largest market for the foreseeable future.

#### Segment Information

We believe that based upon the end use of our products, the value added contributions made by us, the regulatory requirements, our customers and partners, and the strategy required to successfully market finished products, we are operating in a single segment. See Note 13 to the consolidated financial statements (“Business Segment and Sales Concentrations”) elsewhere in this 10-K for more information regarding our business segments.

#### Competition

The markets for SDC and each of its potential channels are highly competitive. We have a number of competitors that vary in size and scope and breadth of products offered. Such competitors include some of the largest corporations in the world, and many of our competitors have greater financial resources than we do in the areas of sales, marketing, branding and product development. We expect to face additional competition from other competitors in the future.

Because SDC is a new technology, our success will depend, in part, upon our ability to achieve market share at the expense of existing, established and future products in our relevant target markets. Even where SDC may have technological competitive advantages over competing products, we, our partners or our distributors, will need to invest significant resources in order to attempt to displace traditional technologies sold by what are in many cases well-known international industry leaders. Alternatively, we may pursue strategies in selective markets of encouraging existing competitors to incorporate our products into their existing brands, thereby reducing the proportion of end-use revenues that would accrue to us. To the extent that we were to grant any existing competitor exclusivity to any field and/or territory, we would risk having our technology marketed in a manner that may be less than optimal for us. We recognize that innovative marketing methods are required in order to establish our products, and that such methods may not be successful.

#### Patents and Intellectual Property

Our goal is to obtain, maintain and enforce patent protection for our products, compounds, formulations, processes, methods and other proprietary technologies invented, developed, licensed or acquired by us, preserve our trade secrets, and operate without infringing on the proprietary rights of other parties, both in the U.S. and in other countries. Our policy is to actively seek to obtain, where appropriate, intellectual property protection for our products,

proprietary information and proprietary technology through a combination of contractual arrangements and laws, including patents, both in the U.S. and elsewhere in the world.

We also depend upon the skills, knowledge and experience of our scientific and technical personnel, as well as that of our advisors, consultants and other contractors. To help protect our proprietary know-how that is not patentable, and for inventions for which patents may be difficult to enforce, we rely on trade secret protection and confidentiality agreements to protect our interests. To this end, we require our employees, consultants, advisors and certain other contractors to enter into confidentiality agreements in order to prohibit the disclosure of confidential information and, where applicable, require disclosure and assignment to us of the ideas, developments, discoveries and inventions important to our business. Additionally, these confidentiality agreements require that our employees, consultants and advisors do not bring to us, or use without proper authorization, any third party's proprietary technology.

We own patents, or have patents pending, related to our SDC technology in the U.S. and in certain other countries covering (i) the disinfectant and its method of making, (ii) the formulation of the aqueous disinfectant in combination with ethyl alcohol, (iii) multiple potential uses for our SDC technology, including water treatment, home care and personal products, the treatment of specific types of bacteria, fungus and viruses, medical treatment and the preservation of consumable and non-consumable products, (iv) the combination of SDC with other antimicrobial compounds, including quaternary ammonia, oxidizers or halogens such as chlorine, bromine or iodine, (v) anhydrous, or crystalline, SDC antimicrobial compositions, processes of making and methods of use, and (vi) our process of manufacturing complexes of electrolytically generated stabilized ionic silver with other organic acids. In addition, we have a patent pending for RoachX and related pesticide products, although such pesticide products are not currently in active development. We intend to continue to apply for patent protection for new technology we develop whenever we determine that the benefit of patent protection outweighs the cost of obtaining patent protection.

We own the registered trademarks or trademark applications for PURE Bioscience®, Powered by SDC Ag+™, Staph Attack®, Staphacide®, Axenohl®, Axen, Silvérior®, Kinderguard®, Cruise Control®, Nutripure™, Elderguard™, Critterguard™, Innovex®, RoachX®, AntX™, TrapX® and Medifier™.

#### Manufacturing

We manufacture and blend SDC products in our manufacturing facility at our corporate headquarters in El Cajon, California. We manufacture SDC concentrate, and all SDC concentrated products, exclusively in our facility and intend to maintain all concentrate manufacturing in our own facility and under our own control. In 2007, we completed a redevelopment of our manufacturing facility, and significantly expanded our SDC manufacturing capacity. Also in 2007, our manufacturing facility and process for the production of pharmaceutical-grade SDC concentrate as an Active Pharmaceutical Ingredient received Current Good Manufacturing Practice (cGMP) certification.

In 2007, we invested in manufacturing equipment, including a new automated blending and packaging operation that allows us to produce finished, labeled, diluted end-use products. If necessary, we are able to outsource some blending and packaging operations to one or more third parties, and may do so where it is economically advantageous to us and to our customers, particularly in regard to the reduction of shipping costs. We did not outsource any manufacturing operations during the year ended July 31, 2008 (“Fiscal 2008”) or Fiscal 2009.

Silver, the primary active ingredient in SDC, is a readily available commodity, and the other active and inactive ingredients in our concentrated and ready-to-use products are readily available from multiple chemical supply companies.

#### Research and Development

We conduct our primary Research and Development (“R&D”) activities in-house, and use third-party laboratories to conduct independent testing. In addition, a number of our international and domestic strategic partners perform R&D at their own cost under our mutual agreements in order to develop and expand markets for SDC.

All in-house R&D costs, outside legal costs for maintaining issued patents, and third-party laboratory testing expenses are charged to operations when incurred, and are included in operating expenses. Outside legal costs and filing fees related to obtaining new patents are capitalized as incurred. The total amounts capitalized for pending patents were \$100,270 and \$125,100 in Fiscal 2009 and 2008, respectively. The cumulative cost of acquiring patents is amortized on a straight-line basis over the estimated remaining useful lives of the patents, generally between 17 and 20 years from the date of issuance. At July 31, 2009, the weighted average remaining amortization period for all patents was approximately 10.9 years. Amortization expense for Fiscal 2009, Fiscal 2008 and the year ended July 31, 2007 (“Fiscal 2007”) was \$172,000, \$175,800, and \$164,500, respectively.

In addition to the amortization of capitalized patents, expense charged to R&D was \$1,296,500, \$1,470,600, and \$1,056,300 in Fiscal 2009, Fiscal 2008 and Fiscal 2007, respectively. Total R&D expense, including amortization, was \$1,468,500, \$1,646,400, and \$1,220,800 in Fiscal 2009, Fiscal 2008 and Fiscal 2007, respectively.

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#### Government Regulation

The SDC-based antimicrobial products that we manufacture and sell in the United States are regulated by the EPA under the Federal Insecticide, Fungicide and Rodenticide Act (“FIFRA”). We have four such products currently registered by the EPA under FIFRA: our 2400-parts per million (ppm) technical grade SDC concentrate (trade name Axenohl); our Axen and Axen30 hard surface disinfectant products; and an SDC-based sanitizer for sanitization of food contact surfaces registered under the trade name Axen50. As we continue to develop new products, we will require a registration from the EPA in order to market our products in the U.S. Each new formulation of an SDC-based product will require such a registration. There is no guarantee that the EPA will grant any registration for the products we submit to them for approval.

In addition to the Federal EPA, each of the 50 U.S. states has its own agency that regulates pesticide sales into their state. Prior to distributing a product into any of these states, a registration from the applicable agency is required. We market our antimicrobial products to third party distributors who are responsible for obtaining these state registrations. Should we begin to directly market our own brands, we would first need to obtain a registration for each state into which we intend to distribute such products.

We have chosen to pursue certain approvals through the FDA by partnering with other companies who have assumed, or will assume, responsibility for the testing and regulatory process for selected potential FDA regulated SDC-based products. In July 2008, we entered into a development and licensing agreement for SDC-based products for human use, FTA Therapeutics, LLC (FTA). FTA has begun formulation and clinical projects for FDA-regulated dermatology products containing SDC. Under our agreement with FTA, we will be responsible for providing pharmaceutical-grade SDC concentrate as an Active Pharmaceutical Ingredient ("API"). Our SDC technology also shows promise as a broad-spectrum antimicrobial for multiple other medical indications, including wound and burn care, and we expect that under future collaboration agreements for such indications, if any, we will also provide pharmaceutical-grade SDC concentrate as an API. As a manufacturer of an API, we are or will be required to register with the FDA and will be subject to periodic inspection by the FDA for compliance with the FDA's Quality System Regulation requirements, which require manufacturers of API's to adhere to certain regulations, including testing, quality control and documentation procedures. In 2007, our manufacturing facility and process for the production of pharmaceutical-grade SDC concentrate as an API received Current Good Manufacturing Practice (cGMP) certification, however there is no guarantee that we will be able to maintain this certification, or otherwise meet FDA regulations for the production of an API. Compliance with applicable regulatory requirements is subject to continual review and is rigorously monitored through periodic inspections by the FDA.

The process of obtaining FDA and other required regulatory approvals is lengthy, expensive and uncertain. There is no guarantee that either FTA, any other potential partner, or we will be able to obtain the resources necessary to obtain such approvals, or that the products will meet the strict criteria imposed by the FDA.

Outside the U.S., we, our distributors or our partners are obligated to obtain and maintain all necessary regulatory approvals or registrations in each specific country, to enable SDC-based products to be manufactured, formulated and/or sold in, or into, that country. Regulations for antimicrobial products and products for human use vary significantly from country to country. Our technology may also face import or export restrictions or burdens, which may change from time to time.

#### Employees

As of October 9, 2009, we employed twenty-four people, twenty-three of whom were full-time employees. We believe that the success of our business will depend, in part, on our ability to attract and retain qualified personnel. None of our employees are covered by a collective bargaining agreement.

#### Company Website

We maintain a website at [www.purebio.com](http://www.purebio.com). We make our periodic and current reports available on our website free of charge. Information contained on, or accessible through, our website is not part of this report or our other filings with the SEC. You can also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. You can obtain additional information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site ([www.sec.gov](http://www.sec.gov)) that contains our periodic reports, proxy and information statements, and other information.

#### Executive Officers of the Registrant

The following table and information below sets forth information with respect to each of our current executive officers:

| Name               | Age | Position                              | Held Position Since |
|--------------------|-----|---------------------------------------|---------------------|
| Michael L. Krall   | 57  | President, CEO, Chairman,<br>Director | 1992                |
| Andrew J. Buckland | 46  | CFO, Principal Accounting<br>Officer  | 2005                |
| Donna Singer       | 39  | Executive Vice President,<br>Director | 1998                |

The executive officers serve at the discretion of the Board.

#### Business Experience

**MICHAEL L. KRALL** Mr. Krall is the President, CEO and Chairman of the Board, positions that he has held since 1992.

**ANDREW J. BUCKLAND** Mr. Buckland joined PURE Bioscience as its Chief Financial Officer in 2005. Prior to joining PURE, Mr. Buckland served as Vice President of Finance at Cardionet, Inc. Previous to that, Mr. Buckland served as Chief Financial Officer and as Chief Accounting Officer of Advanced Tissue Sciences, a public biotechnology company based in San Diego. He earned an MBA from the University of California, Irvine and a BA (with Honors) from the University of the West of England Business School.

**DONNA M. SINGER** Ms. Singer is the Executive Vice President of PURE Bioscience and has been a director since 1997. From 1996-1998, Ms. Singer served as Vice President of Operations for the Company.



## Item 1A. Risk Factors

Except for the historical information contained herein or incorporated by reference, this annual report on Form 10-K and the information incorporated by reference contains forward-looking statements that involve risks and uncertainties. These statements include projections about our accounting and finances, plans and objectives for the future, future operating and economic performance and other statements regarding future performance. These statements are not guarantees of future performance or events. Our actual results may differ materially from those discussed here. Factors that could cause or contribute to differences in our actual results include those discussed in the following section, as well as those discussed in Part I, Item 2 entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere throughout this annual report on Form 10-K and in any other documents incorporated by reference into this report. You should consider carefully the following risk factors, together with all of the other information included or incorporated in this annual report on Form 10-K. Each of these risk factors, either alone or taken together, could adversely affect our business, operating results and financial condition, as well as adversely affect the value of an investment in our common stock. There may be additional risks that we do not presently know of or that we currently believe are immaterial which could also impair our business and financial position. If any of the events described below were to occur, our financial condition, our ability to access capital resources, our results of operations and/or our future growth prospects could be materially and adversely affected and the market price of our common stock could decline. As a result you could lose some or all of any investment you may have made or may make in our common stock.

We have a history of losses, and we may not achieve or sustain profitability

We had a loss of \$7,067,300 after taxes for the fiscal year ended July 31, 2009 ("Fiscal 2009"), a loss of \$6,540,300 after taxes for the fiscal year ended July 31, 2008 ("Fiscal 2008"), and a loss of \$4,654,900 after taxes for the fiscal year ended July 31, 2007 ("Fiscal 2007"). As of July 31, 2009, we had an accumulated deficit of approximately \$38.5 million. We may continue to have losses in the future. If the penetration into the marketplace of SDC takes longer than anticipated, revenue growth is slower than anticipated or operating expenses exceed expectations, it may take an unforeseen period of time to achieve or sustain profitability and we may never achieve or sustain profitability. Slower than anticipated revenue growth could force us to reduce research, testing, development and marketing of our technology and/or force us to reduce the size and scope of our operations, or cease operations altogether.

We do not yet have significant cash inflows from product sales or from other sources of revenue to offset our ongoing and planned investments in corporate infrastructure, research and development projects, regulatory submissions, business development activities, and sales and marketing, among other investments. These investments may not be successful. In addition, some of these investments cannot be postponed and we may be contractually or legally obligated to make them. In future periods we may need to seek additional capital through the issuance of debt, common stock, preferred stock, convertible securities or through other means, any one of which could reduce the value, perhaps substantially, of our outstanding common stock. We currently have no long-term debt, however the issuance of debt, common stock, preferred stock, convertible securities, or other financial instruments in future periods, if any, could lead to the dilution of our existing shareholders. There is no guarantee that we would be able to obtain capital on terms acceptable to us, or at all. Insufficient funds could cause us to fail to execute our business plan, fail to take advantage of future opportunities, or fail to respond to competitive pressures or unanticipated customer requirements, and further may require us to delay, reduce or eliminate some or all of our research and product development programs, license to third parties the right to commercialize products or technologies that we would otherwise commercialize ourselves, sell some or all of our intellectual property, or to reduce or cease operations.



The risks associated with our business may be more acute during periods of economic slowdown or recession. In addition to other consequences, these periods may be accompanied by decreased consumer spending generally, as well as decreased demand for, or additional downward pricing pressure on our products. Accordingly, any prolonged economic slowdown or a lengthy or severe recession with respect to either the U.S. or the global economy is likely to have a material adverse effect on our results of operations, financial condition and business prospects. As a result, given the recent deterioration in the U.S. and global economies, as well as the decreasing purchasing power of consumers and institutions, we expect that our business will continue to be adversely affected for so long as, and to the extent that, such adverse economic conditions exist.

If our efforts to achieve and maintain market acceptance of our core SDC technology are not successful, or we fail to obtain necessary governmental approvals, we are unlikely to attain profitability

We have invested a significant portion of our time and financial resources in the development and commercialization of our core SDC technology. We expect that sales of SDC will constitute a substantial portion, or all, of our revenues in future periods. Any material decrease in the overall level of sales or expected sales of, or the prices for, SDC, whether as a result of competition, change in customer demand, or any other factor, would have a materially adverse effect on our business, financial condition and results of operations.

We are marketing our new antimicrobial silver ion technology to industrial and consumer markets. These products have not yet been accepted into the marketplace, and may never be accepted. In addition, even if our products achieve market acceptance, we may not be able to maintain product sales or other forms of revenue over time if new products or technologies are introduced that are more favorably received than our products, are more cost-effective or otherwise render our products less attractive or obsolete. Other risks involved in introducing these new products include liability for product effectiveness and safety, and competition from existing or emerging sources. Additionally, government regulation in the U.S. and in other countries is a significant factor in the development, manufacturing and marketing of many of our products and in our ongoing research and development activities. We believe that all products derived from SDC, or products that may be derived from SDC in future periods, require or will require approval by government agencies prior to marketing or sale in the U.S. or overseas. Complying with applicable government regulations and obtaining necessary clearances or approvals can be time consuming and expensive, and there can be no assurance that regulatory review will not involve delays or other actions adversely affecting the marketing and sale of our products. For example, regulatory review of SDC by the EPA has historically been time consuming and expensive, due primarily, we believe, to the novel nature of our technology. While we cannot accurately predict the outcome of such regulatory processes, we expect the review process to remain time consuming and expensive as we, or our partners, apply for approval to market new formulations or to make additional claims. We also cannot predict the extent or impact of future legislation or regulation in the U.S. or overseas.

Some of our new bioscience applications, for example those aimed at healthcare, food preparation and agriculture markets, will also require approval by government agencies prior to marketing or sale in the U.S. or overseas. Until we, or our partners, obtain approvals from the appropriate regulatory authorities for future potential product applications, if any, we will not be able to market or sell such products, which would limit our revenues. Even after approval, if any, we will remain subject to changing governmental policies regulating antimicrobial products.

If we are not able to manage our anticipated growth effectively, we may not become profitable

We anticipate that expansion will continue to be required to address potential market opportunities for our SDC technology. There can be no assurance that our infrastructure will be sufficiently scalable to manage any future growth. There also can be no assurance that if we continue to invest in additional infrastructure, we will be effective in expanding our operations or that our systems, procedures or controls will be adequate to support such expansion. In addition, we will need to provide additional sales and support services to our partners if we achieve our anticipated growth with respect to the sale of our SDC technology for various applications. Failure to properly manage an increase in customer demands could result in a material adverse effect on customer satisfaction, our ability to meet our contractual obligations, and on our operating results.

The industries in which we operate are heavily regulated and we may be unable to compete effectively

We are a bioscience company focused on the marketing and continued development of our electrolytically generated stabilized ionic silver technology, including our flagship SDC antimicrobial. The risks, regulatory hurdles and costs of doing business in our target markets are high. Our SDC is a platform technology rather than a single use applied technology. As such, products developed from the platform fall under the jurisdiction of multiple U.S. and international regulatory agencies. We currently have U.S. EPA registration for our 2400-parts per million (ppm) technical grade SDC concentrate (trade name Axenohl), as well as for our Axen and Axen30 hard surface disinfectant products. In addition, in August 2009 we obtained EPA registration for an SDC-based sanitizer for food contact surfaces. In addition to the Federal EPA, each of the 50 United States has its own government agency that regulates pesticide sales into their state. Prior to distributing a product into any of these states, a registration from the state is required. There can be no guarantee that a particular state, or any state, will continue to allow the sale of SDC-based products, or grant any new approvals in future periods.

We intend to fund and manage additional U.S. EPA-regulated product development internally, in conjunction with our regulatory consultants and potentially by partnering with other third parties. We are also partnering, or intend to partner, with third parties who are seeking, or intend to seek, approvals to market SDC-based products in markets outside the U.S. However, the introduction of additional regulated antimicrobial products in the U.S. or in markets outside the U.S. could take several years, or may never be achieved. Existing state, federal or international approvals may not be maintained. Additionally, doing business internationally carries a great deal of risk with regard to foreign government regulation, banking, currency fluctuation, and many other factors.

We are subject to intense competition

Our silver ion and other products compete in highly competitive markets dominated by extremely large, well financed domestically and internationally recognized chemical and pharmaceutical companies. Many of our competitors have greater financial resources than we do in the areas of sales, marketing, branding and product development, and we expect to face additional competition from these competitors in the future. Many of our competitors already have well established brands and distribution. Focused competition by chemical and pharmaceutical giants could substantially limit or eliminate our potential market share and ability to profit from our products and technologies. Our ability to compete will depend upon our ability, and the ability of our distributors and other partners, to develop brand recognition and novel distribution methods, and to displace existing, established and future products in our relevant target markets. We or our partners or distributors may not be successful in doing so.

We rely on a small number of key supply ingredients in order to manufacture our products

All of the supply ingredients used to manufacture our products are readily available from multiple suppliers. However, commodity prices for these ingredients can vary significantly and the margins that we are able to generate could decline if prices rise. For example, both silver and citric acid prices have been volatile recently. In many of our distribution and development agreements, we are unable to raise our product prices to our customers quickly to maintain our margins, and significant price increases for key inputs would therefore have an adverse effect on our results of operations.

We are subject to substantial regulation related to quality standards applicable to our manufacturing and quality processes. Our failure to comply with applicable quality standards could have an adverse effect on our business, financial condition, or results of operations.

The EPA regulates the registration, manufacturing, and sales and marketing of many of our products, and those of our distributors and partners, in the United States. Significant government regulation also exists in overseas markets. Compliance with applicable regulatory requirements is subject to continual review and is monitored through periodic inspections and other review and reporting mechanisms.

Failure by us or our partners to comply with current or future governmental regulations and quality assurance guidelines could lead to temporary manufacturing shutdowns, product recalls or related field actions, product shortages or delays in product manufacturing. Efficacy or safety concerns and/or manufacturing quality issues with respect to our products or those of our partners could lead to product recalls, fines withdrawals, declining sales, and/or our failure to successfully commercialize new products or otherwise achieve revenue growth.

In addition, the FDA and comparable agencies in many foreign countries impose substantial limitations on the introduction of new products through costly and time-consuming laboratory and clinical testing and other procedures. The process of obtaining FDA and other required regulatory approvals is lengthy, expensive and uncertain. There is no guarantee that either our existing partners or any other potential partner, or we, will be able to obtain the resources necessary to further develop our technology or obtain regulatory approvals, or that the products will be successful in meeting the strict criteria imposed by the FDA. It may be several years before we, or any third party to whom we grant rights to use our silver ion technologies, are able to introduce any FDA regulated antimicrobial pharmaceutical products containing our technology.

If a natural or man-made disaster strikes our manufacturing facility, we will be unable to manufacture our products for a substantial amount of time and our sales and profitability will decline.

Our sole manufacturing facility and the manufacturing equipment we use to produce our products would be costly to replace and could require substantial lead-time to repair or replace. The facility may be affected by natural or man-made disasters and in the event they were affected by a disaster, we would be forced to set up alternative production capacity, or rely on third party manufacturers to whom we would have to disclose our trade secrets. Although we possess insurance for damage to our property and the disruption of our business from casualties, such insurance may not be sufficient to cover all of our potential losses, may not continue to be available to us on acceptable terms, or at all, and may not address the marketing and goodwill consequences of our inability to provide products for an extended period of time.

If we are unable to successfully develop or commercialize new applications of our SDC technology, our operating results will suffer

In addition to its use on inanimate surfaces, we believe that our SDC technology also shows promise as a broad-spectrum antimicrobial for use in human and veterinary healthcare products. We plan to pursue additional EPA and FDA regulatory approvals for other applications. We have entered into agreements with FTA Therapeutics for the development and commercialization of certain FDA regulated SDC-based products. However, we do not exercise any control over these development partners. FTA's resources are limited and progress to date on all indications has been slow. Any products developed may never achieve regulatory approval and may never be commercialized. If they are commercialized, we may not receive a share of future revenues that provides an adequate return on our historical or future investment.

Our ability to generate increased revenue depends in part upon the ability and willingness of our current and potential strategic partners in both FDA and non-FDA environments to increase awareness of our technology to their customers, and to provide implementation services. If our strategic partners fail to increase awareness of our

technology or to assist us in getting access to decision-makers, then we may need to increase our marketing expenses, change our marketing strategy or enter into marketing relationships with different parties, any of which could impair our ability to generate increased revenue or to generate profits from our technology.

Because we are an early stage company, it is difficult to evaluate our prospects; our financial results may fluctuate and these fluctuations may cause our stock price to fall

Since acquiring the rights to our SDC technology, we have encountered and likely will continue to encounter risks and difficulties associated with new and rapidly evolving markets. These risks include the following, among others:

- we may not increase our sales to our existing customers and expand our customer base;
- we may not succeed in maintaining and expanding our current sales and in penetrating other markets and applications of our SDC technology;
- we or our partners and/ distributors may not establish and maintain effective marketing programs and create product awareness or brand identity;
  - we may not attract and retain key business development, technical and management personnel;
    - we may not succeed in locating strategic partners and licensees of our technology;
    - we may not effectively manage our anticipated growth; and
    - we may not be able to adequately protect our intellectual property.

In addition, because of our limited operating history and the early stage of the market for our SDC technology, we have limited insight into trends that may emerge and affect our business. Forecasting future revenues is difficult, especially since our technology is novel and we are at the early stages of the adoption of our technology. Market acceptance of our products may change rapidly. In addition, our customer base is highly concentrated. Fluctuations in the buying patterns of our current or potential customers for any reason, could significantly affect the level of our sales on a period to period basis. As a result, our financial results could fluctuate to an extent that may not meet market expectations and that also may adversely affect our stock price. There are a number of other factors that could cause our financial results to fluctuate unexpectedly, including product sales, the mix of product sales, the cost of product sales, the achievement and timing of research and development and regulatory milestones, changes in expenses, including non-cash expenses such as the fair value of stock options granted, and manufacturing or supply issues, among other issues.

We have no product distribution experience and we expect to rely on third parties who may not successfully sell our products

We have no product distribution experience and currently rely and plan to rely primarily on product distribution arrangements with third parties. We also plan to license our technology to certain third parties for commercialization of certain applications. We expect to enter into additional distribution agreements and licensing agreements in the future, and we may not be able to enter into these additional agreements on terms that are favorable to us, if at all. In addition, we may have limited or no control over the distribution activities of these third parties. These third parties could sell competing products and may devote insufficient sales efforts to our products. As a result, our future revenues from sales of our products, if any, will depend on the success of the efforts of these third parties.

We expect to rely on third parties to develop SDC-based products and they may not do so successfully or diligently

We rely on third parties to whom we license rights to our technology to develop products containing SDC for many of the applications for which we believe SDC-based products have, or may have, market opportunities. Generally, under our contractual relationships with these third parties, we rely on the third party to fund and direct product development activities and appropriate regulatory filings. Any of these third parties may not be able to successfully develop such SDC-based products, due to, among other factors, a lack of capital; a lack of appropriate diligence; a change in the evaluation by the third party of the market potential for SDC-based products; technical failures; and poorer than expected test results resulting from trial use of any products that may be developed.

If we are unable to obtain, maintain or defend patent and other intellectual property ownership rights relating to our technology, we or our collaborators and distributors may not be able to develop and market products based on our technology, which would have a material adverse impact on our results of operations and the price of our common stock

We rely and expect in the future to rely on a combination of patent, trademark, trade secret and copyright law, and contractual restrictions to protect the proprietary aspects of our technology and business. These legal protections afford only limited protection for our intellectual property and trade secrets. Despite efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our proprietary technology or otherwise obtain and use information that we regard as proprietary. As a result, we cannot assure you that our means of protecting our proprietary rights will be adequate, and the infringement of such rights could have a material negative impact on our business and on our results of operations.

We have filed for U.S. and foreign patent applications and trademark registrations for our patents and trademarks. We may not be successful in obtaining these patents and trademarks, and we may be unable to obtain additional patent and trademark protection in the future. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. It is possible that, despite our efforts, competitors or others will create and use products in violation of our patents and/or adopt service names similar to our service names or

otherwise misappropriate our intellectual property. Such patent infringement or misappropriation could have a material adverse effect on our business. Any unauthorized production of our SDC-based products, whether in the U.S. or overseas, would or could reduce our own sales of SDC-based products, thereby reducing, perhaps significantly, our actual or potential profits. Adopting similar names and trademarks by competitors could lead to customer confusion. Any claims or customer confusion related to our trademarks could negatively affect our business.

Litigation may be necessary to enforce our intellectual property rights and protect our trade secrets. If third parties prepare and file applications in the U.S. or other countries that claim trademarks used or registered by us, we may oppose those applications and may be required to participate in proceedings before the regulatory agencies who determine priority of rights to such trademarks. Any litigation or adverse priority proceeding could result in substantial costs and diversion of resources, and could seriously harm our business and operating results.

If we are found to have violated the trademark, trade secret, copyright, patent or other intellectual property rights of others, such a finding could result in the need to cease use of a trademark, trade secret, copyrighted work or patented invention in our business and the obligation to pay a substantial amount for past infringement. It could also be necessary for us to pay a substantial amount in the future if the rights holders are willing to permit us to continue to use the intellectual property rights. Either having to cease use or pay such amounts could make us much less competitive and could have a material adverse impact on our business, operating results and financial condition.

To the extent that we operate internationally, the laws of foreign countries may not protect our proprietary rights to the extent as do the laws of the U.S. Many countries have a “first-to-file” trademark registration system. As a result, we may be prevented from registering or using our trademarks in certain countries if third parties have previously filed applications to register or have registered the same or similar trademarks. Our means of protecting our proprietary rights may not be adequate, and our competitors, or potential competitors, could independently develop similar technology.

#### We may become subject to product liability claims

As a business which manufactures and markets products for use by consumers and institutions, we may become liable for any damage caused by our products, whether used in the manner intended or not. Any such claim of liability, whether meritorious or not, could be time-consuming and/or result in costly litigation. Although we maintain general liability insurance, our insurance may not cover potential claims of the types described above and may not be adequate to indemnify for all liabilities that may be imposed. Any imposition of liability that is not covered by insurance or is in excess of insurance coverage could harm our business and operating results, and you may lose some or all of any investment you have made, or may make, in our common stock.

#### Litigation or the actions of regulatory authorities may harm our business or otherwise distract our management

Substantial, complex or extended litigation could cause us to incur major expenditures and distract our management. For example, lawsuits by employees, former employees, shareholders, partners, customers, or others, or actions taken by regulatory authorities, could be very costly and substantially disrupt our business. Such lawsuits or actions could from time to time be filed against the Company and/or our executive officers and directors. Such lawsuits and actions are not uncommon, and we cannot assure you that we will always be able to resolve such disputes or actions on terms favorable to the Company.

Maintaining compliance with our obligations as a public company may strain our resources and distract management, and if we do not remain compliant our stock price may be adversely affected

Our common stock is registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). It is therefore subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act. The SEC continues to issue new and proposed rules, and complying with existing and new rules results in significant costs to us of being a public company, including substantial costs during Fiscal 2009 and Fiscal 2008, and in future years. In addition, in April 2008 we obtained a listing of our common stock on the NASDAQ Capital Market, adding the additional cost and administrative burden of maintaining such a listing. These additional regulatory costs and requirements will reduce our future profits or increase our future losses, and more management time and effort will be needed to meet our regulatory obligations than before.

We are required to evaluate our internal controls systems in order to allow management to report on our internal controls as required by Section 404 of the Sarbanes-Oxley Act. Our management is required to attest to, and have our Independent Registered Public Accounting Firm attest to, the adequacy of our internal controls. We are also required to file our annual and quarterly reports with the Securities and Exchange Commission ("SEC") on an accelerated basis. Recent SEC pronouncements suggest that in the next several years we may be required to report our financial results using new International Financial Reporting Standards, replacing U.S. GAAP, which would require us to make significant investments in training, hiring, consulting and information technology, among other investments. All of these and other reporting requirements and heightened corporate governance obligations that we face, or will face, will further increase the cost to us, perhaps substantially, of remaining compliant with our obligations under the Exchange Act and the Sarbanes-Oxley Act. In order to meet these incremental obligations, we will need to invest in our corporate and accounting infrastructure and systems, and acquire additional services from third party auditors and advisors. As a result of these requirements and investments, we will incur significant additional expenses and will suffer a significant diversion of management's time. There is no guarantee that we will be able to continue to meet these obligations in a timely manner, and we could therefore be subject to sanctions or investigation, or the delisting of our common stock, by regulatory authorities such as the SEC or the NASDAQ Capital Market. Any such actions could adversely affect our financial results and the market price of our common stock, perhaps significantly.

Our publicly-filed reports are reviewed from time to time by the SEC, and any significant changes or amendments required as a result of any such review may result in material liability to us and may have a material adverse impact on the trading price of our common stock



The reports of publicly-traded companies are subject to review by the SEC from time to time for the purpose of assisting companies in complying with applicable disclosure requirements, and the SEC is required, pursuant to the Sarbanes-Oxley Act of 2002, to undertake a comprehensive review of a company's reports at least once every three years. SEC reviews may be initiated at any time. While we believe that our previously filed SEC reports comply, and we intend that all future reports will comply in all material respects with the published rules and regulations of the SEC, we could be required to modify, amend or reformulate information contained in prior filings as a result of an SEC review. Any modification, amendment or reformulation of information contained in such reports could be significant and result in material liability to us and have a material adverse impact on the trading price of our common stock.

We are dependent on our management team, and the loss of any key member of this team may prevent us from achieving our business plan in a timely manner

Our success depends largely upon the continued services of our executive officers and other key personnel. Our executive officers and key personnel could terminate their employment with us at any time without penalty. We do not maintain key person life insurance policies on our executive officers or other employees, other than Michael L. Krall, our President and Chief Executive Officer. The policy we have on Mr. Krall would likely not provide a benefit sufficient to offset the financial losses resulting from the loss of Mr. Krall's future services. The loss of one or more of our executive officers or key employees could seriously harm our business, results of operations, financial condition, and/or the market price of our common stock. We cannot assure you that in such an event we would be able to recruit qualified personnel able to replace these individuals in a timely manner, or at all, on acceptable terms.

Because competition for highly qualified business development and bioengineering personnel is intense, we may not be able to attract and retain the employees we need to support our planned growth

To successfully meet our objectives, we must continue to attract and retain highly qualified business development and bioengineering personnel with specialized skill sets focused on the industries in which we compete, or intend to compete. Competition for qualified business development and bioengineering personnel can be intense. Our ability to meet our business development objectives will depend in part on our ability to recruit, train and retain top quality people with advanced skills who understand our technology and business. In addition, it takes time for our new personnel to become productive and to learn our business. If we are unable to hire or retain qualified business development and bioengineering personnel, it will be difficult for us to sell our products or to license our technology, and we may experience a shortfall in revenue and not achieve our anticipated growth.

Anti-takeover provisions under our charter documents and California law could delay or prevent a change of control and could also limit the market price of our stock

Certain provisions of our charter and by-laws may delay or frustrate the removal of incumbent directors and may prevent or delay a merger, tender offer, or proxy contest involving us that is not approved by our Board of Directors (the "Board"), even if such events may be beneficial to the interests of shareholders. For example, our Board, without shareholder approval, has the authority and power to issue all authorized and unissued shares of common stock which have not otherwise been reserved for issuance, on such terms as the Board determines. The Board could also issue 5,000,000 shares of preferred stock and such preferred stock could have voting or conversion rights which could adversely affect the voting power of the holders of our common stock. In addition, California law contains provisions that have the effect of making it more difficult for others to gain control of the Company.

The price of our common stock may be volatile, which may cause investment losses for our shareholders

Since our initial public offering in August 1996, the price and trading volume of our common stock have been highly volatile. The price has ranged from below \$1 per share to over \$8 per share, and the monthly trading volume has varied from under 200,000 shares to over 7.8 million shares. During the twelve months prior to October 12, 2009, the closing price of our common stock on any given day has ranged from \$1.50 to \$3.99 per share, and the monthly trading volume has varied from approximately 1.5 million shares to approximately 5.4 million shares. In the future, the market price of our common stock may be volatile and could fluctuate substantially due to many factors, including:

- actual or anticipated fluctuations in our results of operations;
- the introduction of new products or services, or product or service enhancements by us or our competitors;
- developments with respect to our or our competitors' intellectual property rights or regulatory approvals or denials;
  - announcements of significant acquisitions or other agreements by us or our competitors;
- the sale by us of our common or preferred stock or other securities, or the anticipation of sales of such securities;
  - sales or anticipated sales of our common stock by our insiders (management and directors);
    - the trading volume of our common stock, particularly if such volume is light;
      - conditions and trends in our industry;
    - changes in our pricing policies or the pricing policies of our competitors;

- changes in the estimation of the future size and growth of our markets and, among other factors;
  - general economic conditions.

In addition, the stock market in general, the NASDAQ Capital Market, and the market for shares of novel technology and biotechnology companies in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Further, the market prices of bioscience companies have been unusually volatile in the last year, and many economists expect such unusual volatility to continue for the foreseeable future. These broad market and industry factors may materially harm the market price of our common stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, shareholder derivative lawsuits and securities class action litigation have often been instituted against that company. Such litigation, if instituted against the Company or our officers and directors, could result in substantial costs and a diversion of management's attention and resources. In addition, this volatility could adversely affect an investor's ability to sell shares of our common stock and/or the available price for such shares, and could result in lower prices being available to an investor if the investor wishes to sell their shares at any given time.

Our future capital needs are uncertain, and we may need to raise additional funds in the future which may not be available on acceptable terms or at all.

Our capital requirements will depend on many factors, including, among other factors:

- acceptance of, and demand for, our products;
- the success of our strategic partners in developing and selling products derived from our technology;
- the costs of further developing our existing, and developing new, products or technologies
  - the extent to which we invest in new technology, testing and product development;
  - the number and timing of acquisitions and other strategic transactions; and
- the costs associated with the continued operation, and any future growth, of our business.

Our existing sources of cash and cash flows may not be sufficient to fund our future activities. As a result, we may need to raise additional funds, and such funds may not be available on favorable terms, or at all. Furthermore, if we issue equity or convertible debt securities to raise additional funds, our existing shareholders may experience dilution, and the new equity or debt securities may have rights, preferences and privileges senior to those of our existing common stock holders. If we incur additional debt, it may increase our leverage relative to our earnings or to our equity capitalization. If we cannot raise funds on acceptable terms, we may need to scale back our expenditures through reductions in our workforce and operations, and we may not be able to develop or enhance our technologies and/or products, execute our business plan, take advantage of future opportunities, or respond to competitive pressures or unanticipated consumer requirements.

We may not be able to maintain our NASDAQ listing

In April 2008, we obtained a listing for our common stock on the NASDAQ Capital Market. In order to maintain our listing, we will need to continue to meet certain minimum listing standards that include, or may include, our shareholders' equity, the market value of our listed or publicly held securities, the number of publicly held shares, our net income, a minimum bid price for our common stock, the number of shareholders, the number of market makers, and certain of our corporate governance policies. If we fail to maintain the standards required now or in future by the NASDAQ Capital Market, our common stock could be delisted from the NASDAQ Capital Market. Such delisting could cause our stock to be classified as "penny stock," among other potentially detrimental consequences, any of which could significantly impact your ability to sell your shares or to sell your shares at a price that you may deem to be acceptable.

If outstanding options and warrants to purchase shares of our common stock are exercised, or if other remaining authorized shares of our common stock are issued, the interests of our shareholders could be diluted

We have approximately 8,495,222 shares of common stock reserved for issuance, which includes shares under equity compensation plans, vested and unvested options, and warrants. These shares have a weighted-average exercise price of approximately \$2.29. In addition, approximately 7,378,630 authorized shares of our common stock remain available for future issuance under equity compensation plans or otherwise. The exercise of options and warrants, and the sale of shares underlying such options or warrants, could have an adverse effect on the market for our common stock, including the price that an investor could obtain for their shares. Investors may experience dilution in the net tangible book value of their investment upon the exercise of outstanding options and warrants granted under our stock option plans, and options and warrants yet to be granted or issued.

We may not be able to utilize all of, or any of, our tax net operating loss carry-forwards and our future after-tax earnings, if any, could be reduced

At July 31, 2009, we had federal and California tax net operating loss carry-forwards of approximately \$50,009,800 and \$39,871,800, respectively. Utilization of the net operating loss carry-forwards may be subject to a substantial annual limitation due to ownership change limitations that may have occurred or that could occur in the future, as required by Section 382 of the Internal Revenue Code as well as similar state provisions. These ownership changes may limit the amount of net operating loss carry-forwards that can be utilized annually to offset future taxable income and tax, respectively. In general, an ownership change, as defined by Section 382 of the Internal Revenue Code results from a transaction or series of transactions over a three-year period resulting in an ownership change of more than 50 percentage points of the outstanding stock of a company by certain stockholders or public groups. Since the Company's formation, we have raised capital through the issuance of capital stock on several occasions (both before and after our initial public offering in 1996) which, combined with the purchasing shareholders' subsequent disposition of those shares, may have resulted in such an ownership change, or could result in an ownership change in the future upon subsequent disposition. While we believe that the Company has not experienced an ownership change, the pertinent tax rules related thereto are complex and subject to varying interpretations, and thus complete assurance cannot be provided that the taxing authorities would not take an alternative position.

In addition, our federal tax loss carry-forwards will begin expiring in the year ending July 31, 2010 unless previously utilized, and will completely expire in the year ending July 31, 2028. Between July 31, 2010 and July 31, 2012, \$3,323,800 of our federal net operating loss carry-forwards will expire, and the balance of our current federal net operating loss carry-forwards will expire between July 31, 2018 and July 31, 2028. Our California tax loss carry-forwards will begin to expire in the year ending July 31, 2014, and will completely expire in the year ending July 31, 2029. If we are unable to earn sufficient profits to utilize the carry-forwards by these dates, they will no longer be available to offset future profits, if any.

We are subject to tax audits by various tax authorities in multiple jurisdictions

From time to time we may be audited by tax authorities to whom we are subject. Any assessment resulting from such audits, if any, could result in material changes to our past or future taxable income, tax payable or deferred tax assets, and could require us to pay penalties and interest that could materially adversely affect our financial results.

We may never pay dividends

We have never paid any cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future. The future payment of dividends on our common stock, if any, is dependent on the discretion of our Board, our earnings, our financial condition and other business and economic factors which our Board may consider relevant.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Our business operates in a 14,879 square foot facility located in a light industrial/office park in El Cajon, California. This location houses all administrative, manufacturing and warehousing functions. In September 2006 we commenced a new sixty month operating lease for the facility.

During Fiscal 2007, we made significant improvements to the manufacturing areas to expand our production capacity and warehousing operations, and in April 2008 we added 1,812 square feet of adjacent space that we are using for additional warehousing operations.

Item 3. Legal Proceedings

From time to time, we may become involved in various lawsuits and legal proceedings which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may harm our business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.

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

No matters were submitted to shareholders in the fourth quarter of Fiscal 2009.

## PART II

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

## Market Information

Since April 2, 2008, our common stock has been traded on the NASDAQ Capital Market under the symbol "PURE." Prior to April 2, 2008, our common stock was traded on the Over the Counter Bulletin Board under the symbol "PURE.OB." The following table sets forth high and low bid prices for each fiscal quarter, for the last two fiscal years, as reported on Yahoo! Finance. Such quotations reflect inter-dealer prices without retail mark-up, mark-down, or commissions and may not represent actual transactions.

| Fiscal Year 2009 |         |         | Fiscal Year 2008 |         |         |
|------------------|---------|---------|------------------|---------|---------|
| Quarter Ended    | High    | Low     | Quarter Ended    | High    | Low     |
| July 31, 2009    | \$ 2.60 | \$ 1.22 | July 31, 2008    | \$ 5.52 | \$ 3.78 |
| April 30, 2009   | \$ 3.19 | \$ 1.64 | April 30, 2008   | \$ 6.40 | \$ 2.58 |
| January 31, 2009 | \$ 4.10 | \$ 1.95 | January 31, 2008 | \$ 8.72 | \$ 4.60 |
| October 31, 2008 | \$ 5.42 | \$ 1.91 | October 31, 2007 | \$ 8.59 | \$ 2.72 |

## Price Performance Graph

Set forth below is a graph comparing the total return on an indexed basis of a \$100 investment in our common stock, against comparable indices. Due to the nature of our business, we do not believe that a comparable peer group of publicly-traded platform technology companies exists; hence, we compared the return on investment in our stock to the NASDAQ Composite Index and the S&P 500 Index. The measurement points utilized in the graph consist of the closing data on the last trading day in each of our fiscal years. The stock performance presented below is not intended to be, and may not be, indicative of future stock performance.



## Security Holders

As of October 9, 2009, we had approximately 169 holders of record of our common stock. This does not include beneficial owners holding common stock in street name. The closing price per share on October 9, 2009 was \$1.83.

## Dividend Policy

We have never paid common stock cash dividends and have no current plans to do so. We currently anticipate that we will retain all of our future earnings for use in the development and expansion of our business and for general corporate purposes. Any determination to pay dividends in the future will be at the discretion of our Board and will depend upon our results of operation, financial condition and other factors as the Board, in its discretion, deems relevant.

## Recent Sales of Unregistered Securities

None.

## Securities Authorized for Issuance under Equity Compensation Plans

| Plan Category                                              | Number of securities to be issued upon exercise of outstanding options, warrants and rights<br>(a) | Weighted-average exercise price of outstanding options, warrants and rights<br>(b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))<br>(c) |
|------------------------------------------------------------|----------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------|
| Equity compensation plans approved by security holders     | 3,071,641                                                                                          | \$1.63                                                                             | 5,458,323                                                                                                                                          |
| Equity compensation plans not approved by security holders | 4,436,156                                                                                          | \$2.71                                                                             | 1,603,000                                                                                                                                          |
| Total                                                      | 7,507,797                                                                                          | \$2.27                                                                             | 7,061,323                                                                                                                                          |

The following equity compensation plans have not been approved by security holders:

1. 2001 ETIH2O Stock Option Plan: Adopted by the Board in January 2001, there are 1,000,000 shares authorized under this Plan. Executive officers and directors are not eligible participants under this plan.
2. 2001 Consultants and Advisors Stock Option Plan: Adopted by the Board in January 2001, there are 500,000 shares authorized under this Plan. Executive officers and directors are not eligible participants under this plan.
3. 2004 Consultants and Advisors Stock Option Plan: Adopted by the Board in April 2004, there are 2,000,000 shares authorized under this plan. Executive officers and directors are not eligible participants under this plan.



## Item 6. Selected Financial Data

The following selected consolidated financial information has been taken or derived from our audited consolidated financial statements. The information set forth below is not necessarily indicative of our results of future operations and should be read in conjunction with “Management's Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and related notes included elsewhere in this Form 10-K. See “Item 8. Consolidated Financial Statements and Supplementary Data.”

|                                                    | Years Ended July 31, |                     |                     |                 |                  |
|----------------------------------------------------|----------------------|---------------------|---------------------|-----------------|------------------|
|                                                    | 2009                 | 2008                | 2007                | 2006            | 2005             |
| <b>Consolidated Statements of Operations Data:</b> |                      |                     |                     |                 |                  |
| Revenue                                            | \$ 728,563           | \$ 1,487,464        | \$ 336,392          | \$ 200,432      | \$ 155,806       |
| Loss from continued operations                     | \$ (7,064,917 ) (1)  | \$ (6,537,919 ) (1) | \$ (4,652,477 ) (1) | \$ (3,812,916 ) | \$ (3,011,818 )  |
| Income / (loss) from discontinued operations       | \$ -                 | \$ -                | \$ -                | \$ -            | \$ 1,530,060 (2) |
| Net loss after taxes                               | \$ (7,067,317 )      | \$ (6,540,319 )     | \$ (4,654,877 )     | \$ (3,682,926 ) | \$ (317,070 )    |
| Net loss per common share, basic and diluted       |                      |                     |                     |                 |                  |
| Continuing operations                              | \$ (0.23 )           | \$ (0.24 )          | \$ (0.19 )          | \$ (0.19 )      | \$ (0.19 )       |
| Discontinued operations                            | \$ -                 | \$ -                | \$ -                | \$ 0.01         | \$ 0.02          |
| Net loss                                           | \$ (0.23 )           | \$ (0.24 )          | \$ (0.19 )          | \$ (0.18 )      | \$ (0.17 )       |
| <b>Consolidated Balance Sheets Data:</b>           |                      |                     |                     |                 |                  |
| Cash, cash equivalents and short-term investments  | \$ 4,213,744         | \$ 6,632,288        | \$ 1,443,712        | \$ 4,720,362    | \$ 405,888       |
| Total assets                                       | \$ 7,648,952         | \$ 10,940,838       | \$ 4,862,039        | \$ 7,965,274    | \$ 3,314,037     |
| Long-term obligations                              | \$ 19,351            | \$ 15,798           | \$ -                | \$ -            | \$ -             |
| Accumulated deficit                                | \$ (38,500,175)      | \$ (31,392,858)     | \$ (24,892,539)     | \$ (20,237,662) | \$ (16,554,736)  |
| Total stockholders' equity                         | \$ 7,066,435         | \$ 9,983,574        | \$ 4,359,658        | \$ 7,553,386    | \$ 2,960,736     |

- (1) Loss from continuing operations for the fiscal years ended July 31, 2009, 2008, and 2007 includes approximately \$501,400, \$2,119,000, and \$1,371,900, respectively, of stock-based compensation expense pursuant to the provisions of Statement of Financial Accounting Standards No. 123R "Share-Based Payment," which we adopted on August 1, 2006.
- (2) In May 2005, we sold the assets of our Water Treatment Division to Maryland-based Innovative Medical Services, LLC for \$2,375,000. The Water Treatment Division was reported as a discontinued operation in the year ended July 31, 2005, during the period prior to its sale.

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

This report contains forward-looking statements. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential" or "continue," the negative of such terms or other comparable terminology. These statements are only predictions. Actual events or results may differ materially.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Moreover, neither we, nor any other person, assume responsibility for the accuracy and completeness of the forward-looking statements. We are under no obligation to update any of the forward-looking statements after the filing of this Annual Report on Form 10-K to conform such statements to actual results or to changes in our expectations.

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part I of this Annual Report under the Caption "Risk Factors".

Risk factors that could cause actual results to differ from those contained in the forward-looking statements include but are not limited to: our limited operating history; our history of losses; our future capital needs; the rapidly changing technologies and market demands; the failure of our products to achieve broad acceptance; our failure to successfully compete; our dependence on a single product; our failure to comply with government regulation; the loss of a key member of our management team; our failure to protect our intellectual property; our exposure to intellectual property and product liability claims; changes in government policies and other risks identified in this Annual Report on Form 10-K.

The financial statements presented herein, and discussed below, have been prepared in accordance with U.S. Generally Accepted Accounting Principles.

### Overview

PURE Bioscience (sometimes referred to herein as the "Company," "we" "us" or "our") was incorporated in the state of California on August 24, 1992. We began as a provider of pharmaceutical water purification products for the pharmacy market. In 2000, we commenced investments in the development of novel bioscience technologies, and subsequent to the May 2005 sale of our Water Treatment Division we have been exclusively focused on the development and commercialization of our current and future bioscience products.

We are expanding into markets with broad potential by developing new, proprietary bioscience products based upon our patented silver ion antimicrobial technologies. We are developing technology-based bioscience products, including our silver dihydrogen citrate-based antimicrobials, which we believe can provide novel, non-toxic solutions to numerous global health challenges and represent innovative advances in diverse markets. We believe that our technologies are in a position to contribute significantly to today's global trend toward industrial and consumer use of environmentally friendly products, while providing competitive advantages in efficacy and safety.

### Bioscience Technologies

Our flagship bioscience technology is a patented, aqueous antimicrobial called silver dihydrogen citrate ("SDC"). A new molecular entity, SDC is an electrolytically generated source of stabilized ionic silver that can serve as the basis for a

broad range of products in diverse markets. SDC liquid is colorless, odorless, tasteless, non-caustic and formulates well with other compounds. As a platform technology, our SDC-based antimicrobial is distinguished from competitors in the marketplace because of its superior efficacy combined with reduced toxicity. We are producing and plan to expand the production of pre-formulated, ready-to-use products for private label distribution, as well as varying strengths of SDC concentrate as an additive or raw material for inclusion in other companies' products, including as an active pharmaceutical ingredient. In addition to SDC, we have obtained patent protection for ionic silver-based molecular entities utilizing 14 organic acids other than citric acid.

We also own certain rights to a patent-pending pesticide technology, Triglycylboride which, like SDC, provides effective results without human toxicity and is an alternative to traditional poisons. Triglycylboride has been formulated into the products RoachX and AntX, however these products are not currently being actively marketed or developed.

#### Sources of Revenue

Our principal sources of revenue are comprised of sales of SDC concentrate as well as both bulk and individually bottled SDC-based hard surface disinfectant. SDC concentrate is sold to distributors that either resell the concentrate as an active ingredient or preservative in other companies' products, or blend the product into hard surface disinfectant products for sale to retail, commercial and institutional customers. SDC-based hard surface disinfectant is sold in bulk and as individually bottled products to distributors that in turn sell the product to retail, commercial and institutional customers. In addition to sales of SDC concentrate and finished goods, we anticipate generating additional revenues from licensing and royalty arrangements in future periods.

Because the development of our SDC technology is at an early stage of development and commercialization, it is difficult to predict our revenues. Our historical revenues have fluctuated from period to period based on factors that include, but are not limited to, the timing of regulatory approvals regarding our and our partners' products containing SDC; the timing of product launches by both our strategic partners and, in some cases, their customers and partners; the timing of our entry into new strategic agreements, and the quantities of our products required by our partners to effect new research programs and product launches.

Our revenues have historically fluctuated from period to period. For example, in Fiscal 2009 we reported revenues from product sales of \$478,000, compared with revenue from product sales for Fiscal 2008 of \$1,487,000. Among other factors, during Fiscal 2008 we recorded product revenue of \$997,000 for sales to two international distributors for whom we did not recognize any revenue in Fiscal 2009.

In future periods, we expect our revenues to continue to fluctuate. In some cases, such as under our agreement with BASF, we will not be aware of the launch of products containing SDC until they are available to end-users. In February 2009 the first name brand personal care products containing SDC as the active ingredient were launched in Europe by a customer of BASF. Notwithstanding that we sold the SDC used as an active ingredient in the product, we were not able to anticipate this launch due to the contractual rights of BASF and its customer.

#### Cost of Revenues and Operating Expenses

**Costs of Revenue.** Costs of product revenue include materials consumed, manufacturing overheads, shipping costs, salaries, benefits and related expenses of operations. In addition, included in our inventory of finished goods as of July 31, 2009 are approximately 12,000 gallons of SDC concentrate that we purchased from an unrelated third party in a lien sale (see Note 5 to the consolidated financial statements for further information regarding this transaction). This transaction had no impact on our consolidated statements of operations for Fiscal 2009, however it is expected to temporarily reduce our cost of goods sold per gallon of SDC concentrate sold in future periods.

Gross profit on product sales represents net revenue less the costs of revenue. Gross profit percentage is highly dependent on pricing, contractual agreements, overhead allocations and other factors. We do not believe that historical gross profit margins on product sales are a reliable indicator of future gross profit margins.

During the three month period ended January 31, 2009 we recorded \$250,000 of licensing revenue on the expiration of an agreement whereby we allowed a third party a limited time period to exclusively evaluate our SDC technology. Cost of goods sold related to this revenue was zero, as we did not incur any costs directly related to our commitments under the agreement.

**Selling and Marketing.** Selling and marketing expenses consist primarily of salaries and benefits, and amounts paid to third party providers for marketing, sales, public relations and advertising, along with promotional and trade show costs and travel expenses. Sales and marketing expenses also include share-based compensation allocable to employees and third party advisors performing services related to sales and marketing.

**General and Administrative.** General and administrative expenses include employee salaries and benefits, and amounts paid to third party providers for finance and accounting, legal activities, human resources, insurance, information technology, and other administrative activities. General and administrative expenses also include share-based compensation allocable to employees and third party advisors performing general and administrative services.

**Research and Development.** Research and development costs include in-house research costs, expenditures for third party testing, patent amortization, outside legal costs for maintaining issued patents, and product registration expenditures. We do not currently expect our research and development expense to grow significantly in future periods, however if opportunities arise, particularly in the development and testing of new formulations, we will evaluate the need for additional research expenditures based on potential market sizes and our estimation of the

likelihood of our technology achieving successful results. Research and development expenses also include share-based compensation allocable to employees and third party advisors performing services related to research and development.

#### Critical Accounting Policies

##### Accounting for Long-Lived Assets / Intangible Assets

We assess the impairment of long-lived assets, consisting of property, plant, equipment and finite-lived intangible assets, whenever events or circumstances indicate that the carrying value may not be recoverable. Examples of such events or circumstances include:

- An asset's ability to continue to generate income from operations and positive cash flow in future periods;
  - Loss of legal ownership or title to an asset;
- Significant changes in our strategic business objectives and utilization of the asset(s); and
  - The impact of significant negative industry or economic trends.

Recoverability of assets to be held and used in operations is measured by a comparison of the carrying amount of an asset to the future net cash flows expected to be generated by the assets. The factors used to evaluate the future net cash flows, while reasonable, requires a high degree of judgment and the results could vary if the actual results are materially different than the forecasts. In addition, we base useful lives and amortization or depreciation expense on our subjective estimate of the period that the assets will generate revenue or otherwise be used by us. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs.



We also periodically review the lives assigned to our intangible assets to ensure that our initial estimates do not exceed any revised estimated periods from which we expect to realize cash flows from the technologies. If a change were to occur in any of the above-mentioned factors or estimates, the likelihood of a material change in our reported results would increase.

#### Accounting for Stock-Based Compensation

We adopted the fair value provisions of SFAS 123(R) on August 1, 2006. Stock-based compensation expense for all stock-based compensation awards granted after August 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Specifically, we estimate the weighted-average fair value of options granted using the Black-Scholes Option Pricing Model based on evaluation assumptions regarding expected volatility, dividend yield, risk-free interest rates, the expected term of the option and the expected forfeiture rate. Each of these assumptions, while reasonable, requires a certain degree of judgment and the fair value estimates could vary if the actual results are materially different than those initially applied. Prior to the adoption of SFAS 123(R), we were not required to record compensation cost in the consolidated financial statements for stock options issued to employees or directors.

#### Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 157, Fair Value Measurements, which provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except Statement No. 123R and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. In February 2008, the Financial Accounting Standards Board (“FASB”) issued FASB Staff Position (“FSP”) No. FAS 157-2, “Effective Date of FASB Statement No. 157,” which provides a one year deferral of the effective date of FAS 157 for non-financial assets and non-financial liabilities to years beginning after November 15, 2008 (our fiscal year ending July 31, 2010). As a result, we are only partially adopting SFAS No. 157 as it relates to our financial assets and liabilities until we are required to apply this pronouncement to our non-financial assets and liabilities beginning with the fiscal year ending July 31, 2010.

In February 2007, the FASB issued SFAS 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 SFAS No. 159 are elective, however the amendment to SFAS 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 SFAS No. 159 permits all entities to choose to measure eligible items at fair value at specified election dates. Under SFAS No. 159, we would report unrealized gains and losses on items for which the fair value option has been elected in 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. This statement became effective for us on August 1, 2008, however we did not elect the fair value option for any of our financial assets or financial liabilities.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (“SFAS 141R”). SFAS 141R replaces SFAS No. 141, Business Combinations and requires an acquirer in a business combination to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in SFAS 141R. SFAS 141R also amends SFAS No. 109, Accounting for Income Taxes, and SFAS 142, Goodwill and Other Intangible Assets. SFAS 141R applies prospectively to business combinations, if any, for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). In April 2009, the FASB

issued SFAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies, which amends the accounting prescribed in SFAS 141(R) for assets and liabilities arising from contingencies in business combinations. SFAS 141(R)-1 requires pre-acquisition contingencies to be recognized at fair value if fair value can be reasonably determined during the measurement period. If fair value cannot be reasonably determined, SFAS 141(R)-1 requires measurement based on the recognition and measurement criteria of SFAS 5, Accounting for Contingencies. The adoption of the provisions of SFAS 141R or SFAS 141(R)-1 did not have a material effect on our financial condition, results of operations or cash flows for Fiscal 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Non-controlling Interests in Consolidated Financial Statements (“SFAS 160”). SFAS 160 amends Accounting Research Bulletin 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the non-controlling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the adoption of the provisions of SFAS No. 160 to have a material effect on our financial condition, results of operations or cash flows.

In April 2008, the FASB issued FSP No. FAS 142-3, Determination of the Useful Life of Intangible Assets. FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets." The intent of the position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, and other U.S. generally accepted accounting principles. The provisions of FSP No. FAS 142-3 are effective for fiscal years beginning after December 15, 2008 (our fiscal year ending July 31, 2010). We are currently evaluating the impact, if any, that the adoption of FSP No. FAS 142-3 could have on our consolidated financial statements or results of operations.

In June 2008, the FASB ratified Emerging Issue Task Force ("EITF") 07-5, Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity's Own Stock ("EITF 07-5"). EITF 07-5 provides a framework for determining whether an instrument is indexed to an entity's own stock, including evaluating the instrument's contingent exercise and settlement provisions. EITF 07-5 is effective for fiscal years beginning after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the implementation of EITF 07-5 to have a material impact on our consolidated financial statements.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active ("FSP FAS 157-3"), which clarifies the application of SFAS 157 in an inactive market. Additional guidance is provided regarding how a reporting entity's own assumptions should be considered when relevant observable inputs do not exist, how available observable inputs in a market that is not active should be considered when measuring fair value, and how the use of market quotes should be considered when assessing the relevance of inputs available to measure fair value. FSP FAS 157-3 became effective immediately upon issuance. Its adoption did not impact our consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly ("FSP 157-4"). Based on the guidance, if an entity determines that the level of activity for an asset or liability has significantly decreased and that a transaction is not orderly, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value in accordance with FASB Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("SFAS 157"). FSP 157-4 is to be applied prospectively and became effective for us as Fiscal 2009. The adoption of FSP 157-4 did not have an impact on the Company's consolidated results or financial condition.

In April 2009, the FASB issued FSP FAS 107-2 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments ("FSP FAS 107-2 and FSP APB 28-1"). FSP FAS 107-2 amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value and the related carrying amount of financial instruments in interim and annual periods. FSP APB 28-1 amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. FSP FAS 107-2 and FSP APB 28-1 also require disclosure about the method and significant assumptions used to estimate the fair value of financial instruments. FAS FSP 107-2 and FSP APB 28-1 became effective for us as of Fiscal 2009. Their adoption did not impact our consolidated financial statements.

In April 2009, the FASB issued FASB Staff Positions FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments ("FSP 115-2 and 124-2"), which amend the other-than-temporary guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. FSP 115-2 and 124-2 became effective for us as of Fiscal 2009. Their adoption did not impact our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events ("SFAS 165"). SFAS 165 provides rules on recognition and disclosure for events and transactions occurring after the balance sheet date but before the financial

statements are issued or available to be issued. In addition, SFAS 165 requires a reporting entity to disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements are issued or the date the financial statements are available to be issued. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. We have adopted SFAS 165 and have included the required additional disclosures in Note 16 to the consolidated financial statements.

In June 2009, the FASB issued FAS No. 167, Amendments to FASB Interpretation No. 46(R) (“FAS 167”). FAS 167 amends FIN 46(R), Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51, to require an issuer to perform an analysis to determine whether the issuer’s variable interest or interests give it a controlling financial interest in a variable interest entity, if any. This analysis identifies the primary beneficiary of a variable interest entity as one with the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance and the obligation to absorb losses of the entity that could potentially be significant to the variable interest. FAS 167 will be effective as of the beginning of the annual reporting period commencing after November 15, 2009 (our fiscal quarter ending October 31, 2010). We will assess the potential impact, if any, of the adoption of FAS 167 on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (“SFAS 168”). SFAS 168 will become the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission (“SEC”) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this statement, the codification will supersede all then existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the codification will become non-authoritative. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009 (our fiscal quarter ended October 31, 2009). We do not currently expect the adoption of SFAS 168 to have a material impact on our financial condition, results of operations or cash flows.

Results of Operations for the Year Ended July 31, 2009 (“Fiscal 2009”) Versus The Year Ended July 31, 2008 (“Fiscal 2008”)

Revenue and Gross Margin

For Fiscal 2009, product revenues of \$478,300 declined by \$1,009,200, or 68%, compared with Fiscal 2008. The decrease is primarily due to the recording of revenue of \$997,300 in Fiscal 2008 for sales to two international distributors for whom we did not recognize any revenue in Fiscal 2009. Product revenues for each of the periods presented were derived from sales of finished products to our partners and distributors, and product sold to our partners for product development and testing.

During Fiscal 2009, 84% of product sales were made to five strategic partners that are also developing markets for our products. 98% of revenue from product sales for the year was derived from sales made to U.S. domestic customers. During Fiscal 2008, 90% of product sales were made to five strategic partners, and 33% of revenue from product sales for the year was derived from sales made to U.S. domestic customers. In some cases we have, or may have in future periods, distributors or strategic partners to whom we have granted rights to sell our technology in multiple countries. Generally, we do not require such distributors to report to us the quantities of products that they sell in each country. In such cases, we report revenues based on the country of first sale.

Gross profit on product sales for Fiscal 2009 was \$240,100, compared with \$1,023,900 in Fiscal 2008. The gross margin percentage declined from 69% in Fiscal 2008 to 50% for Fiscal 2009. The decline is primarily due to an increased proportion of lower margin products sold in the most recent period. During Fiscal 2009, 38% of our product sales were of bulk SDC concentrate, and 62% of our product sales were of bulk Axen30 or finished packaged products containing Axen 30, our ready to use product. During the prior year, 77% of our product sales were of bulk SDC concentrate and 23% of our product sales were of bulk Axen30 or finished packaged products containing Axen 30. We generally sell our SDC bulk concentrate at higher margins than our ready to use products.

During Fiscal 2008 we recorded deferred revenue on receipt of a non-refundable fee of \$250,000 which we received subject to an agreement whereby we allowed a third party a limited time period to exclusively evaluate our SDC technology for use within specified indications and for certain products. Upon the termination of the agreement on January 31, 2009, we recognized the \$250,000 as licensing revenue in the consolidated statements of operations for Fiscal 2009. Cost of goods sold related to this revenue was zero, as we did not incur any costs directly related to our commitments under the agreement.

Operating Costs

Operating costs declined by \$79,700, from \$7,704,200 in Fiscal 2008, to \$7,624,500 in Fiscal 2009. Within these aggregate operating costs, selling expenses declined by \$111,600 to \$694,100 in Fiscal 2009, compared with Fiscal 2008. The decrease in selling expenses is primarily due to \$300,000 of employee and consultant stock option expense recorded in the prior year, which was partially offset by increased salary expense in Fiscal 2009.

General and administrative expenses increased by \$319,000 or 6%, to \$5,462,000 in Fiscal 2009 compared with Fiscal 2008. Included in general and administrative expense for Fiscal 2009 is \$781,600 of bad debt expense. This amount is made up of amounts billed during prior periods to two international distributors. During Fiscal 2008 we granted non-exclusive distribution and blending rights to a new distributor for the sale of SDC-based products in Colombia. In addition, we granted non-exclusive distribution and blending rights to a second distributor, which is affiliated with the first distributor, for the sale of SDC-based products in Argentina, Venezuela, Panama and Costa Rica. The \$781,600 receivable includes \$57,000 for amounts billed at cost to the distributors in August 2008 for parts shipped directly to them by one of our U.S. packaging suppliers. Subsequent to this transaction, we have not sold any products to either of the two referenced distributors.

During the three month period ended January 31, 2009 we determined these accounts to be delinquent, established a full reserve and recorded \$781,600 as bad debt expense, within general and administrative expense. At July 31, 2009 the referenced amounts remained uncollected; and we have written off the full receivable of \$781,600. Management currently considers all other accounts receivable to be fully collectible.

This increase in expense was offset by a decline of \$1,212,300 in stock and stock option expense within general and administrative expense, the most significant factor being \$1,123,000 of stock and stock option expense recorded in Fiscal 2008 for option and stock grants made to our officers and directors. In April 2008, we granted options, which vested on the date of grant, to purchase 275,000 shares of common stock to directors and officers of the Company, valued at approximately \$906,000. We also granted 30,000 shares of common stock to each of three independent directors of the Company, the aggregate of 90,000 shares being valued at \$463,500. \$1,123,000 of the expense for these option and stock grants was booked to general and administrative expense in Fiscal 2008. This expense was partially offset by \$92,200 of expense recorded in Fiscal 2009 for option and stock grants made to our officers and directors in May 2009. We issued options to purchase an aggregate of 360,000 shares of our common stock, to our three executive officers; granted 86,800 shares of restricted stock to four of our directors, and issued a five year option to purchase 30,000 shares of common stock to one of our directors. The aggregate fair value for Fiscal 2009 grants was \$993,500, however as each award has vesting requirements, only \$92,200 of the expense was recorded within the consolidated statements of operations for Fiscal 2009.

We recognized employee and director stock option and stock grant non-cash expense in general and administrative expenses for Fiscal 2009 of \$410,500 and for Fiscal 2008 of \$1,622,800.

General and administrative payroll expense increased by \$242,800 year over year due to new hires and salary increases, and accounting and legal fees increased by \$188,400. Additionally, insurance, depreciation, rent, Board of Directors' Committee fees, and investor relations and public relations expense, accounted for \$338,200 of the increase in general and administrative expense for Fiscal 2009 compared with Fiscal 2008.

Research and development costs, including in-house costs, patent amortization, outside legal costs for maintaining approved patents, and product registration expenditures, declined in Fiscal 2009 by 11% to \$1,468,500, from \$1,646,400 in Fiscal 2008. The decline in expense is primarily related to a decline of \$178,300 in patent related legal fees and a decline of \$135,400 in employee and director stock option expense. These decreases were partially offset by increases in payroll and in consulting costs. We do not currently expect our research and development expense to grow significantly in future periods, however if opportunities arise, particularly in the development and testing of new formulations, we will evaluate the need for additional research expenditures based on potential market sizes, our estimation of the likelihood of our technology achieving successful results, and the availability of working capital.

In July 2008 we suspended the development and marketing efforts for our Triglycylboride boric acid-based pesticides in order to focus on the development of our SDC and related technologies. We concurrently wrote down the net unamortized balance of the capitalized patents associated with the Triglycylboride technology, which amounted to \$109,300, and recorded an impairment charge of \$109,300 within operating costs on the consolidated statements of operations for Fiscal 2008.

Our loss from operations before taxes and other income increased by \$454,100, from a loss of \$6,680,400 in Fiscal 2008 to a loss of \$7,134,400 in Fiscal 2009.

#### Other Income

Other income declined by \$72,900 in Fiscal 2009 compared with Fiscal 2008, due primarily to gains on the sale of T-bills recorded in the prior year, and decreased interest income from lower average cash balances and lower interest rates.

#### Income Taxes

Income tax expense for Fiscal 2009 and 2008 was \$2,400, the minimum franchise tax we pay to the State of California regardless of income or loss. All other federal or state tax liabilities were offset by current period losses or available federal and California net operating loss carry-forwards.

In June 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48 ("FIN 48"), Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Under FIN 48, we must recognize the tax benefit from an uncertain tax position if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position.

FIN 48 became effective for us on August 1, 2007. The adoption of FIN 48 did not have a material impact on our consolidated results of operations or financial position for Fiscal 2009 or 2008, as we had no unrecognized tax benefits that, if recognized, would affect our effective income tax rate in future periods. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense, however we had no accrued interest or penalties at either August 1, 2008 or July 31, 2009.

At July 31, 2009, we had federal and California tax net operating loss carry-forwards of approximately \$50,009,800 and \$39,871,800, respectively. Realization of our deferred tax assets, which relate to operating loss carry-forwards

and timing differences, is dependent on future earnings. The timing and amount of future earnings are uncertain and therefore we establish a 100% valuation allowance.

#### Net Income (Loss)

Our net loss after taxes increased by \$527,000, from a net loss of \$6,540,300 in Fiscal 2008 to a net loss of \$7,067,300 in Fiscal 2009.

#### Results of Operations for the Year Ended July 31, 2008 (“Fiscal 2008”) Versus The Year Ended July 31, 2007 (“Fiscal 2007”)

##### Revenue and Gross Margin

For Fiscal 2008, revenues of \$1,487,500 increased by \$1,151,100 compared with Fiscal 2007. The increase is primarily due to sales made to new customers with whom we had entered into development and distribution agreements during Fiscal 2008. 40% of sales for Fiscal 2008 were made to one strategic partner and 84% of our sales were made to the largest four partners. 67% of sales for Fiscal 2008 were made to international customers and 33% were made to U.S. domestic customers, compared with 24% made to international customers and 76% made to U.S. domestic customers during Fiscal 2007.

Gross profit on product sales for Fiscal 2008 was \$1,023,900, compared with \$115,300 in Fiscal 2007. The gross margin percentage improved from 34% in Fiscal 2007 to 69% in Fiscal 2008. The improvement is primarily due to an increased proportion of higher margin products sold in Fiscal 2008 compared with Fiscal 2007. During Fiscal 2008, 77% of our product sales were of bulk SDC concentrate and 23% of our product sales were of bulk Axen30 or finished packaged products containing Axen 30, our ready to use product. During Fiscal 2007, 28% of our product sales were of bulk SDC concentrate and 72% of our product sales were of bulk Axen30, finished packaged products containing Axen 30, blending systems and RoachX. We generally sell our SDC bulk concentrate at higher margins than our other products.



## Operating Costs

Operating costs increased by \$2,748,100, from \$4,956,100 in Fiscal 2007, to \$7,704,200 for Fiscal 2008. Within these aggregate operating costs, selling expenses, which are primarily made up of our business development consultants and employees and their associated expenses declined by \$93,500, to \$805,600 in Fiscal 2008 compared with Fiscal 2007. The decline in selling expense in Fiscal 2008 is primarily due to a \$79,000 decrease in stock option expense, the majority of which is for grants made to third party consultants and advisors.

General and administrative expenses increased by \$2,306,700, to \$5,143,000 in Fiscal 2008, compared with Fiscal 2007. Stock option expense within general and administrative expense increased by approximately \$830,000 for Fiscal 2008, compared with the prior year. In April 2008, we granted options to purchase 275,000 shares of our common stock, which vested on their date of grant, to directors and officers of the Company. The fair value of these grants was approximately \$906,000. We also granted 30,000 shares of common stock to each of three directors of the Company, the aggregate of 90,000 shares being valued at \$463,500, and we also issued 100,000 fully vested options to purchase our common stock to a new director, for which we recorded \$351,000 of general and administrative expense. We also issued 12,500 shares of our common stock with a fair value of \$44,000 for a legal settlement. The total expense for option and stock grants booked to general and administrative expense in Fiscal 2008 was \$1,622,800.

During Fiscal 2007, we incurred non-cash expense of \$793,900 for stock options granted to officers and directors during the year, based on their Black-Scholes valuation at the grant date, including a grant made to a new director and stock awarded to directors based on the market price of the common stock at the award date.

General and administrative payroll and payroll-related expense increased by approximately \$277,000 year over year due to new hires and salary increases, accounting fees increased by approximately \$190,000, and costs for Fiscal 2008 also included \$81,000 in fees related to the April 2008 listing of our common stock on the NASDAQ Capital Market. Legal fees charged to general and administrative expense, primarily related to the development of contracts and the protection of our intellectual property, increased by \$422,000 for Fiscal 2008 compared with the prior year. Additionally, Sarbanes-Oxley compliance costs, travel expenses, depreciation, and health insurance costs all increased in Fiscal 2008 compared with Fiscal 2007.

Research and development costs increased in Fiscal 2008 by \$425,600, to \$1,646,400, compared with Fiscal 2007. Expense for Fiscal 2008 included \$148,000 of non-cash stock option expense for grants made to officers during the period. There were no such grants made to officers during Fiscal 2007. Additionally, during Fiscal 2008, we incurred \$105,000 of expense for patent related legal services provided in prior years. Research and development payroll and payroll-related expense increased by \$199,000 year over year due to new hires and salary increases, and third party testing costs for Fiscal 2008 increased by \$141,000 over the prior year. These expense increases were partially offset by a decline of \$186,000 in consulting fees paid to outside advisors, including \$65,000 of non-cash expense in Fiscal 2007 for the issuance of 30,000 shares of our common stock.

In July 2008 we suspended the development and marketing efforts for our Triglycylboride boric acid-based pesticides in order to focus on the development of our SDC and related technologies. We concurrently wrote down the net unamortized balance of the capitalized patents associated with the Triglycylboride technology, which amounted to \$109,300, and recorded an impairment charge of \$109,300 within operating costs on the consolidated statements of operations for Fiscal 2008.

Our loss from operations before taxes and other income increased by \$1,839,600, from a loss of \$4,840,800 for Fiscal 2007 to a loss of \$6,680,400 for Fiscal 2008.

## Other Income

Other income declined by \$45,900 for Fiscal 2008 compared with Fiscal 2007. Gains on the sale of U.S. Treasury Bills were almost entirely offset by decreased interest income from lower average cash balances and lower interest rates.

#### Income Taxes

Income tax expense for Fiscal 2008 and Fiscal 2007 was \$2,400, the minimum franchise tax we pay to the State of California regardless of income or loss. All other federal or state tax liabilities were offset by current period losses or available federal and California net operating loss carry-forwards. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense, however we had no accrued interest or penalties at either August 1, 2007 or July 31, 2008.

At July 31, 2008, we had federal and California tax net operating loss carry-forwards of approximately \$40,888,600 and \$30,753,000, respectively. Realization of our deferred tax assets, which relate to operating loss carry-forwards and timing differences, is dependent on future earnings. The timing and amount of future earnings are uncertain and therefore we establish a 100% valuation allowance.

#### Net Income (Loss)

Our net loss after taxes increased by \$1,885,400, from a net loss of \$4,654,900 for Fiscal 2007 to a net loss of \$6,540,300 for Fiscal 2008.

## LIQUIDITY AND CAPITAL RESOURCES

### Fiscal 2009 vs. Fiscal 2008

From inception through the present, we have financed our operations primarily through sales of our equity securities, through lines of credit and the issuance of debentures, and in May 2005 by the sale of our Water Treatment Division.

At July 31, 2009, we had cash and cash equivalents of \$4,213,700, no short-term investments, and no long-term debt. On September 3, 2009, subsequent to the end of Fiscal 2009, we closed a registered direct offering whereby we sold \$3 million of our common stock and warrants to institutional investors. After fees and expenses, the net proceeds of this offering to us were approximately \$2.78 million.

Total current assets at July 31, 2009 were \$4,847,700, a decline of \$3,041,900 from July 31, 2008. \$2,418,500 of this decline was in cash, cash equivalents and short-term investments. Cash used in operating activities for Fiscal 2009 was \$5,910,100, compared with \$4,404,600 for Fiscal 2008. The increase in operating cash expenditures is primarily due to reduced revenue collections and increased general and administrative expenses, and the timing of the payment of accounts payable. In particular, in Fiscal 2008 we received a non-refundable fee of \$250,000 subject to an agreement whereby we allowed a third party a limited time period to exclusively evaluate our SDC technology. Our net accounts receivable declined by \$691,700 from July 31, 2008 to July 31, 2009, primarily due to a bad debt write-off in Fiscal 2009 of \$781,600 related to amounts unpaid by two international distributors. The increased general and administrative cash expenditures in Fiscal 2009 include increased payroll, insurance, legal fees, accounting fees, and investor relations and public relations expenses. In Fiscal 2009, inventory increased by \$51,600 to \$421,700 at July 31, 2009. In Fiscal 2008 accounts payable and accrued liabilities increased by \$222,300, whereas in Fiscal 2009 accounts payable and accrued liabilities declined by \$161,500.

Our operating cash outflows could be greater in future periods. Net cash used in operations was \$5,910,100 in Fiscal 2009, \$4,404,600 in Fiscal 2008, and \$2,672,000 in Fiscal 2007. Our future capital needs and our future profits, if any, are uncertain, and will depend on many factors including, among others, the acceptance of, and demand for, our products; the success of our strategic partners in selling our products; our success and the success of our strategic partners in obtaining regulatory approvals to sell our products; the costs of further developing our existing, and developing new, products or technologies; the extent to which we invest in new technology and product development; and the costs associated with the continued operation, and any future growth, of our business.

During Fiscal 2009, cash provided by investing activities was \$4,392,000, compared with \$4,306,200 of cash used in investing activities during Fiscal 2008. During Fiscal 2009, a net amount (cash sales less cash purchases) of \$4,589,300 was provided by short-term investments, compared with \$3,881,200 used in Fiscal 2008. In addition, during Fiscal 2009 we invested \$100,300 in patents and \$97,000 to purchase property, plant and equipment; whereas in Fiscal 2008, such investments were \$125,100 and \$299,900 respectively. During Fiscal 2008, we invested \$149,000 in software and consulting services related to the April 2008 implementation of a new Enterprise Resource Planning (ERP) System. At July 31, 2009 the net capitalized value of our capitalized patents and our property, plant and equipment was \$1,944,700 and \$856,500 respectively.

Total cash inflows from financing activities for Fiscal 2009 were \$3,707,400, compared with \$9,999,600 in Fiscal 2008. Net proceeds from the sale of common stock in Fiscal 2009 were \$2,769,500, compared with \$7,741,000 during Fiscal 2008. Sales of common stock in Fiscal 2009 were derived from a registered direct offering in May 2009, whereby we sold \$3 million of our common stock and warrants to institutional investors. After fees and expenses, the net proceeds of the offering to us were \$2,769,500 (see Note 8 to the consolidated financial statements for more information regarding this offering). Sales of common stock in Fiscal 2008 were derived from a private placement in October 2007, whereby we sold \$8,438,308 of unregistered common stock and warrants to accredited investors. The net proceeds of the private placement to us were \$7,741,000.

Cash proceeds from exercise of stock options and warrants in Fiscal 2009 were \$937,900, compared with \$2,254,000 in Fiscal 2008. In August 2008, we received an aggregate of \$150,000 from the exercise of non-employee options to purchase 50,000 shares of our common stock at an exercise price of \$3.00, and received \$15,000 from the exercise of options to purchase 28,450 shares of our common stock by two officers, at an average exercise price of \$0.53. In December 2008, we received \$631,600 from the exercise of options to purchase 339,800 shares of our common stock by one of our directors, at an average exercise price of \$1.86. In January 2009, we received \$79,500 from a director for the exercise of options to purchase 150,000 shares of our common stock at an exercise price of \$0.53; and received \$18,000 from the same director for the exercise of common stock warrants to purchase 36,000 shares of our common stock at an exercise price of \$0.50. In addition, during the three month period ended July 31, 2009 we received \$24,750 from the exercise of options to purchase 15,000 shares of common stock issued in prior periods for consulting services, and we received \$19,000 from the exercise of options to purchase 27,500 shares of our common stock issued under employee stock options plans.

At July 31, 2009, we had total liabilities of \$582,500, a decline of \$414,700 from July 31, 2008, primarily due to a decline in accounts payable and a decline in deferred revenue. The decline in deferred revenue is primarily related to the receipt in Fiscal 2008 of a non-refundable fee of \$250,000 which we received subject to an agreement whereby we allowed a third party a limited time period to exclusively evaluate our SDC technology. The fee was recognized into revenue in Fiscal 2009.

Fiscal 2008 versus Fiscal 2007

During Fiscal 2008, cash, cash equivalents and short-term investments increased by \$5,188,600, due primarily to \$7,741,000 raised in a private placement of common stock and \$2,254,000 in cash received from the exercise of stock options during Fiscal 2008, which was partially offset by \$4,404,600 of cash used in operations for the year. In Fiscal 2007, cash flows from financing activities were \$475,190, which was received pursuant to the exercise of stock options. There were no other sales of common stock in Fiscal 2007.

The \$4,404,600 of cash used in operations for Fiscal 2008 was \$1,732,600 greater than the \$2,672,000 of cash used in operations for Fiscal 2007. The increase in operating cash expenditures is primarily as a result of increased general and administrative expenses including payroll, accounting fees, legal fees, patent related research and development expenditures, and investments in new manufacturing staff and inventory to support new partners and anticipated product needs.

During Fiscal 2008, cash used in investing activities was \$4,306,200. Of this amount, a net amount (cash purchases less cash sales) of \$3,881,200 was invested in short-term investments, \$125,100 was invested in patents, and \$299,900 was invested in property, plant and equipment. During Fiscal 2007, cash used in investing activities was \$1,787,900. Of this amount, a net amount of \$708,100 was invested in short-term investments, \$204,200 was invested in patents, and \$875,700 was invested in property, plant and equipment. During Fiscal 2007 we spent approximately \$524,000 to redevelop the manufacturing and office areas of our El Cajon facility.

Future Cash Needs

During the next twelve months, we anticipate making significant investments in manufacturing processes, to improve efficiency and to be able to meet anticipated demand; in regulatory applications for new products or additional claims; in our corporate and business development infrastructure; and in programs required for us to maintain our compliance with securities laws as well as the listing standards of the NASDAQ Capital Market, among other investments. We believe, however, that our cash resources are sufficient to meet our anticipated needs during the next twelve months. Our assessment is based on historical working capital needs, operating loss trends, and our current business outlook.

In future periods we may need to seek additional capital through the issuance of debt, equity, convertible securities or through other means, any one of which could reduce the value to us, perhaps substantially, of our technology and its commercial potential. We currently have no long-term debt, however the issuance of debt, equity or convertible securities in future periods, if any, could lead to the dilution of our existing shareholders. There is no guarantee that we would be able to obtain capital on terms acceptable to us, or at all. Insufficient funds could cause us to fail to execute our business plan, fail to take advantage of future opportunities, or fail to respond to competitive pressures or unanticipated consumer requirements, and further may require us to delay, scale back or eliminate some or all of our research and product development programs, license to third parties the right to commercialize products or technologies that we would otherwise commercialize ourselves, or to reduce or cease operations.

OFF BALANCE SHEET ARRANGEMENTS

We do not have any off balance sheet arrangements.

CONTRACTUAL OBLIGATIONS

Payments due by period

| Total | Less than<br>1 year | 1–3 years | 3–5 years | More than 5<br>years |
|-------|---------------------|-----------|-----------|----------------------|
|-------|---------------------|-----------|-----------|----------------------|

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|                                                                                          |           |            |            |   |   |
|------------------------------------------------------------------------------------------|-----------|------------|------------|---|---|
| Long-Term Debt Obligations                                                               | –         | –          | –          | – | – |
| Capital Lease Obligations                                                                | –         | –          | –          | – | – |
| Operating Lease Obligations                                                              | \$442,200 | \$ 178,300 | \$ 263,900 | – | – |
| Purchase Obligations                                                                     | –         | –          | –          | – | – |
| Other Long-Term Liabilities<br>Reflected on the Registrant's Balance<br>Sheet under GAAP | –         | –          | –          | – | – |
| Total                                                                                    | \$442,200 | \$ 178,300 | \$ 263,900 | – | – |

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Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Our exposure to interest rate risk at July 31, 2009 was related to our investment portfolio which consisted largely of institutional money market mutual funds investing. From time to time our investments may be exposed to market risk related to changes in interest rates. Our current investment policy is to maintain an investment portfolio consisting only of diversified institutional money market mutual funds investing in A-1 (S&P) or Prime-1 (Moody's); U.S. Treasury Securities, or United States Government obligations issued by or backed by a federal agency of the United States Government. We do not enter into investments for trading or speculative purposes, and our cash is deposited in, and invested through, highly rated financial institutions in the United States. While our available for sale securities, if any, are subject to interest rate risk and would fall in value if market interest rates increased, we estimate that the fair value of such an investment portfolio would not decline by a material amount in the event of an increase in market interest rates. We therefore would not expect our operating results or cash flows to be affected to any significant degree by the effect of a change in market interest rates.

We have operated mainly in the United States, and during the fiscal years ended July 31, 2009, 2008, and 2007, all of our sales, both international and domestic, have been denominated in U.S. dollars. Additionally, our purchases are predominantly made in U.S. dollars. Accordingly, we have not had any material exposure to foreign currency rate fluctuations.

Item 8. Consolidated Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
PURE Bioscience

We have audited the accompanying consolidated balance sheets of PURE Bioscience as of July 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended July 31, 2009. These consolidated 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 PURE Bioscience as of July 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for each of the three years in the period ended July 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of PURE Bioscience's internal control over financial reporting as of July 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated October 13, 2009 expressed an unqualified opinion thereon.

/s/ Mayer Hoffman McCann P.C.  
San Diego, California  
October --13, 2009



## PURE Bioscience

## CONSOLIDATED BALANCE SHEETS

|                                                                                                                                                                                      | July 31,    |              |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|--------------|
|                                                                                                                                                                                      | 2009        | 2008         |
| <b>ASSETS</b>                                                                                                                                                                        |             |              |
| Current Assets                                                                                                                                                                       |             |              |
| Cash and cash equivalents                                                                                                                                                            | \$4,213,744 | \$2,024,400  |
| Short-term investments                                                                                                                                                               | -           | 4,607,888    |
| Accounts receivable, net of allowance for doubtful accounts<br>of \$0 at July 31, 2009 and \$0 at July 31, 2008                                                                      | 143,031     | 834,721      |
| Inventories, net                                                                                                                                                                     | 421,655     | 370,043      |
| Prepaid expenses                                                                                                                                                                     | 69,317      | 52,560       |
| Total current assets                                                                                                                                                                 | 4,847,747   | 7,889,612    |
| Total property, plant and equipment, net                                                                                                                                             | 856,504     | 1,034,835    |
| Patents                                                                                                                                                                              | 1,944,701   | 2,016,391    |
| Total assets                                                                                                                                                                         | \$7,648,952 | \$10,940,838 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                          |             |              |
| Current Liabilities                                                                                                                                                                  |             |              |
| Accounts payable                                                                                                                                                                     | \$368,418   | \$596,132    |
| Accrued liabilities                                                                                                                                                                  | 192,348     | 126,141      |
| Deferred revenue                                                                                                                                                                     | -           | 256,793      |
| Taxes payable                                                                                                                                                                        | 2,400       | 2,400        |
| Total current liabilities                                                                                                                                                            | 563,166     | 981,466      |
| Deferred rent                                                                                                                                                                        | 19,351      | 15,798       |
| Total liabilities                                                                                                                                                                    | 582,517     | 997,264      |
| Stockholders' Equity                                                                                                                                                                 |             |              |
| Preferred Stock, no par value:<br>5,000,000 shares authorized, no shares issued                                                                                                      | -           | -            |
| Class A common stock, no par value:<br>50,000,000 shares authorized<br>32,307,966 issued and outstanding at July 31, 2009, and<br>29,573,936 issued and outstanding at July 31, 2008 | 38,498,904  | 35,436,077   |
| Additional Paid-In Capital                                                                                                                                                           | 4,566,024   | 4,155,608    |
| Warrants:<br>1,411,725 issued and outstanding at July 31, 2009, and<br>880,351 issued and outstanding at July 31, 2008                                                               | 2,501,682   | 1,766,159    |

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|                                            |              |              |
|--------------------------------------------|--------------|--------------|
| Accumulated other comprehensive income     | -            | 18,588       |
| Accumulated deficit                        | (38,500,175) | (31,432,858) |
| Total stockholders' equity                 | 7,066,435    | 9,943,574    |
| Total liabilities and stockholders' equity | \$7,648,952  | \$10,940,838 |

The accompanying notes are an integral part of the consolidated financial statements

## PURE Bioscience

## CONSOLIDATED STATEMENTS OF OPERATIONS

|                                                                                              | For the Years Ended July 31, |                |                |
|----------------------------------------------------------------------------------------------|------------------------------|----------------|----------------|
|                                                                                              | 2009                         | 2008           | 2007           |
| <b>REVENUES FROM PRODUCT SALES</b>                                                           |                              |                |                |
| Net revenues                                                                                 | \$478,263                    | \$1,487,464    | \$336,392      |
| Cost of sales                                                                                | 238,168                      | 463,596        | 221,108        |
| Gross profit                                                                                 | 240,095                      | 1,023,868      | 115,284        |
| <b>OTHER REVENUES</b>                                                                        |                              |                |                |
| Revenues from license agreements                                                             | 250,000                      | -              | -              |
| Cost of other revenues                                                                       | -                            | -              | -              |
| Gross profit                                                                                 | 250,000                      | -              | -              |
| Total gross profit                                                                           | 490,095                      | 1,023,868      | 115,284        |
| Selling expenses                                                                             | 694,073                      | 805,628        | 899,145        |
| General and administrative expenses                                                          | 5,462,007                    | 5,142,961      | 2,836,224      |
| Research and development                                                                     | 1,468,460                    | 1,646,352      | 1,220,764      |
| Impairment of capitalized assets                                                             | -                            | 109,286        | -              |
| Total operating expenses                                                                     | 7,624,540                    | 7,704,227      | 4,956,133      |
| Loss from operations                                                                         | (7,134,445 )                 | (6,680,359 )   | (4,840,849 )   |
| Other income and (expense):                                                                  |                              |                |                |
| Interest income                                                                              | 18,718                       | 30,786         | 150,878        |
| Other                                                                                        | 50,810                       | 111,654        | 37,494         |
| Total other income (expense)                                                                 | 69,528                       | 142,440        | 188,372        |
| Net loss before income taxes                                                                 | (7,064,917 )                 | (6,537,919 )   | (4,652,477 )   |
| Income tax provision                                                                         | (2,400 )                     | (2,400 )       | (2,400 )       |
| Net loss                                                                                     | \$(7,067,317 )               | \$(6,540,319 ) | \$(4,654,877 ) |
| Net loss per common share, basic and diluted                                                 | \$(0.23 )                    | \$(0.24 )      | \$(0.19 )      |
| Weighted average common shares used in computing basic and diluted net loss per common share | 30,595,299                   | 27,553,215     | 24,432,905     |

The accompanying notes are an integral part of the consolidated financial statements



## PURE Bioscience

## CONSOLIDATED STATEMENTS OF CASH FLOWS

|                                                                             | For the Years Ended July 31, |               |               |
|-----------------------------------------------------------------------------|------------------------------|---------------|---------------|
|                                                                             | 2009                         | 2008          | 2007          |
| Cash flows from operating activities:                                       |                              |               |               |
| Net loss                                                                    | \$(7,067,317)                | \$(6,540,319) | \$(4,654,877) |
| Adjustments to reconcile net loss to net cash used in operating activities: |                              |               |               |
| Amortization and depreciation                                               | 447,282                      | 405,749       | 257,086       |
| Impairment of capitalized assets                                            | -                            | 113,158       | 167,643       |
| Stock-based compensation                                                    | 501,359                      | 2,119,034     | 1,371,863     |
| Bad debt expense                                                            | 781,627                      | -             | -             |
| Changes in assets and liabilities:                                          |                              |               |               |
| Accounts receivable                                                         | (89,937)                     | (827,173)     | 50,527        |
| Prepaid expense                                                             | (16,757)                     | (42,816)      | 116,242       |
| Inventories                                                                 | (51,612)                     | (127,144)     | (70,960)      |
| Deferred rent                                                               | 3,553                        | 15,798        | -             |
| Deferred revenue                                                            | (256,793)                    | 256,793       | -             |
| Accounts payable and accrued liabilities                                    | (161,507)                    | 222,292       | 90,492        |
| Net cash (used) in operating activities                                     | (5,910,102)                  | (4,404,628)   | (2,671,984)   |
| Cash flows from investing activities                                        |                              |               |               |
| Investment in patents                                                       | (100,270)                    | (125,108)     | (204,188)     |
| Purchase of property, plant and equipment                                   | (96,991)                     | (299,900)     | (875,668)     |
| Purchases of short-term investments                                         | (4,076,992)                  | (10,633,849)  | (2,488,981)   |
| Sales of short-term investments                                             | 8,666,292                    | 6,752,608     | 1,780,923     |
| Net cash provided by (used) in investing activities                         | 4,392,039                    | (4,306,249)   | (1,787,914)   |
| Cash flows from financing activities                                        |                              |               |               |
| Net proceeds from the sale of common stock                                  | 2,769,478                    | 7,740,967     | 475,190       |
| Proceeds from exercise of stock options and warrants                        | 937,929                      | 2,253,963     | -             |
| Proceeds from section 16(b) short-swing profits                             | -                            | 4,693         | -             |
| Net cash provided by financing activities                                   | 3,707,407                    | 9,999,623     | 475,190       |
| Net increase (decrease) in cash and cash equivalents                        | 2,189,344                    | 1,288,746     | (3,984,708)   |

|                                                   |             |             |           |
|---------------------------------------------------|-------------|-------------|-----------|
| Cash and cash equivalents at beginning of period  | 2,024,400   | 735,654     | 4,720,362 |
| Cash and cash equivalents at end of period        | \$4,213,744 | \$2,024,400 | \$735,654 |
| Supplemental disclosures of cash flow information |             |             |           |
| Cash paid for taxes                               | \$2,400     | \$2,400     | \$2,400   |
| Cash paid for interest                            | \$-         | \$49        | \$-       |

The accompanying notes are an integral part of the consolidated financial statements

## PURE Bioscience

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

|                                                 | Common Stock |              | Additional<br>Paid-In<br>Capital | Warrants |           | Comprehensive<br>Income | Accumulated<br>Deficit | Total<br>Stockholders'<br>Equity |
|-------------------------------------------------|--------------|--------------|----------------------------------|----------|-----------|-------------------------|------------------------|----------------------------------|
|                                                 | Shares       | Amount       |                                  | Shares   | Amount    |                         |                        |                                  |
| Balance, July<br>31, 2006                       | 23,983,002   | \$25,801,653 | \$1,743,570                      | 391,698  | \$245,825 | \$-                     | \$(20,237,662)         | \$7,553,386                      |
| Net loss                                        | -            | -            | -                                | -        | -         | -                       | (4,654,877 )           | (4,654,877)                      |
| Common stock<br>issued for<br>services          | 30,000       | 65,100       | -                                | -        | -         | -                       | -                      | 65,100                           |
| Stock options<br>issued for<br>services         | -            | -            | 91,290                           | -        | -         | -                       | -                      | 91,290                           |
| Share-based<br>compensation -<br>options        | -            | -            | 651,969                          | -        | -         | -                       | -                      | 651,969                          |
| Share-based<br>compensation -<br>stock grants   | 60,000       | 177,600      | -                                | -        | -         | -                       | -                      | 177,600                          |
| Stock options<br>exercised                      | 978,803      | 475,190      | -                                | -        | -         | -                       | -                      | 475,190                          |
| Canceled<br>shares                              | (90,000 )    | -            | -                                | -        | -         | -                       | -                      | -                                |
| Balance, July<br>31, 2007                       | 24,961,805   | \$26,519,543 | \$2,486,829                      | 391,698  | \$245,825 | \$-                     | \$(24,892,539)         | \$4,359,658                      |
| Comprehensive<br>loss:                          |              |              |                                  |          |           |                         |                        |                                  |
| Net loss                                        | -            | -            | -                                | -        | -         | -                       | (6,540,319 )           | (6,540,319)                      |
| Change in<br>unrealized<br>gains                | -            | -            | -                                | -        | -         | 18,588                  | -                      | 18,588                           |
| Comprehensive<br>loss                           |              |              |                                  |          |           |                         |                        | (6,521,731)                      |
| Private<br>placement of<br>common stock,<br>net | 1,677,596    | 6,155,321    | -                                | 587,153  | 1,585,647 | -                       | -                      | 7,740,968                        |
| Common stock<br>issued for                      | 12,500       | 43,750       | -                                | -        | -         | -                       | -                      | 43,750                           |

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|                                                    |            |              |             |           |             |          |                |              |
|----------------------------------------------------|------------|--------------|-------------|-----------|-------------|----------|----------------|--------------|
| services                                           |            |              |             |           |             |          |                |              |
| Stock options issued for services                  | -          | -            | 192,550     | -         | -           | -        | -              | 192,550      |
| Share-based compensation - options                 | -          | -            | 1,406,223   | -         | -           | -        | -              | 1,406,223    |
| Share-based compensation - stock grants            | 90,000     | 463,500      | -           | -         | -           | -        | -              | 463,500      |
| Section 16(b) short-swing profits                  | -          | -            | 4,693       | -         | -           | -        | -              | 4,693        |
| Stock options exercised                            | 2,761,053  | 2,228,403    | -           | -         | -           | -        | -              | 2,228,403    |
| Exercised warrants                                 | 70,982     | 25,560       | 65,313      | (98,500 ) | (65,313 )   | -        | -              | 25,560       |
| Canceled shares                                    | -          | -            | -           | -         | -           | -        | -              | -            |
| Balance, July 31, 2008                             | 29,573,936 | \$35,436,077 | \$4,155,608 | 880,351   | \$1,766,159 | \$18,588 | \$(31,432,858) | \$9,943,574  |
| Comprehensive loss:                                |            |              |             |           |             |          |                |              |
| Net loss                                           | -          | -            | -           | -         | -           | -        | (7,067,317 )   | (7,067,317 ) |
| Change in unrealized gains                         | -          | -            | -           | -         | -           | (18,588) | -              | (18,588 )    |
| Comprehensive loss                                 |            |              |             |           |             |          |                | (7,085,905)  |
| Registered offering of common stock                | 1,418,441  | 2,023,984    | -           | 567,374   | 745,494     | -        | -              | 2,769,478    |
| Common stock issued for services                   | 20,000     | 58,600       | -           | -         | -           | -        | -              | 58,600       |
| Stock options issued for services                  | -          | -            | 9,310       | -         | -           | -        | -              | 9,310        |
| Share-based compensation - stock options           | -          | -            | 391,135     | -         | -           | -        | -              | 391,135      |
| Share-based compensation - restricted stock grants | -          | 42,314       | -           | -         | -           | -        | -              | 42,314       |
|                                                    | 1,259,589  | 919,929      | -           | -         | -           | -        | -              | 919,929      |



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|                         |            |              |             |           |             |     |                |             |
|-------------------------|------------|--------------|-------------|-----------|-------------|-----|----------------|-------------|
| Stock options exercised |            |              |             |           |             |     |                |             |
| Exercised warrants      | 36,000     | 18,000       | 9,971       | (36,000 ) | (9,971 )    | -   | -              | 18,000      |
| Canceled shares         | -          | -            | -           | -         | -           | -   | -              | -           |
| Balance, July 31, 2009  | 32,307,966 | \$38,498,904 | \$4,566,024 | 1,411,725 | \$2,501,682 | \$- | \$(38,500,175) | \$7,066,435 |

The accompanying notes are an integral part of the consolidated financial statements

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

This summary of significant accounting policies of PURE Bioscience is presented to assist in understanding the Company's financial statements. The financial statements and notes are representations of the Company's management, who are responsible for their integrity and objectivity. These accounting policies conform to U.S. Generally Accepted Accounting Principles ("GAAP") and have been consistently applied in the preparation of the financial statements.

Organization and Business Activity

PURE Bioscience (sometimes referred to herein as the "Company" or "we") was incorporated in the state of California on August 24, 1992. We began as a provider of pharmaceutical water purification products for the pharmacy market. In 2000, we began investing in the development of novel bioscience technologies and since the May 2005 sale of our Water Treatment Division we have been exclusively focused on the development and commercialization of our current and future bioscience products. The accompanying financial statements include the consolidated accounts of PURE Bioscience and its subsidiary, ETIH2O Corporation, a Nevada corporation.

Basis of Presentation and Principles of Consolidation

The accompanying financial statements include the consolidated accounts of PURE Bioscience and its subsidiary, ETIH2O Corporation, a Nevada corporation. All inter-company balances and transactions have been eliminated.

Use of Estimates

The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The results of operations for the year ended July 31, 2009 ("Fiscal 2009"), are not necessarily indicative of the results of operations for future periods.

Reclassifications

Certain comparative figures for prior periods have been reclassified. Specifically, in our Annual Report for the year ended July 31, 2007 ("Fiscal 2007"), we reported a net use of cash of \$708,058 for short-term investments, on the face of the Consolidated Statements of Cash Flows for Fiscal 2007. On the face of the Consolidated Statements of Cash Flows for the Fiscal 2007 presented herein, we have reported net cash used for the purchase of short-term investments of \$2,488,981; and net cash received from the sale of short-term investments of \$1,780,923. The net cash used for the purchases and sales (\$2,488,981 less \$1,780,923) is equal to the \$708,058 previously reported.

Concentration of Credit Risk

As of July 31, 2009 all cash deposits and short-term investments were invested in either U.S. FDIC insured bank accounts; institutional money market mutual funds investing in A-1 (S&P) or Prime-1 (Moody's); U.S. Treasury Securities, or United States Government obligations issued by or backed by a federal agency of the United States Government. \$3,098,900 of our cash and cash equivalents were maintained at three separate major financial institutions in the United States in accounts that are insured by the Federal Deposit Insurance Corporation ("FDIC") up to \$100,000. Effective October 3, 2008, the Emergency Economic Stabilization Act of 2008 raised the FDIC deposit coverage limits to \$250,000 per owner from \$100,000 per owner. The enhanced limits are currently available through December 31, 2009.

Also at July 31, 2009, \$1,114,800 of our cash and cash equivalents were held in accounts maintained at two separate major financial institutions in the United States that are provided with up to \$500,000 in protection by the Securities Investor Protection Corporation (“SIPC”) should such a firm close due to bankruptcy or other financial difficulties and customer assets are missing.

At July 31, 2009 we had no short-term investments. During Fiscal 2009, our short-term investments, which were all converted to cash and cash equivalents during the year, were invested in U.S. Treasury Bills with maturities of less than 360 days, and were held at a major financial institution in the United States. These assets were provided with up to \$500,000 in protection by the SIPC.

We have not experienced any losses in our cash, cash equivalents and short-term investments and believe we are not exposed to any significant credit risk. At times, deposits held may exceed the amount of insurance provided by the FDIC or SIPC. Generally, these deposits may be redeemed upon demand and, therefore, are believed to bear low risk.

Other financial instruments that potentially subject us to concentrations of credit risk consist of accounts receivable. We extend credit to our customers based on credit evaluations and past payment performance, but do not obtain collateral to secure our accounts receivable.

#### Revenue Recognition

During the periods presented herein our product revenue was derived from the sale of silver dihydrogen citrate (“SDC”) concentrate and the sale of finished packaged products containing SDC. We recognize revenue from sales of these products under the provisions of Staff Accounting Bulletin No. 104, Revenue Recognition, which is generally when we ship the products free on board from either our facility or from third party packagers, we have transferred title to the goods, and we have eliminated our risk of loss.

Any amounts received prior to satisfying our revenue recognition criteria are recorded as deferred revenue in the accompanying consolidated balance sheets. See Note 2 for further information regarding our licensing revenues and amounts previously recorded as deferred revenue in the consolidated balance sheets.

## Cost of Goods Sold

Cost of goods sold for product sales includes direct and indirect costs to manufacture products, including materials consumed, manufacturing overheads, shipping costs, salaries, benefits and related expenses of operations. Cost of goods sold related to licensing revenues recorded in Fiscal 2009 was zero, as we did not incur any costs directly related to our commitments under the agreement to allow a third party a limited time period to exclusively evaluate our SDC technology.

## Accounts Receivable

Trade accounts receivable are recorded net of allowances for doubtful accounts. Estimates of allowances for doubtful accounts are determined based on payment history and individual customer circumstances.

## Intangible Assets / Long-Lived Assets

Our intangible assets primarily consist of the worldwide patent portfolio of our silver ion technologies. Outside legal costs and filing fees related to obtaining patents are capitalized as incurred. The total amounts capitalized for pending patents was \$100,270 and \$125,108 in Fiscal 2009, and in the year ended July 31, 2008 (“Fiscal 2008”), respectively. Patents are stated net of accumulated amortization of \$1,252,225 and \$1,080,265 at July 31, 2009 and July 31, 2008 respectively.

The cumulative cost of acquiring patents is amortized on a straight-line basis over the estimated remaining useful lives of the patents, generally between 17 and 20 years from the date of issuance. At July 31, 2009 the weighted average remaining amortization period for all patents was approximately 10.9 years. Amortization expense for Fiscal 2009, Fiscal 2008 and Fiscal 2007, was \$172,000, \$175,800, and \$164,500, respectively, and the estimated amortization expense over each of the next five years is as follows:

| Year Ended | Estimated    |
|------------|--------------|
| July 31    | Amortization |
| 2010       | \$ 177,000   |
| 2011       | \$ 183,000   |
| 2012       | \$ 188,000   |
| 2013       | \$ 194,000   |
| 2014       | \$ 200,000   |

In accordance with Statement of Financial Accounting Standards (“SFAS”) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, our long-lived assets and amortizable intangible assets are tested for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. We assess the recoverability of such assets by determining whether their carrying value can be recovered through undiscounted future operating cash flows, including our estimates of revenue driven by assumed market segment share and estimated costs. If impairment is indicated, we measure the amount of such impairment by comparing the fair value to the carrying value. During Fiscal 2009, Fiscal 2008 and Fiscal 2007, we recorded impairment charges of zero, \$109,286, and zero, respectively. See Note 11 for more information regarding the impairment charge recorded in Fiscal 2008.

## Accounting for Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (“FASB”) revised SFAS 123(R), Share-Based Payment, which establishes accounting for share-based awards exchanged for employee and director services and requires us to expense the estimated fair value of these awards over the applicable service period. Under SFAS No. 123(R), share-based compensation cost is measured at the grant date based on the estimated fair value of the award, and is

recognized as expense over the applicable service period. We do not have, and have not had during Fiscal 2009, Fiscal 2008 or Fiscal 2007, any stock option awards with market or performance conditions.

We adopted the accounting provisions of SFAS No. 123(R) effective August 1, 2006, using the modified prospective application. Under the modified prospective application, prior fiscal periods are not revised for comparative purposes. Prior to August 1, 2006, we followed Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, as amended, in our accounting for share-based compensation. The valuation provisions of SFAS No. 123(R) apply to awards that were outstanding on August 1, 2006 and were or are subsequently modified or cancelled, and to awards made subsequent to August 1, 2006.

#### Stock Options to Non-Employees

Charges for stock options granted to non-employees have been determined in accordance with SFAS No. 123(R) and EITF No. 96-18, Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services, whereby we use the estimated fair value of the stock options issued, based on the Black-Scholes Option Pricing Model. For such stock options, during Fiscal 2009 we recorded \$1,149 in selling expense and \$8,161 in research and development expense; during Fiscal 2008 we recorded \$192,550 in selling expense and \$13,011 in research and development expense; and during Fiscal 2007 we recorded \$346,873 in selling expense, \$91,290 in general and administrative expense, and \$39,032 in research and development expense.

#### Depreciation Method

The cost of property, plant and equipment is depreciated on a straight-line basis over the estimated useful lives of the related assets. The useful lives of property, plant, and equipment for purposes of computing depreciation are:

|                         |           |
|-------------------------|-----------|
| Computers and equipment | 7.0 years |
| Computer Software       | 5.0 years |
| Furniture and Fixtures  | 10.0      |
|                         | years     |
| Leasehold Improvements  | 4.5 years |

All capitalized costs associated with leasehold improvements are depreciated over the remaining life of the lease. See Note 7 for details of the current lease term of our facility.

### Shipping and Handling Costs

Shipping and handling costs payable by us are charged to cost of sales.

### Inventory

Inventories are stated at the lower of cost or net realizable value using the average cost method. See Note 5 for further information regarding our inventory and its valuation.

### Cash, Cash Equivalents and Short-term Investments

We consider all liquid investments with maturities of ninety days or less when purchased to be cash equivalents. Our short-term investments have maturities of greater than ninety days from the date of purchase. We classify securities as “available-for-sale” in accordance with SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, and carry these investments at fair value with any unrealized gains and losses reported as a component of shareholders’ equity on the consolidated balance sheets and in the statements of shareholders’ equity. At July 31, 2009 we had no short-term investments. All of our short-term investments as of July 31, 2008 were carried at fair value, based upon market prices quoted on the last day of the fiscal period, and were considered available for sale. We use the specific identification method to determine the cost of debt securities sold, and include gross realized gains and losses in investment income. Realized gains recorded for Fiscal 2009, Fiscal 2008, and Fiscal 2007 were \$57,992, \$124,181, and zero respectively. All interest and dividends received from short-term investments are included in interest income.

In future periods we may need to seek additional capital through the issuance of debt, equity, convertible securities or through other means, any one of which could reduce the value to us, perhaps substantially, of our technology and its commercial potential. We currently have no long-term debt, however the issuance of debt, equity or convertible securities in future periods, if any, could lead to the dilution of our existing shareholders. There is no guarantee that we would be able to obtain capital on terms acceptable to us, or at all. Insufficient funds could cause us to fail to execute our business plan, fail to take advantage of future opportunities, or fail to respond to competitive pressures or unanticipated customer requirements, and further may require us to delay, scale back or eliminate some or all of our research and product development programs, license to third parties the right to commercialize products or technologies that we would otherwise commercialize ourselves, or to reduce or cease operations.

### Comprehensive Income

SFAS 130, Reporting Comprehensive Income, requires us to display comprehensive income or loss and its components as part of our consolidated financial statements. Our comprehensive loss includes our net loss and certain changes in equity that are excluded from our net loss, including unrealized holding gains and losses on available-for-sale securities. SFAS 130 requires such changes in shareholders’ equity to be included in accumulated other comprehensive income or loss. For Fiscal 2009, 2008 and 2007, our comprehensive loss was \$7,085,905, \$6,521,731, and \$4,654,877, respectively, and included unrealized holding gains on available-for-sale securities at the end of the periods of zero, \$18,588, and zero, respectively. During Fiscal 2007, we had no realized gains or losses on available for sale securities.

### Fair Value of Financial Instruments

The carrying amounts for receivables and payables are the approximate fair value because of their short maturity, generally less than three months. Whenever shares are issued for services, we use market prices of our common stock to estimate the fair value of the shares issued. Whenever options or warrants are issued for services, we use the Black Scholes Option Pricing Model to estimate the fair value of the equity instrument, using historical market prices of our common stock and prevailing risk-free interest rates.

### Advertising and Promotional Costs

The cost of advertising and promotion is expensed as incurred.

### Net Loss Per Common Share

In accordance with FASB Statement No. 128, Earnings Per Share (“SFAS 128”), we compute basic loss per share by dividing the applicable net loss by the weighted average number of common shares outstanding during the respective period. Diluted per share amounts assume the conversion, exercise or issuance of all potential common stock equivalents, including stock options and warrants, unless the effect is to reduce a loss or increase the income per common share from continuing operations. As we incurred losses in Fiscal 2009, Fiscal 2008 and Fiscal 2007, we did not include common stock equivalent shares of 7,673,741, 8,322,798, and 10,685,448, respectively, in the computation of net loss per share as the effect would have been anti-dilutive. Therefore, both the basic and diluted loss per common share for Fiscal 2009, Fiscal 2008 and Fiscal 2007 are based on the weighted average number of shares of our common stock outstanding during the periods.

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The following is a reconciliation of the weighted average number of shares actually outstanding with the number of shares used in the computations of loss per common share:

|                                                               | For the Years Ended |                  |                  |
|---------------------------------------------------------------|---------------------|------------------|------------------|
|                                                               | July 31,<br>2009    | July 31,<br>2008 | July 31,<br>2007 |
| Shares outstanding                                            | 32,307,966          | 29,573,936       | 24,961,805       |
| Weighted average number of common shares actually outstanding | 30,595,299          | 27,553,215       | 24,432,905       |
| Stock options                                                 | 6,175,216           | 7,442,447        | 10,293,750       |
| Restricted stock                                              | 86,800              | -                | -                |
| Warrants                                                      | 1,411,725           | 880,351          | 391,698          |
| Total weighted average shares                                 | 38,269,040          | 35,876,013       | 35,118,353       |
| Net loss                                                      | \$(7,067,317 )      | \$(6,540,319 )   | \$(4,654,877 )   |
| Net loss per common share, basic and diluted                  | \$(0.23 )           | \$(0.24 )        | \$(0.19 )        |

### Income Taxes

We record deferred taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." The Statement requires recognition of deferred tax assets and liabilities for temporary differences between the tax basis of assets and liabilities and the amounts at which they are carried in the financial statements, based upon the enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

### Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 157, Fair Value Measurements, which provides a single definition of fair value, a framework for measuring fair value, and expanded disclosures concerning fair value. Previously, different definitions of fair value were contained in various accounting pronouncements creating inconsistencies in measurement and disclosures. SFAS No. 157 applies under those previously issued pronouncements that prescribe fair value as the relevant measure of value, except Statement No. 123R and related interpretations and pronouncements that require or permit measurement similar to fair value but are not intended to measure fair value. In February 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. FAS 157-2, "Effective Date of FASB Statement No. 157," which provides a one year deferral of the effective date of FAS 157 for non-financial assets and non-financial liabilities to years beginning after November 15, 2008 (our fiscal year ending July 31, 2010). As a result, we are only partially adopting SFAS No. 157 as it relates to our financial assets and liabilities until we are required to apply this pronouncement to our non-financial assets and liabilities beginning with the fiscal year ending July 31, 2010.

In February 2007, the FASB issued SFAS 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 SFAS No. 159 are elective, however the amendment to SFAS 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 SFAS No. 159 permits all entities to choose to measure eligible items at fair value at specified election dates. Under SFAS No. 159, we would report unrealized gains and losses on items for which the fair value option has been elected in 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. This statement became



effective for us on August 1, 2008, however we did not elect the fair value option for any of our financial assets or financial liabilities.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (“SFAS 141R”). SFAS 141R replaces SFAS No. 141, Business Combinations and requires an acquirer in a business combination to recognize the assets acquired, the liabilities assumed, including those arising from contractual contingencies, any contingent consideration, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions specified in SFAS 141R. SFAS 141R also amends SFAS No. 109, Accounting for Income Taxes, and SFAS 142, Goodwill and Other Intangible Assets. SFAS 141R applies prospectively to business combinations, if any, for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). In April 2009, the FASB issued SFAS 141(R)-1, Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies, which amends the accounting prescribed in SFAS 141(R) for assets and liabilities arising from contingencies in business combinations. SFAS 141(R)-1 requires pre-acquisition contingencies to be recognized at fair value if fair value can be reasonably determined during the measurement period. If fair value cannot be reasonably determined, SFAS 141(R)-1 requires measurement based on the recognition and measurement criteria of SFAS 5, Accounting for Contingencies. The adoption of the provisions of SFAS 141R or SFAS 141(R)-1 did not have a material effect on our financial condition, results of operations or cash flows for Fiscal 2009.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, Non-controlling Interests in Consolidated Financial Statements (“SFAS 160”). SFAS 160 amends Accounting Research Bulletin 51, Consolidated Financial Statements, to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It also clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 also changes the way the consolidated income statement is presented by requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the non-controlling interest. It also requires disclosure, on the face of the consolidated statement of income, of the amounts of consolidated net income attributable to the parent and to the non-controlling interest. SFAS 160 requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated and requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent owners and the interests of the non-controlling owners of a subsidiary. SFAS 160 is effective for fiscal periods, and interim periods within those fiscal years, beginning on or after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the adoption of the provisions of SFAS No. 160 to have a material effect on our financial condition, results of operations or cash flows.

In April 2008, the FASB issued FSP No. FAS 142-3, Determination of the Useful Life of Intangible Assets. FSP No. FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, “Goodwill and Other Intangible Assets.” The intent of the position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R, and other U.S. generally accepted accounting principles. The provisions of FSP No. FAS 142-3 are effective for fiscal years beginning after December 15, 2008 (our fiscal year ending July 31, 2010). We are currently evaluating the impact, if any, that the adoption of FSP No. FAS 142-3 could have on our consolidated financial statements or results of operations.

In June 2008, the FASB ratified Emerging Issue Task Force (“EITF”) 07-5, Determining Whether an Instrument (or an Embedded Feature) is Indexed to an Entity’s Own Stock (“EITF 07-5”). EITF 07-5 provides a framework for determining whether an instrument is indexed to an entity’s own stock, including evaluating the instrument’s contingent exercise and settlement provisions. EITF 07-5 is effective for fiscal years beginning after December 15, 2008 (our fiscal year ending July 31, 2010). We do not currently expect the implementation of EITF 07-5 to have a material impact on our consolidated financial statements.

In October 2008, the FASB issued FSP No. FAS 157-3, Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active (“FSP FAS 157-3”), which clarifies the application of SFAS 157 in an inactive market. Additional guidance is provided regarding how a reporting entity’s own assumptions should be considered when relevant observable inputs do not exist, how available observable inputs in a market that is not active should be considered when measuring fair value, and how the use of market quotes should be considered when assessing the relevance of inputs available to measure fair value. FSP FAS 157-3 became effective immediately upon issuance. Its adoption did not impact our consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly (“FSP 157-4”). Based on the guidance, if an entity determines that the level of activity for an asset or liability has significantly decreased and that a transaction is not orderly, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value in accordance with FASB Statement of Financial Accounting Standards No. 157, Fair Value Measurements (“SFAS 157”). FSP 157-4 is to be applied prospectively and became effective for us as of Fiscal 2009. The adoption of FSP 157-4 did not have an impact on the Company’s consolidated results or financial condition.

In April 2009, the FASB issued FSP FAS 107-2 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (“FSP FAS 107-2 and FSP APB 28-1”). FSP FAS 107-2 amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value and the related carrying amount of financial instruments in interim and annual periods. FSP APB 28-1 amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. FSP FAS 107-2 and FSP APB 28-1 also require disclosure about the method and significant assumptions used to estimate the fair value of financial instruments. FAS FSP 107-2 and FSP APB 28-1 became effective for us as of Fiscal 2009. Their adoption did not impact our consolidated financial statements.

In April 2009, the FASB issued FASB Staff Positions FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (“FSP 115-2 and 124-2”), which amend the other-than-temporary guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. FSP 115-2 and 124-2 became effective for us as of Fiscal 2009. Their adoption did not impact our consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (“SFAS 165”). SFAS 165 provides rules on recognition and disclosure for events and transactions occurring after the balance sheet date but before the financial statements are issued or available to be issued. In addition, SFAS 165 requires a reporting entity to disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements are issued or the date the financial statements are available to be issued. SFAS 165 is effective for interim and annual periods ending after June 15, 2009. We have adopted SFAS 165 and have included the required additional disclosures in Note 17.

In June 2009, the FASB issued FAS No. 167, Amendments to FASB Interpretation No. 46(R) (“FAS 167”). FAS 167 amends FIN 46(R), Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51, to require an issuer to perform an analysis to determine whether the issuer’s variable interest or interests give it a controlling financial interest in a variable interest entity, if any. This analysis identifies the primary beneficiary of a

variable interest entity as one with the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and the obligation to absorb losses of the entity that could potentially be significant to the variable interest. FAS 167 will be effective as of the beginning of the annual reporting period commencing after November 15, 2009 (our fiscal quarter ending October 31, 2010). We will assess the potential impact, if any, of the adoption of FAS 167 on our consolidated financial statements.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles ("SFAS 168"). SFAS 168 will become the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. On the effective date of this statement, the codification will supersede all then existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the codification will become non-authoritative. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009 (our fiscal quarter ended October 31, 2009). We do not currently expect the adoption of SFAS 168 to have a material impact on our financial condition, results of operations or cash flows.

#### Note 2. Deferred Revenue

Any amounts received prior to satisfying our revenue recognition criteria are recorded as deferred revenue in the consolidated balance sheets. During Fiscal 2008 we recorded deferred revenue on receipt of a non-refundable fee of \$250,000 which we received subject to an agreement whereby we allowed a third party a limited time period to exclusively evaluate our SDC technology for use within specified indications and for certain products. Upon the termination of the agreement in January 2009, we recognized the \$250,000 as licensing revenue in the consolidated statements of operations for Fiscal 2009.

### Note 3. Accounts Receivable

Trade accounts receivable are recorded net of allowances for doubtful accounts. Estimates for allowances for doubtful accounts are determined based on payment history and individual customer circumstances. The allowance for doubtful accounts was zero at July 31, 2009, and 2008, respectively.

During Fiscal 2008 we granted non-exclusive distribution and blending rights to a new distributor for the sale of SDC-based products in Colombia. In addition, we granted non-exclusive distribution and blending rights to a second distributor, which is affiliated with the first distributor, for the sale of SDC-based products in Argentina, Venezuela, Panama and Costa Rica. The invoiced total for both distributors was \$781,600. The \$781,600 receivable included \$57,000 for amounts billed at cost to the distributors in August 2008 for parts shipped directly to them by one of our U.S. packaging suppliers. Subsequent to this transaction, we have not sold any products to either of the two referenced distributors.

During the three month period ended January 31, 2009 we determined these accounts to be delinquent, established a full reserve and recorded \$781,600 as bad debt expense, within general and administrative expense. At July 31, 2009 the referenced amounts remained uncollected; and we have written off the full receivable of \$781,600.

Management currently considers all other accounts receivable to be fully collectible.

### Note 4. Research and Development

All in-house Research and Development (“R&D”) costs, and outside legal costs and filing fees for maintaining issued patents are charged to operations when incurred and are included in operating expenses.

### Note 5. Inventory

Inventories are stated at the lower of cost or net realizable value using the weighted average cost method. Inventories at July 31, 2009 and 2008 consisted of:

|                  | 2009       | 2008       |
|------------------|------------|------------|
| Raw Materials    | \$ 194,652 | \$ 252,491 |
| Work in Progress | -          | -          |
| Finished Goods   | 227,003    | 117,552    |
|                  | \$ 421,655 | \$ 370,043 |

Included in our inventory of finished goods as of July 31, 2009 are approximately 12,000 gallons of SDC concentrate that we purchased from an unrelated third party in a lien sale. During the fourth quarter of Fiscal 2009 we were advised that YRC Logistics Global, LLC (“YRC”), a global logistics company based in the United States, was warehousing this SDC concentrate on behalf of one of our international distributors, in addition to fixed assets that the distributor had ordered from multiple U.S. manufacturers. As YRC had not been paid for either warehousing or shipping costs, they placed a lien on the SDC and fixed assets and conducted a public lien sale in June 2009. We purchased the concentrate and assets in the lien sale for \$28,191. \$26,267 of this amount was attributable to the SDC concentrate and \$1,924 to the fixed assets. With the addition of \$1,200 in costs to ship the SDC to our facility, we added \$27,467 to the value of our SDC concentrate inventory for the addition of the approximately 12,000 gallons. This transaction had no impact on our consolidated statements of operations for Fiscal 2009, however it is expected to temporarily reduce our cost of goods sold per gallon of SDC concentrate sold in future periods.

### Note 6. Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. All improvements and additions that extend the life of existing assets are capitalized. The cost of maintenance and repairs that do not extend or improve the asset are expensed as incurred. The following is a summary of property, plant, and equipment – at cost less accumulated depreciation:

|                                | July 31,<br>2009 | July 31,<br>2008 |
|--------------------------------|------------------|------------------|
| Computers and equipment        | \$ 800,947       | \$ 782,480       |
| Furniture and fixtures         | 18,034           | 30,566           |
| Leasehold improvements         | 605,883          | 604,436          |
|                                | 1,424,864        | 1,417,482        |
| Less: accumulated depreciation | 568,360          | 382,647          |
| Total                          | \$ 856,504       | \$ 1,034,835     |

Total depreciation expense for Fiscal 2009, Fiscal 2008 and Fiscal 2007 was \$275,322, \$229,930, and \$92,600, respectively.

Note 7. Commitments and Contingencies, and Legal Proceedings

In September 2006, we entered into a sixty month operating lease agreement for our office and manufacturing location in El Cajon, California. In April 2008, we amended our operating lease to include an additional 1,812 square feet, resulting in a total area of 14,879 square feet. Rental expense recorded in general and administrative expenses for Fiscal 2009, Fiscal 2008 and Fiscal 2007 was \$210,400, \$185,300, and \$173,300, respectively. Future minimum rental payments under the lease for each of the four fiscal years, excluding variable and therefore currently unknown costs for the maintenance of common areas, are as follows:

| Year<br>Ended<br>July 31 | Amount     |
|--------------------------|------------|
| 2010                     | \$ 178,300 |
| 2011                     | \$ 185,400 |
| 2012                     | \$ 78,500  |
| 2013                     | \$ -       |
|                          | \$ 442,200 |

During Fiscal 2008 we issued 12,500 shares of our common stock with a fair value of \$43,750 and paid an additional \$135,000 for two legal settlements. During Fiscal 2007 we received approximately \$205,000 in proceeds from legal settlements and recorded this amount as "Other" within "Other income and (expense)" in the consolidated statements of operations for Fiscal 2007. We have been awarded other amounts in arbitration proceedings related to the ownership of, and trade secrets related to, our SDC technology. We believe it is unlikely that we will ever be able to collect any part of such awards and we have therefore not recorded any amounts as assets on the consolidated balance sheets as at July 31, 2008 or 2009.

#### Note 8. Sales of Common Stock

On May 28, 2009 we closed a registered direct offering whereby we sold \$3 million of our common stock and warrants to institutional investors. A shelf registration statement relating to the securities sold in the offering was declared effective by the Securities and Exchange Commission on May 8, 2009.

Under the terms of the offering, we issued to the investors 1,418,441 shares of common stock, and warrants to purchase 496,452 shares of our common stock. The common stock was sold at a price of \$2.115 per share, and the investors received warrants to purchase 0.35 shares of common stock at an exercise price of \$2.37 per share for each share of common stock they purchased in the offering. The fair value of the investor warrants, based on their fair value relative to the common stock issued, was \$652,694 (based on the Black-Scholes Option Pricing Model assuming no dividend yield, volatility of 155.86%, and a risk-free interest rate of 2.16%). The warrants were exercisable as of May 27, 2009 and will expire five years from that date. In addition we paid a fee of \$180,000 to Axiom Capital Management, Inc. ("Axiom") in consideration for its services as the placement agent in the offering. We also issued to Axiom and its principals, warrants to purchase 70,922 shares of our common stock at an exercise price of \$2.64 per share. The fair value of the warrants issued to Axiom, based on their fair value relative to the common stock issued, was \$92,800 (based on the Black-Scholes Option Pricing Model assuming no dividend yield, volatility of 155.86%, and a risk-free interest rate of 2.16%). These warrants were exercisable as of May 27, 2009 and will expire five years from that date.

After fees and expenses, the net proceeds of the offering to us were \$2,769,478. The net proceeds from the offering will be used for working capital.

See Note 16 for information regarding sales of common stock subsequent to July 31, 2009.

#### Note 9. Other Equity and Common Stock Transactions

We paid no cash dividends during any of the periods presented, and have never paid cash dividends.

In August 2008, we received an aggregate of \$150,000 from the exercise of non-employee options to purchase 50,000 shares of our common stock at an exercise price of \$3.00, and received \$15,079 from the exercise of options to purchase 28,450 shares of our common stock by two officers, at an average exercise price of \$0.53.

In September 2008, we entered into a one year consulting agreement with an independent third party for intellectual property legal services, the compensation being a fee of \$11,000 per month and an option to purchase 25,000 shares of our common stock which vests in equal increments bi-annually over a two year period. The options, which have an exercise price of \$4.41, were valued at \$59,745 (based on the Black-Scholes Option Pricing Model, assuming no dividend yield, volatility of 103.18% and a risk free interest rate of 2.00%). During Fiscal 2009 we expensed \$8,161 of the options fair value to research and development. The options will be revalued quarterly until fully vested with any change to fair value expensed.

In October 2008, we issued 10,000 shares in exchange for consulting services, valued at \$24,600 based on the market price of \$2.46 per share. In addition, there was a net exercise by one of our directors of 165,000 options that resulted

in the issuance of 133,430 shares of our common stock. Furthermore, during the three months ended October 31, 2008 we recorded \$57,412 of employee stock option expense.

In December 2008, we received \$631,600 from the exercise of options to purchase 339,800 shares of our common stock by one of our directors, at an average exercise price of \$1.86. In the same month, there were net exercises by two of our officers on 444,531 options that resulted in the issuance of 371,583 shares of our common stock.

In January 2009, we received \$79,500 from a director for the exercise of options to purchase 150,000 shares of our common stock at an exercise price of \$0.53; and received \$18,000 from the same director for the exercise of common stock warrants to purchase 36,000 shares of our common stock at an exercise price of \$0.50. Furthermore, we issued 10,000 shares in exchange for consulting services, valued at \$34,000. During the three month period ended January 31, 2009 we recorded \$64,032 of employee stock option expense.

During the three month period ended April 30, 2009 there was a net exercise by one of our directors of 150,000 options that resulted in the issuance of 106,126 shares of our common stock. During the three month period, we also recorded \$96,677 of employee stock option expense.

In May 2009, we issued options to purchase an aggregate of 360,000 shares of our common stock, to our three executive officers. These options have a five year term and vest annually in equal increments over four years. The options, which have an exercise price of \$2.34, were valued at \$734,301 (based on the Black-Scholes Option Pricing Model assuming no dividend yield, volatility of 155.42%, and a risk free interest rate of 1.65%). Additionally, in the same month we granted 86,800 shares of restricted stock to four of our directors, and a five year option to purchase 30,000 shares of common stock at an exercise price of \$2.34 per share, to one of our directors. Both stock and options vest after one year. The 86,800 restricted shares were valued at \$203,112 or \$2.34 per share (based on the prevailing market price of our common stock on the date of grant), while the options were valued at \$56,082 (based on the Black Scholes Option Pricing Model assuming no dividend yield, volatility of 145.97%, and a risk free interest rate of 1.65%). The stock options and stock granted to directors and officers in May 2009 were issued under the 2007 Equity Incentive Plan.

In June 2009, there was a net exercise of 50,000 options that resulted in the issuance of 37,700 shares of our common stock. In addition, we received \$19,000 from the exercise of options to purchase 27,500 shares of our common stock issued under employee stock options plans.

In July 2009, we entered into a one year agreement with two independent third party consultants who joined our Advisory Panel. Each consultant was issued an option to purchase 25,000 shares of common stock. The options have a two year term and vest in bi-annual increments over one year. The options, which have an exercise price of \$1.66, were valued at \$27,571 (based on the Black-Scholes Option Pricing Model, assuming no dividend yield, volatility of 99.11% and a risk free interest rate of 0.46%). The options will be revalued quarterly until fully vested with any change to fair value expensed. In addition, during the three month period ended July 31, 2009 we received \$19,000 from the exercise of options to purchase 27,500 shares of common stock issued under employee purchase plans; received \$24,750 from the exercise of options to purchase 15,000 shares of common stock issued in prior periods for consulting services; and recorded \$215,326 of expense for stock and options issued to employees, officers, and directors.

At July 31, 2009, we had outstanding warrants to purchase 1,411,725 shares of our common stock with exercise prices ranging from \$2.37 to \$8.60. These warrants expire at various times between March 2011 and May 2014. See Note 16 for information regarding warrants issued subsequent to July 31, 2009.

#### Note 10. Stock-Based Compensation

We have, or have had during the fiscal years presented herein, the following equity incentive plans (the Plans) pursuant to which options to acquire common stock have been granted:

**1998 Directors And Officers Stock Option Plan:** In December 1998, the Company's shareholders approved the Amended PURE Bioscience 1998 Officers and Directors Stock Option Plan.

**2001 Directors And Officers Stock Option Plan:** In January 2001, the Company's shareholders approved the PURE Bioscience 2001 Officers and Directors Stock Option Plan.

**2001 ETIH2O Stock Option Plan:** Adopted by the Board in January 2001, there are 1,000,000 shares authorized under this Plan. Executive Officers and Directors are not eligible participants under this plan.

**2001 Consultants and Advisors Stock Option Plan:** Adopted by the Board in January 2001, there are 500,000 shares authorized under this Plan. Executive officers and directors are not eligible participants under this plan.

**2002 Non-Qualified Stock Option Plan:** In March 2002, the Company's shareholders approved the PURE Bioscience 2002 Non-Qualified Stock Option Plan. Eligible plan participants include the directors and officers of the Company, consultants, advisors and other individuals deemed by the Compensation Committee to provide valuable services to



the Company but who are not otherwise eligible to participate in the Employee Incentive Stock Option Plan.

**2002 Employee Incentive Stock Option Plan:** In March 2002, the Company's shareholders approved the PURE Bioscience 2002 Employee Incentive Stock Option Plan. Eligible plan participants include employees and non-employee directors of the Company.

**2004 Consultants and Advisors Stock Option Plan:** Adopted by the Board in April 2004, there are 2,000,000 shares authorized under this plan. Executive officers and directors are not eligible participants under this plan.

**2007 Equity Incentive Plan:** Approved by the Company's shareholders in April 2007, the 2007 Equity Incentive Plan has a share reserve of 5,000,000 shares of common stock, which were registered under a Form S-8 filed with the SEC in May 2007. The Plan provides for the grant of incentive and nonstatutory stock options as well as stock appreciation rights, common stock awards, restricted stock units, performance units and shares and other stock-based awards. During Fiscal 2007 common stock options and common stock awards were granted under this Plan. Eligible plan participants include employees, directors and consultants of the Company, although incentive stock options generally may be granted only to employees.

Non-employee directors are eligible to receive stock option or other incentive grants under the Company's 1998 and 2001 Directors and Officers Stock Option Plans, the 2002 Non-Qualified and Employee/Incentive Stock Option Plan, and the 2007 Equity Incentive Plan. Employee directors are eligible to receive stock option or other incentive grants under the Company's 1998 and 2001 Directors and Officers Stock Option Plans, the 2002 Non-Qualified Stock Option Plan, and the 2007 Equity Incentive Plan.

The Plans are administered by the Compensation Committee of the Board (the “Compensation Committee”). The exercise price for stock options, or the value of other incentive grants granted under the Plans, are set by the Compensation Committee but may not be for less than the fair market value of the shares on the date the award is granted. Fair market value is defined under the Plans as being the average of the closing price for a specified number of consecutive trading days ending on the day prior to the date the option or other award is granted. The period in which options can be exercised is set by the Compensation Committee but is not to exceed five years from the date of grant. Options granted to new executive officers or directors vest one year from date of appointment or election. Options granted to continuing officers or directors are immediately exercisable and vest upon exercise.

On August 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards (“SFAS”) No. 123 (revised 2004), Share-Based Payment (“SFAS123(R)”), requiring us to recognize expense related to the fair value of share-based compensation awards to employees and directors. We elected to use the modified-prospective-transition method as permitted by SFAS 123R and therefore have not restated our financial results for prior fiscal years. We recognize compensation expense for stock option awards on a straight-line basis over the applicable service period of the award. The service period is generally the vesting period, with the exception of options granted subject to a consulting agreement, whereby the option vesting period and the service period defined pursuant to the terms of the consulting agreement may be different. Share-based compensation expense for awards granted subsequent to July 31, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R, using the Black-Scholes option pricing model. The following methodology and assumptions were used to calculate share based compensation for Fiscal 2009 and Fiscal 2008:

|                                | For the years ended July 31 |                      |
|--------------------------------|-----------------------------|----------------------|
|                                | 2009                        | 2008                 |
| Expected price volatility      | 97.70% -<br>156.73 %        | 66.10% -<br>117.58 % |
| Risk-free interest rate        | 0.25 % -<br>2.00 %          | 2.00% - 5.25 %       |
| Expected rate of forfeiture    | 0.0 %                       | 0.0 %                |
| Expected dividend yield        | 0.0 %                       | 0.0 %                |
| Weighted average expected term | 3.4 years                   | 2.3 years            |

Expected price volatility is the measure by which our stock price is expected to fluctuate during the expected term of an option. Expected volatility is derived from the historical daily change in the market price of our common stock, as we believe that historical volatility is the best indicator of future volatility. For stock options granted subsequent to July 31, 2006, we have excluded the period prior to November 1, 2005 from our historical price volatility, as during this period our market price reflected significant uncertainty associated with both our arbitration proceedings against Falken Industries and our ability to close the sale of the assets of the Water Treatment Division. We believe that the volatility of the market price of our common stock during periods prior to November 1, 2005 is not reflective of future expected volatility.

Following the guidance of Staff Accounting Bulletin No. 107 (“SAB 107”), we have been following the “Simplified Method” to determine the expected term of “Plain Vanilla” options issued to employees and directors. All of our outstanding options granted to employees and directors are Plain Vanilla options. Under the Simplified Method, the expected term is presumed to be the mid-point between the vesting date and the end of the contractual term. In SAB 107, the Staff stated that it would not expect a company to use the Simplified Method for share option grants after December 31, 2007, however on December 21, 2007 the SEC published Staff Accounting Bulletin No. 110 (“SAB 110”), which expressed the views of the Staff regarding the continued use of a Simplified Method in certain circumstances where a company is unable to rely on historical data. We are unable to rely on our historical exercise data as there have been only a limited number of option exercises in recent periods; there have been a limited number of plan participants which is expected to grow; our common stock was traded until April 2008 on the illiquid Bulletin Board but our common stock is now listed on the NASDAQ Capital Market; we have had over recent years significant

trading blackout periods for employees and directors; there has been minimal employee and director turnover; we have recently changed the terms of employee stock option grants to reduce the term of such grants; there are no comparable companies in terms of size, location and industry (particularly as we are developing a platform technology and operate in multiple industries); and we have had significant structural changes in our business including the sale of the Water Treatment Division and abandonment of our Triglycylboride technology, and expect to continue to change in the foreseeable future. We are therefore, under the guidance of SAB 110, continuing to use the Simplified Method to determine the expected term of options issued to employees and directors, but will continually evaluate our historical data as a basis for determining the expected terms of such options.

Our estimation of the expected term for stock options granted to parties other than employees or directors is the contractual term of the option award.

For the purposes of estimating the fair value of stock option awards, the risk-free interest rate used in the Black-Scholes calculation is based on the prevailing U.S Treasury yield as determined by the U.S. Federal Reserve. We have never paid any cash dividends on our common stock and do not anticipate paying cash dividends on our common stock in the foreseeable future.

Stock-based compensation expense recognized in the consolidated statements of operations is based on awards ultimately expected to vest, reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant, and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Historically, we have not had significant forfeitures of unvested stock options granted to employees and directors. A significant number of our stock option grants are fully vested at issuance or have short vesting provisions. Therefore, we have estimated the forfeiture rate of our outstanding stock options as zero, but will continually evaluate our historical data as a basis for determining expected forfeitures.

The following table sets forth the share-based compensation expense recorded in our consolidated statements of operations for Fiscal 2009 and Fiscal 2008 resulting from share-based compensation awarded to our employees, directors and third party service providers:

|                                                                  | Fiscal 2009 | Fiscal 2008  |
|------------------------------------------------------------------|-------------|--------------|
| Share-based compensation for employees and directors:            |             |              |
| Selling expense                                                  | \$ 10,199   | \$ 98,784    |
| General and administrative expenses                              | 410,502     | 1,622,764    |
| Research and development                                         | 12,748      | 148,176      |
| Total share-based compensation for employees and directors       | 433,449     | 1,869,724    |
| Share-based compensation for third party service providers:      |             |              |
| Selling expense                                                  | \$ 1,149    | \$ 51,736    |
| General and administrative expenses                              | 58,600      | 43,750       |
| Research and development                                         | 8,161       | -            |
| Total share-based compensation for third party service providers | 67,910      | 95,486       |
| Total share-based compensation expense                           | \$ 501,359  | \$ 1,965,210 |

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A summary of stock option activity is as follows:

|                          | Number of<br>Shares | Weighted-Average<br>Exercise Price | Aggregate<br>Intrinsic Value<br>(\$000's) |
|--------------------------|---------------------|------------------------------------|-------------------------------------------|
| Balance at July 31, 2007 | 10,293,750          | \$1.18                             | \$22,500                                  |
| Granted                  | 593,300             | \$5.48                             |                                           |
| Exercised                | (2,761,053 )        | \$0.85                             |                                           |
| Forfeited / Cancelled    | (683,550 )          | \$1.41                             |                                           |
| Balance at July 31, 2008 | 7,442,447           | \$1.62                             | \$26,479                                  |
| Granted                  | 892,250             | \$2.42                             |                                           |
| Exercised                | (1,259,589 )        | \$1.00                             |                                           |
| Forfeited / Cancelled    | (899,892 )          | \$2.06                             |                                           |
| Balance at July 31, 2009 | 6,175,216           | \$1.80                             | \$3,836                                   |

| Range of<br>Exercise<br>Prices | Number of<br>Shares<br>Outstanding | Outstanding<br>Weighted<br>Average<br>Remaining<br>Contractual<br>Life (in<br>years) | Weighted<br>Average<br>Exercise<br>Price | Number of<br>Shares<br>Exercisable | Exercisable<br>Weighted<br>Average<br>Remaining<br>Contractual<br>Life (in<br>years) | Weighted<br>Average<br>Exercise<br>Price |
|--------------------------------|------------------------------------|--------------------------------------------------------------------------------------|------------------------------------------|------------------------------------|--------------------------------------------------------------------------------------|------------------------------------------|
| \$0.50 to<br>\$0.75            | 1,560,000                          | 0.78                                                                                 | \$0.53                                   | 1,560,000                          | 0.78                                                                                 | \$0.53                                   |
| \$0.80 to<br>\$1.20            | 711,666                            | 1.32                                                                                 | \$0.81                                   | 711,666                            | 1.32                                                                                 | \$0.81                                   |
| \$1.50 to<br>\$7.50            | 3,903,550                          | 2.48                                                                                 | \$2.48                                   | 3,006,225                          | 1.98                                                                                 | \$2.46                                   |
|                                | 6,175,216                          | 1.91                                                                                 | \$1.80                                   | 5,277,891                          | 1.54                                                                                 | \$1.67                                   |

Cash received from options and warrants exercised in Fiscal 2009, Fiscal 2008 and Fiscal 2007 was \$937,929, \$2,253,964 and \$475,190, respectively. During Fiscal 2009 there were net exercises of options to purchase 809,531 shares which resulted in the issuance of 648,839 shares of common stock. During Fiscal 2008 there were net exercises of options to purchase 250,000 shares which resulted in the issuance of 228,950 shares of common stock, and a net exercise of 88,500 warrants which resulted in the issuance of 60,982 shares of common stock. The intrinsic value of all options exercised during Fiscal 2009, Fiscal 2008 and Fiscal 2007 was \$2,096,641, \$12,874,047 and \$2,012,600, respectively. The weighted-average grant date fair value of equity options granted during Fiscal 2009, Fiscal 2008 and Fiscal 2007 was \$1.88, \$2.99 and \$1.45 respectively.

On March 10, 2008, Gary Brownell resigned as a director of PURE Bioscience in order to allow us to meet corporate governance standards which require that we have a majority of independent directors. On that date, our Board extended the post-termination exercise period applicable to 837,500 vested and outstanding stock options held by Mr. Brownell from three days following his resignation to September 10, 2008. We expensed \$23,040 to general and administrative expense during Fiscal 2008 based on this modification, in accordance with SFAS 123(R). There were no stock option modifications during Fiscal 2009.

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As of July 31, 2009, there was \$1,519,844 of unrecognized non-cash compensation cost related to unvested options, which will be recognized over a weighted average period of 3.2 years.

During the three month period ended July 31, 2009 we issued 86,800 shares of restricted stock to four of our independent directors. The restricted shares, valued at \$203,112, will be expensed over the one year vesting term. Prior to Fiscal 2009 all stock awards were immediately vested. A summary of restricted stock units issued during fiscal 2009 is as follows:

|                           | Number of<br>Shares |
|---------------------------|---------------------|
| Unvested at July 31, 2008 | -                   |
| Granted                   | 86,800              |
| Exercised                 | -                   |
| Forfeited / Cancelled     | -                   |
| Unvested at July 31, 2009 | 86,800              |

During Fiscal 2009 and Fiscal 2008, we recognized stock based compensation expense for restricted stock of \$42,314 and zero respectively. As of July 31, 2009, there was \$160,797 of unrecognized non-cash compensation cost related to unvested restricted shares, which will be recognized over a weighted average period 0.80 years.

### Note 11. Patent Impairment and Related Expenses

No impairment charges were recorded during Fiscal 2009.

In July 2008, we suspended the development and marketing efforts for our Triglycylboride boric acid-based pesticides in order to focus on the development of our SDC and related technologies. We concurrently wrote down the net unamortized balance of the capitalized patents associated with the Triglycylboride technology, which amounted to \$109,286, and the value of our remaining inventory of raw materials and finished goods, which amounted to \$33,063. We recorded the impairment charge of \$109,286 within operating expenses on the consolidated statements of operations for Fiscal 2008, and included the \$33,063 of remaining inventory of raw materials and finished goods within cost of goods sold for the same period.

### Note 12. Taxes

We file federal and California consolidated tax returns with our subsidiaries. Our income tax provision for each of Fiscal 2009 and 2008 was \$2,400, which is the minimum franchise tax we pay to the State of California regardless of income or loss.

At July 31, 2009, we had federal and California tax net operating loss carry-forwards of approximately \$50,009,800 and \$39,871,800, respectively. Included in these net operating loss carry-forward amounts is \$14,836,100 related to a deduction for income tax purposes for which the Company has not realized a tax benefit. In future periods an adjustment would be recorded to Additional Paid in Capital at the time that these net operating losses may be utilized and reduce income tax. At July 31, 2008, we had federal and California tax net operating loss carry-forwards of approximately \$40,888,600 and \$30,753,000, respectively. Utilization of the net operating loss carry-forwards may be subject to a substantial annual limitation due to ownership change limitations that may have occurred or that could occur in the future, as required by Section 382 of the Internal Revenue Code as well as similar state provisions. These ownership changes may limit the amount of net operating loss carry-forwards that can be utilized annually to offset future taxable income and tax, respectively. In general, an ownership change, as defined by Section 382 of the Internal Revenue Code results from a transaction or series of transactions over a three-year period resulting in an ownership change of more than 50 percentage points of the outstanding stock of a company by certain stockholders or public groups. Since the Company's formation, we have raised capital through the issuance of capital stock on several

occasions (both before and after our initial public offering in 1996) which, combined with the purchasing stockholders' subsequent disposition of those shares, may have resulted in such an ownership change, or could result in an ownership change in the future upon subsequent disposition. While the Company does not believe it has experienced an ownership change, the pertinent tax rules related thereto are complex and subject to varying interpretations, and thus complete assurance cannot be provided that the taxing authorities would not take an alternative position.

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Our federal tax loss carry-forwards will begin expiring in the year ending July 31, 2010 unless previously utilized, and will completely expire in the year ending July 31, 2028. Between July 31, 2010 and July 31, 2012, \$3,323,800 of our federal net operating loss carry-forwards will expire, and the balance of our current federal net operating loss carry-forwards will expire between July 31, 2018 and July 31, 2028. Our California tax loss carry-forwards will begin to expire in the year ending July 31, 2014, and will completely expire in the year ending July 31, 2029.

Significant components of our deferred tax assets are as follows:

|                                             | July 31, 2009 | July 31, 2008 |
|---------------------------------------------|---------------|---------------|
| Net operating loss carry-forward            | \$ 13,419,700 | \$ 10,735,700 |
| Stock options and warrants                  | 1,014,700     | 1,005,000     |
| Other temporary differences                 | (26,000 )     | (87,400 )     |
| Total deferred tax assets                   | 14,408,400    | 11,653,300    |
| Valuation allowance for deferred tax assets | (14,408,400)  | (11,653,300)  |
| Net deferred tax assets                     | \$ -          | \$ -          |

Realization of our deferred tax assets, which relate to operating loss carry-forwards and timing differences, is dependent on future earnings, among other factors. The timing and amount of future earnings are uncertain and therefore a valuation allowance has been established. The increase in the valuation allowance on the deferred tax asset during Fiscal 2009 was \$2,755,100.

A reconciliation of income taxes computed using the statutory income tax rate, compared to the effective tax rate, is as follows:

|                                                    | 2009     |   | 2008     |   |
|----------------------------------------------------|----------|---|----------|---|
| Federal tax benefit at the expected statutory rate | 0.34     | % | 0.34     | % |
| State income tax, net of federal tax benefit       | 5.80     |   | 5.80     |   |
| Other                                              | (0.80 )  |   | 1.00     |   |
| Valuation allowance                                | (39.00 ) |   | (40.80 ) |   |
| Income tax benefit – effective rate                | 0.00     | % | 0.00     | % |

In June 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48 (“FIN 48”), Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Under FIN 48, we recognize the tax benefit from a tax position if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position.

FIN 48 became effective for us on August 1, 2007, however the adoption of FIN 48 did not have a material impact on our consolidated results of operations and financial position as we had no unrecognized tax benefits that, if recognized, would have impacted our effective income tax rate in future periods. Our practice is to recognize interest and/or penalties related to income tax matters in income tax expense, however we had no accrued interest or penalties at either August 1, 2009 or July 31, 2008. We are subject to taxation in the United States and in California, and our historical tax years remain subject to future examination by the U.S. and California tax authorities.

The following table summarizes the activity related to our unrecognized tax benefits:

|                          |      |
|--------------------------|------|
| Balance at July 31, 2007 | None |
|                          | None |

|                                                                  |      |
|------------------------------------------------------------------|------|
| Increases related to current year tax positions                  |      |
| Expiration of statute of limitations for the assessment of taxes | None |
| Other                                                            | None |
| Balance at July 31, 2008                                         | None |
| Increases related to current year tax positions                  | None |
| Expiration of statute of limitations for the assessment of taxes | None |
| Balance at July 31, 2009                                         | None |

Note 13. Business Segment and Sales Concentrations

In accordance with the provisions of SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, certain information may be disclosed based on the way we organize financial information for making operating decisions and assessing performance. SFAS 131 requires that we apply standards based on a management approach, and requires segmentation based upon our internal organization and disclosure of revenue and operating income based upon internal accounting methods. In determining operating segments, we have reviewed the current management structure reporting to the chief operating decision-maker (“CODM”) and analyzed the reporting the CODM receives to allocate resources and measure performance.

We believe that based upon the end use of our products, the value added contributions made by us, the regulatory requirements, our customers and partners, and the strategy required to successfully market finished products, we are operating in a single segment.

Our customers are strategic partners who are developing markets for, and distributors who sell, products containing our SDC technology. During Fiscal 2009, 84% of product sales were made to five strategic partners that are also developing markets for our products. 98% of revenue from product sales for Fiscal 2009 was derived from sales made to U.S. domestic customers. During Fiscal 2008, 90% of product sales were made to five strategic partners, and 33% of revenue from product sales for the year was derived from sales made to U.S. domestic customers.

In some cases we have, or may have in future periods, distributors or strategic partners to whom we have granted rights to sell our technology in multiple countries. Generally, we do not require such distributors to report to us the quantities of products that they sell in each country. In such cases, we report revenues based on the country of first sale.

During Fiscal 2009, 38% of our product sales were of bulk SDC concentrate, and 62% of our product sales were of bulk Axen30 or finished packaged products containing Axen 30, our ready to use product. During the prior year, 77% of our product sales were of bulk SDC concentrate and 23% of our product sales were of bulk Axen30 or finished packaged products containing Axen 30.

All of our tangible assets are located in the United States.





## Note 14. Quarterly Financial Data (Unaudited)

The following financial information reflects all normal recurring adjustments, which are, in the opinion of management, necessary for a fair statement of the results of the interim periods. Summarized quarterly data for Fiscal 2009 and Fiscal 2008 are as follows:

|                                      |               | For the quarters ended |               |               |
|--------------------------------------|---------------|------------------------|---------------|---------------|
|                                      | October 31    | January 31             | April 30      | July 31       |
| 2009:                                |               |                        |               |               |
| Revenue                              | \$ 110,621    | \$ 284,762             | \$ 129,905    | \$ 202,975    |
| Gross profit                         | \$ 50,809     | \$ 273,940             | \$ 69,314     | \$ 96,032     |
| Net loss                             | \$(1,605,316) | \$(2,219,750)          | \$(1,545,584) | \$(1,696,667) |
| Basic and diluted net loss per share | \$(0.05 )     | \$(0.07 )              | \$(0.05 )     | \$(0.06 )     |
| 2008:                                |               |                        |               |               |
| Revenue                              | \$ 95,290     | \$ 152,434             | \$ 416,464    | \$ 823,276    |
| Gross profit                         | \$ 63,597     | \$ 101,947             | \$ 322,618    | \$ 535,706    |
| Net loss                             | \$(1,008,704) | \$(1,553,707)          | \$(2,466,396) | \$(1,471,512) |
| Basic and diluted net loss per share | \$(0.04 )     | \$(0.06 )              | \$(0.09 )     | \$(0.05 )     |

## Note 15. Fair Value

Effective August 1, 2008, we adopted Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements” (“SFAS 157”). In February 2008, the FASB issued FASB Staff Position (“FSP”) No. SFAS 157-2, “Effective Date of FASB Statement No. 157,” which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. As a result, we only partially adopted SFAS 157 as it relates to our financial assets and liabilities until we are required to apply this pronouncement to our non-financial assets and liabilities beginning with fiscal year 2010. The adoption of SFAS 157 did not have a material impact on our consolidated results of operations or financial condition.

In October 2008, the FASB issued FSP No. SFAS 157-3 “Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active” (“FSP SFAS 157-3”). FSP SFAS 157-3 clarifies the application of SFAS No. 157, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP SFAS 157-3 is effective upon issuance, including prior periods for which financial statements have not been issued. The adoption of FSP SFAS 157-3 had no impact on our consolidated results of operations, financial position or cash flows.

SFAS 157 defines fair value, establishes a framework for measuring fair value under U.S. GAAP and enhances disclosures about fair value measurements. Fair value is defined under SFAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. SFAS 157 describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.

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- Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The following table represents our fair value hierarchy for our financial assets (cash, cash equivalents and short-term investments) measured at fair value on a recurring basis as of July 31, 2009:

|                    | Level 1      | Level 2 | Level 3 | Total        |
|--------------------|--------------|---------|---------|--------------|
| Cash               | \$ 1,001,583 | —       | —       | \$ 1,001,583 |
| Money market funds | \$ 3,212,161 | —       | —       | \$ 3,212,161 |
| Total              | \$ 4,213,744 | \$ —    | \$ —    | \$ 4,213,744 |

Note 16. Subsequent Events

On May 28, 2009, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 165, Subsequent Events. The statement establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. In particular, this statement sets forth the period after the balance sheet date during which our management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements; the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements; and the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. Additionally, the statement requires disclosure of the date through which our management has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued.

Our management has evaluated events as of October 12, 2009, which is the last practical date prior to the filing of this Annual Report. All events to this date are recognized or disclosed in the financial statements herein, to the extent that they impact our balance sheets as at July 31 2009 or 2008; or our statements of operations, statements of cash flows, or statements of stockholders' equity for Fiscal 2009, Fiscal 2008 or Fiscal 2007. Other events that occurred subsequent to July 31, 2009 include the following:

On September 3, 2009 we closed a registered direct offering whereby we sold \$3 million of our common stock and warrants to institutional investors. A shelf registration statement relating to the securities sold in the offering was declared effective by the Securities and Exchange Commission on May 8, 2009. Under the terms of the offering, we issued to the investors 1,818,182 shares of our common stock, and warrants to purchase 727,272 shares of our common stock. The common stock was sold at a price of \$1.65 per share, and the investors received warrants to purchase 0.4 shares of common stock at an exercise price of \$2.10 per share for each share of common stock they purchased in the offering. The warrants will be exercisable as of March 3, 2010, and will expire five years from that date. In addition we paid a fee of \$180,000 to Rodman & Renshaw, LLC ("Rodman") in consideration for its services as the placement agent in the offering. We also issued to Rodman and its principals, warrants to purchase 90,909 shares of our common stock at an exercise price of \$2.0625 per share. These warrants will be exercisable as of March 3, 2010, and will expire on May 7, 2014. After fees and expenses, the net proceeds of the offering to us were \$2,783,233, which will be used for working capital.

Effective September 1, 2009, Tommy G. Thompson resigned as a director of the Company to join our Advisory Panel.

On October 12, 2009, the Company entered into an amended and restated employment agreement with Michael L. Krall, our Chief Executive Officer, which agreement amends and restates in its entirety the employment agreement the Company previously entered into with Mr. Krall effective as of April 17, 1996. In addition, on October 12, 2009, the Company entered into employment agreements with Andrew Buckland, our Chief Financial Officer, and Donna Singer, our Executive Vice President. The agreements are filed as exhibits to this Annual Report.

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

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to our management including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) under the Exchange Act, we conducted an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon the foregoing evaluation, our Principal Executive Officer and our Principal Financial Officer concluded that as of July 31, 2009 our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Our Controls

There were no changes in our internal controls over financial reporting during our most recent quarter that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, including our CEO and CFO, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under this framework, our management concluded that our internal control over financial reporting was effective as of July 31, 2009. Mayer Hoffman McCann P.C., an independent registered public accounting firm, has issued an attestation report on the effectiveness of our internal control over financial reporting as of July 31, 2009. This report, which expressed an unqualified opinion on the effectiveness of our internal control over financial reporting as of July 31, 2009, is included elsewhere herein.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
PURE Bioscience

We have audited PURE Bioscience's ("the Company") internal control over financial reporting as of July 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, PURE Bioscience maintained, in all material respects, effective internal control over financial reporting as of July 31, 2009, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of PURE Bioscience as of July 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended July 31, 2009 of PURE Bioscience, and our report dated October 13, 2009 expressed an unqualified opinion on those financial statements.

/s/ Mayer Hoffman McCann P.C.  
San Diego, California  
October 13, 2009

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Item 9B. Other Information

In order to retain the experience, skills, abilities, background and knowledge of our current executive officers and provide well defined employment terms consistent with U.S. biotechnology companies, on October 12, 2009, the Company entered into an amended and restated employment agreement with Michael L. Krall, our Chief Executive Officer, which agreement amends and restates in its entirety the employment agreement the Company previously entered into with Mr. Krall effective as of April 17, 1996. In addition, on October 12, 2009, the Company entered into employment agreements with Andrew Buckland, our Chief Financial Officer, and Donna Singer, our Executive Vice President. The agreements were approved by the Board of Directors upon the recommendation of the Company's Compensation Committee and are filed as exhibits to this Annual Report. Capitalized terms used below are defined in the agreements. The principal terms of the agreements are as follows:

Pursuant to the agreements, as applicable, Mr. Krall is entitled to a base salary of \$300,000 per year, Mr. Buckland is entitled to a base salary of \$225,000 per year, and Ms. Singer is entitled to a base salary of \$200,000 per year. In each case, the executive's base salary may be increased, but not decreased, from such amounts by the Company's Board of Directors or the Compensation Committee in its discretion.

Each agreement continues until termination by either the Company or the executive. The agreements provide, as applicable, for annual bonus targets equal to 50% of the executive's then applicable base salary for Mr. Krall and 35% of the executive's then applicable base salary for each of Mr. Buckland and Ms. Singer, in each case to be awarded at the sole discretion of the Compensation Committee. Each agreement also provides that the executive will be eligible for equity compensation grants to be awarded at the discretion of the Compensation Committee. In each case, if the employment agreement is terminated without Cause by the Company or terminated by the executive for Good Reason, the Executive, upon signing a release in favor of the Company, will be entitled to severance pay in the form of a single lump sum cash payment. In the case of Mr. Krall, such severance payment equals 150% of his then current Annual Base Compensation plus eighteen months of health and dental insurance in accordance with COBRA. In the case of Ms. Singer, such severance payment equals 100% of her then current Annual Base Compensation, plus twelve months of health and dental insurance in accordance with COBRA. In the case of Mr. Buckland, such severance payment equals 75% of his then current Annual Base Compensation, plus nine months of health and dental insurance in accordance with COBRA. In addition, in the event of a termination for any reason other than by the Company for Cause, each agreement provides that all outstanding vested stock options held by the executive at the date of such termination would continue to be exercisable for a period of up to 120 days following such termination, but in no event beyond the maximum permitted expiration date.

The agreements provide that, in the event either the executive's employment is terminated by the Company without Cause within twelve months following a Change in Control, or the Executive resigns for Good Reason within such period, the Executive will be entitled to additional severance pay in excess of the amounts described in the preceding paragraph, in each case in an amount equal to a single lump sum payment equal to 100% of the executive's then current Annual Base Compensation, plus the average annual bonus awarded to the executive for the preceding two fiscal years. In addition, in such event, the vesting of all outstanding stock options then held by each executive would automatically accelerate and all stock options would continue to be exercisable for 12 months, but in no event beyond the maximum permitted expiration date.



PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this Item is incorporated herein by reference to the information contained in the Proxy Statement relating to our Annual Meeting of Shareholders scheduled to be held on January 20, 2010, which will be filed with the SEC no later than 120 days after the close of Fiscal 2009. Certain information regarding our executive officers required by this item is set forth in Part I of this Annual Report under the caption "Executive Officers of the Registrant."

Item 11. Executive Compensation

The information required by this Item is incorporated herein by reference to the information contained in the Proxy Statement relating to our Annual Meeting of Shareholders scheduled to be held on or about January 20, 2010, which will be filed with the SEC no later than 120 days after the close of Fiscal 2009.

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

The information required by this Item is incorporated herein by reference to the information contained in the Proxy Statement relating to our Annual Meeting of Shareholders scheduled to be held on or about January 20, 2010, which will be filed with the SEC no later than 120 days after the close of Fiscal 2009.

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

The information required by this Item is incorporated herein by reference to the information contained in the Proxy Statement relating to our Annual Meeting of Shareholders scheduled to be held on or about January 20, 2010, which will be filed with the SEC no later than 120 days after the close of Fiscal 2009.

Item 14. Principal Accounting Fees and Services

The information required by this Item is incorporated herein by reference to the information contained in the Proxy Statement relating to our Annual Meeting of Shareholders scheduled to be held on or about January 20, 2010, which will be filed with the SEC no later than 120 days after the close of Fiscal 2009.

PART IV

Item 15. Exhibits

A. The following Exhibits are filed as part of this registration statement pursuant to Item 601 of Regulation S-K:

- |         |      |                                                                                      |
|---------|------|--------------------------------------------------------------------------------------|
| 3.1     | (1)  | -- Articles of Incorporation                                                         |
| 3.1.1   | (2)  | -- Articles of Amendment to Articles of Incorporation, dated March 11, 2002          |
| 4.3     | (3)  | -- Amended and Restated Bylaws                                                       |
| 4.3     | (1)  | -- Form of Common Stock Certificate                                                  |
| 4.4     | (4)  | -- Form of Investor Warrant                                                          |
| 4.41    | (5)  | -- Form of Investor Warrant                                                          |
| 4.42    | (6)  | -- Form of Investor Warrant                                                          |
| 4.5     | (7)  | -- Form of Placement Agent Warrant                                                   |
| 10.15.1 | (8)  | -- Innovative Medical Services Amended 1998 Directors and Officers Stock Option Plan |
| 10.15.2 | (9)  | -- The Innovative Medical Services ETI H2O Option Plan                               |
| 10.15.3 | (10) | -- Innovative Medical Services Consultant and Advisors Stock Option Plan             |
| 10.15.4 | (11) | -- Innovative Medical Services 2001 Directors and Officers Stock Option Plan         |
| 10.15.5 | (12) | -- Innovative Medical Services 2002 Employee Incentive Stock Option Plan             |
| 10.15.6 | (13) | -- Innovative Medical Services 2002 Non-Qualified Stock Option Plan                  |
| 10.15.7 | (14) | -- PURE Bioscience 2004 Consultant and Advisors Stock Option Plan                    |
| 10.15.8 | (15) | -- The PURE Bioscience 2007 Equity Incentive Plan                                    |
| 10.16   | (16) |                                                                                      |

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- 10.17 (17) -- Placement Agent Agreement, dated as of April 28, 2009, by and between Pure Bioscience and Axiom Capital Management, Inc.
- 10.18 -- Placement Agent Agreement, dated as of August 3, 2009, by and between Pure Bioscience and Rodman & Renshaw, LLC
- 10.19 -- Employment Agreement by and between Pure Bioscience and Michael L. Krall dated October 12, 2009\*
- 10.20 -- Employment Agreement by and between Pure Bioscience and Andrew Buckland dated October 12, 2009\*
- 14.1 (18) -- Employment Agreement by and between Pure Bioscience and Donna Singer dated October 12, 2009\*
- 21.1 -- Code of Ethics
- 23.0 -- Subsidiaries of the Registrant\*
- 31.1 -- Consent of Mayer Hoffman McCann P.C.\*
- 31.2 -- Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 32.1 -- Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002\*
- 32.2 -- Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*
- 32.2 -- Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002\*

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- (1) Incorporated by reference from Exhibit 3.1 to the Form SB-2 registration statement, SEC File #333-00434 effective August 8, 1996
- (2) Incorporated by reference from Exhibit 3.1.2 to the Annual Report on Form 10KSB for the fiscal year ended July 31, 2002, filed with the SEC on October 29, 2003
- (3) Incorporated by reference from Exhibit 3.2 to the Current Report on Form 8-K, filed with the SEC on February 25, 2008
- (4) Incorporated by reference from Exhibit 4.4 to the Current Report on Form 8-K, filed with the SEC on October 25, 2007
- (5) Incorporated by reference from Exhibit 4.5 to the Current Report on Form 8-K, filed with the SEC on May 22, 2009
- (6) Incorporated by reference from Exhibit 4.5 to the Current Report on Form 8-K, filed with the SEC on September 2, 2009
- (7) Incorporated by reference from Exhibit 4.5 to the Current Report on Form 8-K, filed with the SEC on October 25, 2007
- (8) Incorporated by reference from Form S-8 filed with the SEC on December 23, 1998
- (9) Incorporated by reference from Exhibit 99.6 to Form S-8 filed with the SEC on January 30, 2001
- (10) Incorporated by reference from Exhibit 99.5 to Form S-8 filed with the SEC on January 30, 2001
- (11) Incorporated by reference from Exhibit 99.4 to Form S-8 filed with the SEC on January 30, 2001
- (12) Incorporated by reference from Exhibit 99.8 to Form S-8 filed with the SEC on May 20, 2002
- (13) Incorporated by reference from Exhibit 99.7 to Form S-8 filed with the SEC on May 20, 2002
- (14) Incorporated by reference from Exhibit 99 to Form S-8 filed with the SEC on April 23, 2004
- (15) Incorporated by reference from Exhibit 10.15.8 to Form 10-K filed with the SEC on October 14, 2008
- (16) Incorporated by reference from Exhibit 10.2 on Form 8-K, filed with the SEC on May 22, 2009
- (17) Incorporated by reference from Exhibit 10.2 on Form 8-K, filed with the SEC on September 2, 2009
- (18) Incorporated by reference from Exhibit 14.1 on Form 8-K, filed with the SEC on February 25, 2008

\* Filed herewith

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PURE BIOSCIENCE

DATE

/s/ MICHAEL L. KRALL  
 Michael L. Krall, President / Chief  
 Executive Officer  
 (Principal Executive Officer)

October 13, 2009

/s/ ANDREW J. BUCKLAND  
 Andrew J. Buckland, Chief Financial Officer  
 (Principal Financial and Accounting Officer)

October 13, 2009

Pursuant to the requirements of the Securities Exchange Act of 1934, this report is signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| NAME                                     | TITLE                                 | DATE             |
|------------------------------------------|---------------------------------------|------------------|
| /s/ GREGORY BARNHILL<br>Gregory Barnhill | Director                              | October 13, 2009 |
| /s/ DENNIS BROVARONE<br>Dennis Brovarone | Director                              | October 13, 2009 |
| /s/ JOHN J. CARBONE<br>John J. Carbone   | Director                              | October 13, 2009 |
| /s/ MICHAEL L. KRALL<br>Michael L. Krall | President/CEO and Director            | October 13, 2009 |
| /s/ PAUL V. MAIER<br>Paul V. Maier       | Director                              | October 13, 2009 |
| /s/ DONNA SINGER<br>Donna Singer         | Executive Vice President and Director | October 13, 2009 |



