

EARTHSHELL CORP  
Form 10-Q  
November 15, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the Quarterly Period Ended September 30, 2002

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

For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 333-13287

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**EARTHSHELL CORPORATION**

(Exact name of registrant as specified in its charter)

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

**77-0322379**  
(I.R.S. Employer  
Identification No.)

**800 Miramonte Drive, Santa Barbara, California 93109**

(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: **(805) 897-2248**

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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

The number of shares outstanding of the registrant's common stock as of November 14, 2002 is 144,598,356.

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**EARTHSHELL CORPORATION**

**FORM 10-Q**

**For the Quarter Ended September 30, 2002**

**INDEX**

**Part I. Financial Information**

Item 1.	Financial Statements	
a)	Balance Sheets as of September 30, 2002 (unaudited) and December 31, 2001	1
b)	Statements of Operations for the three and nine months ended September 30, 2002 and September 30, 2001 (unaudited) and for the period from November 1, 1992 (inception) through September 30, 2002 (unaudited)	2
c)	Statements of Stockholders' Equity (Deficit) for the period from November 1, 1992 (inception) to September 30, 2002 (unaudited)	3
d)	Statements of Cash Flows for the nine months ended September 30, 2002 and September 30, 2001 (unaudited) and for the period from November 1, 1992 (inception) through September 30, 2002 (unaudited)	4
e)	Notes to Financial Statements (unaudited)	5
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	8
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	12
Item 4.	Controls and Procedures	12
<b>Part II. Other Information</b>		
Item 1.	Legal Proceedings	13
Item 2.	Changes in Securities	13
Item 3.	Defaults Upon Senior Securities	13
Item 4.	Submission of Matters to a Vote of Security Holders	13
Item 5.	Other Information	13
Item 6.	Exhibits and Reports on Form 8-K	13
<b>Signature</b>		14
<b>Certifications</b>		15-18

**EARTHSHELL CORPORATION**

(A Development Stage Enterprise)

**BALANCE SHEETS**September 30,  
2002December 31,  
2001

(Unaudited)

**ASSETS****CURRENT ASSETS:**

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	September 30, 2002	December 31, 2001
Cash and cash equivalents	\$ 245,870	\$ 828,007
Prepaid expenses and other current assets	513,992	580,472
<b>Total current assets</b>	<b>759,862</b>	<b>1,408,479</b>
RESTRICTED CASH	12,500,000	3,500,000
PROPERTY AND EQUIPMENT, NET	13,015,976	14,591,111
INVESTMENT IN JOINT VENTURE	341,275	386,275
<b>TOTAL</b>	<b>\$ 26,617,113</b>	<b>\$ 19,885,865</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable and accrued expenses	\$ 7,335,797	\$ 8,349,808
Note Payable to EKI	2,000,000	
<b>Total current liabilities</b>	<b>9,335,797</b>	<b>8,349,808</b>
CONVERTIBLE NOTES PAYABLE	7,699,505	
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred Stock, \$.01 par value, 10,000,000 shares authorized; 9,170,000 Series A shares designated; no shares issued and outstanding as of September 30, 2002 and December 31, 2001		
Common stock, \$.01 par value, 200,000,000 shares authorized; 141,141,113 and 118,323,054 shares issued and outstanding as of September 30, 2002 and December 31, 2001	1,411,411	1,183,231
Additional paid-in common capital	288,570,517	266,595,422
Deficit accumulated during the development stage	(280,400,117)	(256,242,596)
<b>Total stockholders' equity</b>	<b>9,581,811</b>	<b>11,536,057</b>
<b>TOTAL</b>	<b>\$ 26,617,113</b>	<b>\$ 19,885,865</b>

See notes to financial statements.

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(A Development Stage Enterprise)

STATEMENTS OF OPERATIONS

(Unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,		November 1, 1992 (inception) through September 30,
	2002	2001	2002	2001	2002
<b>Expenses:</b>					
Related party research and development	\$ 300,000	\$ 401,055	\$ 1,068,313	\$ 1,092,197	\$ 69,459,151
Other research and development	2,941,860	6,756,532	13,418,082	15,186,975	122,293,868
Related party general and administrative expenses					2,240,502
Other general and administrative expenses	2,366,377	2,367,682	6,954,026	8,445,850	59,738,230
Depreciation and amortization	795,065	1,138,516	2,385,770	3,648,965	21,747,833
Related party patent expenses					8,693,105
<b>Total expenses</b>	<b>6,403,302</b>	<b>10,663,785</b>	<b>23,826,191</b>	<b>28,373,987</b>	<b>284,172,689</b>
Interest income	(18,345)	(95,058)	(61,259)	(299,440)	(10,736,501)
Related party interest expense					4,770,731
Other interest expense	79,447		80,319		1,869,057
Miscellaneous Expense	320,970		320,970		320,970
Gain on Sale of Asset			(9,500)		(9,500)
<b>Loss Before Income Taxes</b>	<b>6,785,374</b>	<b>10,568,727</b>	<b>24,156,721</b>	<b>28,074,547</b>	<b>280,387,446</b>
Income Taxes			800		12,671
<b>Net Loss</b>	<b>6,785,374</b>	<b>10,568,727</b>	<b>24,157,521</b>	<b>28,074,547</b>	<b>280,400,117</b>
Preferred Dividends					9,926,703
<b>Net Loss Available To Common Stockholders</b>	<b>\$ 6,785,374</b>	<b>\$ 10,568,727</b>	<b>\$ 24,157,521</b>	<b>\$ 28,074,547</b>	<b>\$ 290,326,820</b>
<b>Basic And Diluted Loss Per Common Share</b>	<b>\$ 0.05</b>	<b>\$ 0.09</b>	<b>\$ 0.18</b>	<b>\$ 0.25</b>	<b>\$ 3.08</b>
Weighted Average Number Of Common Shares	138,500,013	114,169,194	132,433,714	110,746,927	94,297,674

See notes to financial statements.

EARTHSHELL CORPORATION

(A Development Stage Enterprise)

STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

(Unaudited)

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	Cumulative Convertible Preferred Stock Series A		Additional Paid-In Preferred Capital	Common Stock		Additional Paid-In Common Capital	Deficit Accumulated during Development Stage	Total
	Shares	Amount		Shares	Amount			
<b>ISSUANCE OF COMMON STOCK AT INCEPTION</b>				82,530,000	\$ 3,150	\$ 6,850		\$ 10,000
Sale of preferred stock, net	6,988,850	\$ 267	\$ 24,472,734					24,473,001
Net loss							\$ (7,782,551)	(7,782,551)
<b>BALANCE, DECEMBER 31, 1993</b>	6,988,850	267	24,472,734	82,530,000	3,150	6,850	(7,782,551)	16,700,450
Net loss							(16,582,080)	(16,582,080)
<b>BALANCE, DECEMBER 31, 1994</b>	6,988,850	267	24,472,734	82,530,000	3,150	6,850	(24,364,631)	118,370
Contribution to equity						1,117,723		1,117,723
Net loss							(13,914,194)	(13,914,194)
<b>BALANCE, DECEMBER 31, 1995</b>	6,988,850	267	24,472,734	82,530,000	3,150	1,124,573	(38,278,825)	(12,678,101)
Contribution to equity						650,000		650,000
Issuance of stock warrants						246,270		246,270
Net loss							(16,950,137)	(16,950,137)
<b>BALANCE, DECEMBER 31, 1996</b>	6,988,850	267	24,472,734	82,530,000	3,150	2,020,843	(55,228,962)	(28,731,968)
Compensation related to stock options, warrants and stock grants.						3,156,659		3,156,659
Net loss							(18,992,023)	(18,992,023)
<b>BALANCE, DECEMBER 31, 1997</b>	6,988,850	267	24,472,734	82,530,000	3,150	5,177,502	(74,220,985)	(44,567,332)
262 to 1 stock split		69,621	(69,621)		822,150	(822,150)		
Conversion of preferred stock to common stock	(6,988,850)	(69,888)	(24,403,113)	6,988,850	69,888	24,403,113		
Issuance of common stock				10,526,316	105,263	205,883,493		205,988,756
Preferred stock dividends						(9,926,703)		(9,926,703)
Net loss							(26,620,052)	(26,620,052)
<b>BALANCE, DECEMBER 31, 1998</b>				100,045,166	1,000,451	224,715,255	(100,841,037)	124,874,669
Net loss							(44,188,443)	(44,188,443)
<b>BALANCE, DECEMBER 31, 1999</b>				100,045,166	1,000,451	224,715,255	(145,029,480)	80,686,226
Net Loss							(48,911,605)	(48,911,605)
Issuance of common stock				4,457,169	44,572	10,477,216		10,521,788
<b>BALANCE, DECEMBER 31, 2000</b>				104,502,335	1,045,023	235,192,471	(193,941,085)	42,296,409
Net Loss							(62,301,511)	(62,301,511)
Compensation related to stock options, warrants and stock grants.				300,000	3,000	984,119		987,119
Issuance of common stock				13,520,719	135,208	30,418,832		30,554,040
<b>BALANCE, DECEMBER 31, 2001</b>				118,323,054	1,183,231	266,595,422	(256,242,596)	11,536,057
Net Loss							(24,157,521)	(24,157,521)
Issuance of common stock				20,793,708	207,937	19,297,821		19,505,758

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	<b>Cumulative Convertible Preferred Stock Series A</b>			<b>Deficit Accumulated during Development Stage</b>	
Conversion of convertible notes payable to common stock	2,024,351	20,243	979,757	1,000,000	1,521,046
Issuance of stock warrants			1,521,046		1,521,046
Debt conversion cost			176,471		176,471
<b>BALANCE, SEPTEMBER 30, 2002</b>	141,141,113	\$ 1,411,411	\$ 288,570,517	\$ (280,400,117)	\$ 9,581,811

See notes to financial statements

3

**EARTHSHELL CORPORATION**

**(A Development Stage Enterprise)**

**STATEMENTS OF CASH FLOWS**

**(Unaudited)**

	<b>For the Nine Months Ended September 30,</b>		<b>November 1, 1992 (inception) through September 30, 2002</b>
	<b>2002</b>	<b>2001</b>	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (24,157,521)	\$ (28,074,547)	\$ (280,400,117)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	2,385,770	3,648,965	21,747,833
Issuance of stock options to director, consultant and officer		751,724	4,848,641
Amortization and accretion of debt issue costs	76,052		347,329
Debt conversion cost	320,970		320,970
Loss on sale, disposal, or impairment of property and equipment	1,842,143		39,715,308
Loss from investment in joint venture	45,000	45,000	174,163
Net Loss on Sale of Investments			32,496
Accretion of Discounts on Investments			(410,084)
Changes in operating assets and liabilities:			
Prepaid expense and other current assets	66,480	(89,052)	(513,992)
Accounts payable and accrued expenses	(1,014,011)	(446,226)	7,335,797
Trade payable to majority stockholder		(266,312)	
Net cash used in operating activities	(20,435,117)	(24,430,448)	(206,801,656)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of short-term investments			(52,419,820)
Purchase of restricted time deposit, net	(9,000,000)		(12,500,000)
Proceeds from sales and redemptions of investments			52,797,408
Proceeds from sale of property and equipment	9,500		307,170
Investment in joint venture		(200,000)	(515,438)
Purchase of property and equipment	(2,662,278)	(3,289,680)	(75,658,022)

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	For the Nine Months Ended September 30,		November 1, 1992 (inception) through September 30, 2002
Net cash used in investing activities	(11,652,778)	(3,489,680)	(87,988,702)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuance of notes payable to stockholders			14,270,000
Proceeds from drawings on line of credit with bank			14,000,000
Proceeds from issuance of common stock	19,505,758	22,047,939	281,644,222
Proceeds from notes payable to EKI	3,030,000		3,030,000
Proceeds from convertible notes payable	10,000,000		10,000,000
Common stock issuance costs			(15,178,641)
Preferred dividends paid			(9,926,703)
Proceeds from issuance of preferred stock			25,675,000
Preferred stock issuance costs			(1,201,999)
Repayment of line of credit with bank			(14,000,000)
Repayment of notes payable to EKI	(1,030,000)		(1,030,000)
Repayment of note payable			(12,245,651)
Net cash provided by financing activities	31,505,758	22,047,939	295,036,228
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(582,137)</b>	<b>(5,872,189)</b>	<b>245,870</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>828,007</b>	<b>7,791,654</b>	
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 245,870</b>	<b>\$ 1,919,465</b>	<b>\$ 245,870</b>
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid for:			
Income taxes	\$ 800		\$ 11,871
Interest			3,028,240
Warrants issued with debt	1,521,046		1,827,214
Transfer of property from EKI			28,745
Convertible notes payable converted to common stock	1,000,000		1,000,000
Conversion of preferred stock to common stock			69,888

See notes to financial statements.

**EARTHSHELL CORPORATION**

**NOTES TO FINANCIAL STATEMENTS (Unaudited)**

**SEPTEMBER 30, 2002**

**Presentation of Financial Information**

The foregoing interim financial information is unaudited and has been prepared from the books and records of EarthShell Corporation (the "Company"). In the opinion of management, the financial information reflects all adjustments necessary for a fair presentation of the financial condition, results of operations and cash flows of the Company in conformity with generally accepted accounting principles. All such adjustments were of a normal recurring nature for interim financial reporting. Certain reclassifications have been made to the 2001 financial statements to conform to the 2002 presentation.

The accompanying unaudited financial statements and these notes do not include certain information and footnote disclosures required by generally accepted accounting principles, which were included in the Company's financial statements for the year ended December 31, 2001.

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The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto for the year ended December 31, 2001 included in the Company's Annual Report on Form 10-K.

The accompanying financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. During the period from November 1, 1992 (inception) to September 30, 2002, the Company has incurred a cumulative net loss of \$280,400,117 and has a working capital deficit of \$8,575,935 at September 30, 2002. These factors among others may indicate that the Company will be unable to continue as a going concern for a reasonable period of time.

The financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern. The Company's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to meet its obligations on a timely basis, to obtain additional financing or refinancing as may be required, and ultimately to attain successful operations. Management is continuing its efforts to obtain additional funds so that the Company can meet its obligations and sustain operations from sources that are described in the notes to the financial statements. (See *Convertible Debt*, and *Liquidity and Capital Resources*)

Basic and diluted loss per common share is calculated based on the weighted average shares outstanding of 138,500,013 and 132,433,714 for the three and nine months ended September 30, 2002, respectively and 114,169,194 and 110,746,927 for the three and nine months ended September 30, 2001, respectively. Basic and diluted per share calculation is the same because common stock equivalents are anti-dilutive. The Company had 3,771,150 options outstanding at September 30, 2002.

### Related Party Transactions

E. Khashoggi Industries LLC and its wholly owned subsidiaries ("EKI") own approximately 43% of the Company's shares, and may be deemed to be a controlling shareholder. For the three months ended September 30, 2002 and 2001, the Company paid or accrued \$300,000 and \$401,055 respectively, and \$1,068,313 and \$1,092,197 for the nine months ended September 30, 2002 and 2001, respectively, for payments related to a license agreement between Biotec, a wholly-owned subsidiary of EKI, and the Company, related primarily to the EarthShell sandwich wraps technology.

5

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During the nine months ended September 30, 2002 the Company has, from time to time, received short term working capital loans from EKI, at an interest rate of 10% per annum. At September 30, 2002 the Company had notes payable of \$2,000,000. During October 2002, the Company increased notes payable to EKI by \$850,000. In the beginning of November 2002, notes payable were reduced by \$1,100,000. At November 14, 2002, the Company had notes payable to EKI of \$1,750,000.

### Commitments

During 1998, EKI entered into certain agreements with an equipment manufacturer providing for the purchase by EKI of certain technology applicable to starch-based disposable packaging. EKI licenses such technology to the Company on a royalty-free basis pursuant to the License Agreement. In connection with the purchase, and pursuant to the terms of a letter agreement with EKI, the Company agreed to pay the seller of the technology \$3,500,000 on or about December 31, 2003, which obligation is secured by a letter of credit. The Company's obligation to the seller of the technology will be reduced by 5% of the purchase price of any equipment purchased by EKI, the Company or its licensees or joint venture partners from the seller of the technology. The Company believes that there will be a demand for more than \$70 million in new equipment over the next 2-3 years, which will extinguish the obligation.

In addition, the Company is required to pay \$3,000,000 over the five-year period commencing January 1, 2004 if EKI, the Company or the Company's licensees or joint venture partners have not purchased, by December 31, 2003, at least \$35,000,000 of equipment from the seller of the technology and EKI, the Company or the Company's licensees or joint venture partners make active use of the purchased technology. To date the Company has not made active use of such patents and related technology. EKI has agreed to indemnify the Company to the extent the Company is required to pay any portion of this \$3,000,000 obligation solely as a result of EKI's or its licensees' active use of such patents and related technology (other than use by the Company or its sublicensees).

### Convertible Debt

On August 12, 2002 the Company issued \$10 million in convertible debentures to institutional investors. The debentures bear interest at a rate of 1.5% per annum. The holders of the debentures have the right to convert the debenture to the Company's common stock at \$1.30 per



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share. Since the conversion price was significantly above the fair market value of the common stock at the date of issue, the debentures were deemed to have no beneficial conversion feature. The proceeds from the debentures were used to secure an irrevocable letter of credit in favor of the debenture holders such that unrestricted access to the proceeds of the debentures occurs only upon conversion of the debentures into shares of the Company's common stock accompanied by a pro rate reduction in the letter of credit. In addition to the holders' conversion option, the Company has the right to force conversion of up to \$500,000 of the debenture per week at a 15% discount to the market price of the Company's stock. During the third quarter of 2002, the Company forced conversion of \$1 million of the debentures, reducing the outstanding balance of the debentures to \$9 million. A non-cash expense of \$176,471 was recorded as a result of this conversion to reflect the 15% discount to the market price of the Company's common stock.

In connection with the issuance of the debentures, the Company issued to the holders warrants to purchase 2.5 million shares of common stock at \$1.20 per share. A value of \$1,521,046 was ascribed to the warrants and recorded as an original issue discount based on the Black-Scholes method of valuation

6

(assuming a warrant term of 5 years, a discount rate of 3.4%, and a volatility factor of 276%). A non-cash accretion charge of \$220,551 to amortize this original issue discount was recorded for the third quarter of 2002.

The debentures may be prepaid upon twenty days notice for 104% of the outstanding balance of the debentures.

### Property and Equipment:

The cost and accumulated depreciation of property and equipment at September 30, 2002 and December 31, 2001 consisted of the following:

	<u>2002</u>	<u>2001</u>
<b>Commercial Manufacturing Equipment</b>		
Owings Mills, Maryland	\$ 9,690,103	\$ 10,000,000
Goettingen, Germany	4,000,000	2,915,215
Other Construction in Progress	522,473	544,833
	<u>14,212,576</u>	<u>13,460,048</u>
<b>Other Property and Equipment</b>		
Product Development Center	3,793,738	3,793,737
Office Furniture and Equipment	744,142	774,146
Leasehold improvements	571,361	571,361
	<u>5,109,241</u>	<u>5,139,244</u>
<b>Total cost</b>	<u>19,321,817</u>	<u>18,599,292</u>
Less: accumulated depreciation and amortization	<u>(6,305,841)</u>	<u>(4,008,181)</u>
<b>Property and equipment net</b>	<u>\$ 13,015,976</u>	<u>\$ 14,591,111</u>

In connection with the startup of the demonstration line in Goettingen, Germany, the Company expects that the PolarCup EarthShell joint venture will accept the performance of the line and will acquire the equipment very soon. It has been agreed that the joint venture will reimburse EarthShell for the cost of the line on a replacement cost basis, which will exclude one-time engineering or development costs. In analyzing the asset for impairment, the Company has secured quotations from the various machinery suppliers for an identical line, and has concluded that \$1.6 million of development cost will not be reimbursable by the joint venture and therefore was written off in the third quarter of 2002, which is included in other Research and Development expense in the Statements of Operations.

With regard to the equipment at Owings Mills, the Company entered into a new Sublicense and Operating Agreement with Sweetheart Cup Company on October 3, 2002 wherein Sweetheart was granted a "priority" for certain EarthShell product groups in certain key US market segments. Under the agreement, Sweetheart will be developing production capacity at Owings Mills. It is expected that Sweetheart will utilize the Company's existing infrastructure and equipment as much as is practicable. Specific agreements regarding the amount, form or timing of compensation to the Company will be reached over the course of the coming year as Sweetheart builds out the Owings Mills facility. In this context, the Company has evaluated the Owings Mills asset for impairment and has written off \$251,791 related to a portion of the forming process, which is included in other Research and Development expense in the Statements of Operations.

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

### Forward Looking Statements

Information contained in this Quarterly Report on Form 10-Q including "Management's Discussion and Analysis of Financial Condition and Results of Operations" contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. These statements may be identified by the use of forward-looking terminology such as "may," "will," "expect," "anticipate," "estimate," or "continue," or the negative thereof or other comparable terminology. Any one factor or combination of factors could cause the Company's actual operating performance or financial results to differ substantially from those anticipated by management that are described herein. Factors influencing the Company's operating performance and financial results include, but are not limited to, changes in the general economy, the availability of financing, governmental regulations concerning, but not limited to, environmental issues, and other risks and unforeseen circumstances affecting the Company's business and should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2001.

The Company's continuation as a going concern is dependent upon its ability to generate sufficient cash flow to meet its obligations on a timely basis, to obtain additional financing or refinancing as may be required, and ultimately to attain successful operations.

### Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with generally accepted accounting principals requires management to make judgments, assumptions and estimates that affect the amounts reported in the Company's financial statements and the accompanying notes. The amounts of assets and liabilities reported in the Company's balance sheet and the amounts of expenses reported for each fiscal period are affected by estimates and assumptions which are used for, but not limited to, the accounting for asset impairments. Actual results could differ from these estimates. The following critical accounting policies are significantly affected by judgments, assumptions and estimates used in the preparation of the consolidated financial statements.

*Restricted Cash.* At March 30, 1998, a certificate of deposit for \$3,500,000 was opened as collateral on the letter of credit related to the Company's obligation under a letter agreement between the Company's majority stockholder, EKI, and the Company relating to a patent purchase agreement between EKI and a third party as discussed in the *Commitments* and is classified as restricted cash on the balance sheet.

*Convertible Debt.* The debentures may be prepaid upon twenty days notice for 104% of the outstanding balance of the debentures.

*Estimated Net Realizable Value of Property and Equipment.* The Company has been engaged in the development of manufacturing equipment to demonstrate the commercial viability of its manufacturing processes. To this end the Company has developed commercial manufacturing lines in Goleta, California and Owings Mills, Maryland and Goettingen, Germany. The operating equipment and machinery and related manufacturing assets are carried on the Company's books at the lower of cost (net of depreciation), or fair value.

The Company's business plans call for the transfer of manufacturing responsibility for its products to its operating partners. The Company expects to negotiate a fair market value for its existing

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manufacturing equipment, not to exceed the then current replacement value of the equipment, to certain of its operating partners. (See *Property and Equipment*). However, until the transfers and sales are complete, the Company cannot be certain that such value will be realized. Failure of the equipment to perform at a level satisfactory to the operating partners, failure to negotiate mutually agreeable terms of transfer, or any other failure to conclude the transfer of one or more on the operating lines to the respective operating partners may require the Company to consider alternative approaches to utilize the equipment such as funding an alternative operating partner to take over, relocating the equipment, or dismantling the line. Any one of these alternatives could have a negative economic impact on the carrying value of the equipment.

The key accounting estimates and policies are reviewed with the Audit Committee of the Board of Directors.

### Overview of Operations

Organized in November 1992 as a Delaware corporation, EarthShell® Corporation (the "Company"), is engaged in the commercialization of composite material technology for the manufacture of foodservice disposable packaging designed with the environment in mind. EarthShell Packaging® is based on patented composite material technology (collectively, the "EarthShell Technology"), licensed on an exclusive, worldwide basis from EKI.

The EarthShell Technology has been developed over many years in consultation with leading material scientists and environmental experts to reduce the environmental burdens of foodservice disposable packaging through the careful selection of raw materials, processes, and suppliers. EarthShell Packaging, including hinged-lid sandwich containers, plates, bowls, and cups, is primarily made from commonly available natural raw materials such as natural ground limestone and potato starch. The Company believes that EarthShell Packaging has comparable or superior performance characteristics and can be commercially produced and sold at prices that are competitive with comparable paper and plastic foodservice disposable packaging.

Currently, the Company's key strategic relationships include Sweetheart Cup Company Inc. ("Sweetheart") in Maryland, Huhtamäki Oyj, ("Huhtamäki") in Europe, Green Earth Packaging, Inc. ("GEP") in the U.S.,

Green Packaging SDN BHD ("Green Packaging") in Malaysia, and E. I. DuPont de Nemours and Company ("DuPont") in the U.S. During the quarter ended September 30, 2002, the following significant milestones were achieved.

The Company:

Entered into a definitive agreement with DuPont.

Signed a Sublease and Operations Agreement to enable GEP to run EarthShell's Goleta, California plate and bowl manufacturing operations which supplies most of EarthShell's current commercial customers. (The existing license agreement with GEP is for the US market and requires a minimum capital investment of \$10 million in order to build production capacity to support sales of at least \$25 million per year.)

Entered into a Supplemental Agreement with Green Packaging in Malaysia wherein Green Packaging agreed to invest at least \$10 million in production equipment and to achieve annual product sales of at least \$50 million beginning in 2004.

9

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Entered into a definitive Operating and Sublicense Agreement with Sweetheart granting to Sweetheart a priority right to access \$500 million of product sales for specified product families in the US in select market segments. Sweetheart's priority rights are subject to Sweetheart meeting certain investment and sales minimums.

Completed the installation of the first commercial EarthShell production line in Germany in cooperation with its joint venture partner, Huhtamäki, who is starting up the line in anticipation of commercial production.

The Company has been manufacturing and selling initial quantities of commercial product in cooperation with its strategic partners. The Company recorded the proceeds from such sales since its inception as an offset to the cost of the manufacturing operations.

**Comparison of the Three and Nine Months Ended September 30, 2002, to the Three and Nine Months Ended September 30, 2001.**

**Total Research and Development Expenses** Total research and development expenditures for the development of EarthShell Packaging decreased \$1.8 million to \$14.5 million from \$16.3 million for the nine months ended September 30, 2002 compared to the nine months ended September 30, 2001, and decreased \$4.0 million to \$3.2 million from \$7.2 million for the three months ended September 30, 2002 compared to the three months ended September 30, 2001. The decreases for both the three and nine months ended September 30, 2002 compared to September 30, 2001 are related to the elimination of operating costs related to the Owings Mills facility, and the completion of the critical work by the Company's licensees and operating partners to allow them to take over manufacturing responsibility for EarthShell products. This reduction has been offset by the impairment of \$1.6 million for demonstration line in Goettingen, Germany and the impairment of \$251,791 for the commercial line in Owings Mills, Maryland.

**Total General and Administrative Expenses** Total general and administrative expenses decreased \$1.4 million to \$7.0 million from \$8.4 million for the nine months ended September 30, 2002 compared to the nine months ended September 30, 2001, and remained constant at \$2.4 million for the three months ended September 30, 2002 compared to September 30, 2001. For the nine months ended September 30, 2002 compared to September 30, 2001 there was a \$750,000 decrease in salaries and related payroll expense, and a \$750,000 decrease for legal expenses related to the settlement of the lawsuit with Novamont, to the Company's satisfaction, which occurred in the second quarter of 2001. The Company's expenditure on maintaining patents remained constant when comparing the nine months ended September 30, 2002 to the nine months ended September 30, 2001.

**Depreciation and Amortization Expense** Depreciation and amortization expense decreased \$1.2 million to \$2.4 million from \$3.6 million for the nine months ended September 30, 2002 compared with the nine months ended September 30, 2001, and decreased \$0.3 million to \$0.8 million from \$1.1 million when comparing the three months ended September 30, 2002 to September 30, 2001. The decrease in depreciation expense is attributable to the decrease in fixed assets as a result of write down of equipment to net realizable value during the fourth quarter of 2001.

**Miscellaneous Expense.** The \$320,970 increase for both the three and nine months ended September 30, 2002 compared to September 30, 2001 is a direct result of \$144,409 discount on debt and \$176,471 for debt conversion costs.

**Liquidity and Capital Resources at September 30, 2002**

**Cash Flow.** The Company's principal use of cash for the nine months ended September 30, 2002 was to fund operations. Net cash used in operations decreased \$4.0 million to \$20.4 million for the nine months ended September 30, 2002 compared to \$24.4 million for the nine months ended September 30, 2001. Net cash used in investing activities was \$12.7 million and \$3.5 million for the nine months ended September 30, 2002 and 2001, respectively. Net cash provided by financing activities was \$32.5 million and \$22.0 million for the nine months ended September 30, 2002 and 2001, respectively.

**Capital Requirements.** Through September 30, 2002 the Company has paid or accrued approximately \$2.7 million in capital expenditures. The Company paid or accrued approximately \$3.6 million in capital expenditures for the year ended December 31, 2001. The Company expects to spend a total of \$3.0 million in 2002 for capital expenditures, all of which are related to manufacturing equipment for EarthShell Packaging.

**Sources of Capital.** As part of the Company's initial public offering on March 27, 1998, the Company issued 10,526,316 shares of common stock, for which it received net proceeds of \$206 million. On April 18, 2000 and January 4, 2001, the Company filed shelf registrations statements for 5 million and 15 million shares, respectively, of the Company's common stock. During the years ended December 31, 2001 and December 31, 2000 the Company sold approximately 13.5 million and 4.5 million shares of common stock in negotiated transactions under such registration statements and received net proceeds from such sales of approximately \$30.5 million and \$10.5 million, respectively.

In December of 2001 the Company filed a shelf registration statement that provides for the sale of up to \$50 million of securities, including secured or unsecured debt securities, preferred stock, common stock, and warrants. These securities may be offered, separately or together, in distinct series, and in amounts, at prices and on terms to be set forth in the prospectus contained in the registration statement, and in subsequent supplements to the prospectus. From January 1, 2002 through September 30, 2002 the Company sold approximately 22.8 million shares of common stock in negotiated transactions under such registration statements and received net proceeds from such sales of approximately \$20.5 million.

On August 12, 2002 the Company issued \$10 million in convertible debentures to institutional investors. The debentures bear interest at a rate of 1.5% per annum. The holders of the debentures have the right to convert the debenture to the Company's common stock at \$1.30 per

share. Based on the conversion price relative to the fair market value of the common stock at the date of issue, the debentures were deemed to have no beneficial conversion feature. The proceeds from the debentures are subject to an irrevocable letter of credit in favor of the holders, secured by cash such that unrestricted access to the proceeds of the debentures occurs only upon conversion of the debentures into shares of the Company's common stock. In addition to the holders' conversion option, the Company has the right to force conversion of up to \$500,000 of the debenture per week at a 15% discount to the market price of the Company's stock. During the third quarter of 2002, the Company forced conversion of \$1 million of the debenture, reducing the outstanding balance to \$9 million.

During September, the Company's largest shareholder, EKI, made various simple interest working capital loans to the Company in the net amount of \$2 million. These loans bear interest at a rate of 10% per annum and are payable on demand.

The Company continues to consider various financing opportunities to fund its operations and to minimize the cost of capital to the Company. To this end, the Company may continue to utilize its shelf registration statement as necessary from time to time. While the Company believes that it will continue to raise sufficient capital as necessary to fund its operations, the Company cannot be certain that funding commitments can be obtained on favorable terms, if at all.

The Company's business plan calls for the transfer of technology to its operating partners and the transition of manufacturing responsibility to these operating partners. Certain EarthShell operating partners have already begun to invest directly in the purchase of their own manufacturing equipment for EarthShell products. Upon the successful completion of transition of the manufacturing responsibility to its operating partners and the subsequent build-up of manufacturing capacity by these partners and consequent commencement of in-the-market products sales, the Company expects to then begin recognizing royalty revenues. Meanwhile, the Company has largely restructured its operations to reflect this transition. This has resulted in a significant reduction in headcount and operating costs, which began to occur as early as the first quarter of 2002.

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

The Company has \$12.5 million in restricted cash. If interest rates increase or decrease by 1%, interest income will increase or decrease by \$125,000. The Company has \$7.7 million in convertible notes payable. If interest rates increase or decrease by 1%, interest expense will increase or decrease by \$90,000. The Company's exposure to foreign currency risk is not material.

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

*Evaluation of disclosure controls and procedures.* Based on their evaluation, as of a date within 90 days of the filing date of this Form 10-Q, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Rule 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal controls.* There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

## **Part II. Other Information**

### **Item 1. Legal Proceedings**

Not applicable

**Item 2. Changes in Securities**

Not applicable

**Item 3. Defaults Upon Senior Securities**

Not applicable

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

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits and Reports on Form 8-K**

The Company filed three reports on Form 8-K during the quarter ended September 30, 2002. Information regarding the items reported on is as follows:

<u>Date</u>	<u>Item Reported On</u>
August 01, 2002	The Company entered into a Common Stock Purchase Agreement with private investors for the sale of 1,898,735 shares of the Company's common stock with aggregate proceeds to the Company of \$1,500,000.
August 13, 2002	The Company entered into a Securities Purchase Agreement with private investors for the sale of secured convertible debentures to the Company in the aggregate principal amount of \$10,000,000.
September 26, 2002	The Company entered into a Loan Agreement with E. Khashoggi Industries, LLC whereby EKI agreed to extend short term loans to the Company in its sole discretion.
10.53	Alliance Agreement dated 25 July, 2002 between EarthShell Corporation and E. I. DuPont de Nemours and Company.
10.54	Second Amendment dated 29 July, 2002 to Amended and Restated License Agreement between E. Khashoggi Industries, LLC and EarthShell Corporation.
10.55	License and Information Transfer Agreement dated 29 July, 2002 between the Biotec Group and EarthShell Corporation.

13

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned.

EarthShell Corporation

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Date: November 14, 2002

By: /s/ D. SCOTT HOUSTON

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D. Scott Houston  
*Chief Financial Officer*  
(Principal Financial and Accounting Officer and Duly  
Authorized Officer)

14

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**CERTIFICATIONS**

I, Simon K. Hodson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of EarthShell Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6.

The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

By: /s/ SIMON K. HODSON

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Simon K. Hodson  
Chief Executive Officer

15

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**CERTIFICATIONS**

I, D. Scott Houston, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of EarthShell Corporation;

2.

Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a)

designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b)

evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c)

presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5.

The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):

a)

all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and



- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 14, 2002

By: /s/ D. SCOTT HOUSTON

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D. Scott Houston  
Chief Financial Officer  
16

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**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Report of EarthShell Corporation (the "Company") on Form 10-Q for the fiscal quarter ending June 30, 2002, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Simon K. Hodson, Chief Executive Officer of the Company, certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

By: /s/ SIMON K. HODSON

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Simon K. Hodson  
Chief Executive Officer  
November 14, 2002

17

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**CERTIFICATION PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the report of EarthShell Corporation (the "Company") on Form 10-Q for the fiscal quarter ending June 30, 2002, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, D. Scott Houston, Chief Financial Officer of the Company, certify pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) b)The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

By: /s/ D. SCOTT HOUSTON

D. Scott Houston  
Chief Financial Officer  
November 14, 2002

QuickLinks

[EARTHSHELL CORPORATION FORM 10-Q For the Quarter Ended September 30, 2002 INDEX](#)

[EARTHSHELL CORPORATION \(A Development Stage Enterprise\) BALANCE SHEETS](#)

[EARTHSHELL CORPORATION \(A Development Stage Enterprise\) STATEMENTS OF OPERATIONS \(Unaudited\)](#)

[EARTHSHELL CORPORATION \(A Development Stage Enterprise\) STATEMENTS OF STOCKHOLDERS' EQUITY \(DEFICIT\) \(Unaudited\)](#)

[EARTHSHELL CORPORATION \(A Development Stage Enterprise\) STATEMENTS OF CASH FLOWS \(Unaudited\)](#)

[EARTHSHELL CORPORATION NOTES TO FINANCIAL STATEMENTS \(Unaudited\) SEPTEMBER 30, 2002](#)

[Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations](#)

[Item 3. Quantitative and Qualitative Disclosures About Market Risk](#)

[Item 4. Controls and Procedures](#)

[Part II. Other Information](#)

[Item 1. Legal Proceedings](#)

[Item 2. Changes in Securities](#)

[Item 3. Defaults Upon Senior Securities](#)

[Item 4. Submission of Matters to a Vote of Security Holders](#)

[Item 5. Other Information](#)

[Item 6. Exhibits and Reports on Form 8-K](#)

[Signature](#)

[CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002](#)

[CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002](#)