EARTHSHELL CORP
Form 10-K/A
June 09, 2005

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

FORM 10-K/A
Amendment No. 3

(Mark One)

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

For the fiscal year ended December 31, 2004

OR

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

For the Transition Period From to

Commission File Number 333-13287

EARTHSHELL CORPORATION
(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Delaware | 77-0322379 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

3916 State St. Ste. 110, Santa Barbara, California 93105
(Address of principal executive office) (Zip Code)

(805) 563-7590
(Registrant's telephone number, including area code)

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

None

Securities registered pursuant to Section 12 (g) of the Act:
Common Stock $.01 par value
(Title of each class)

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 |X| 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. Yes |_|

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes |X| No |_|

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of June 30, 2004 was $28,681,801.

The number of shares outstanding of the Registrant's Common Stock as of June 8, 2005 was 18,435,452.

DOCUMENTS INCORPORATED BY REFERENCE

None.

ANNUAL REPORT ON FORM 10-K/A

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004



EXPLANATORY NOTE

EarthShell Corporation (the "Company") is filing this Amendment No. 3 on Form 10-K/A (this "Amendment") to the Company's Annual Report on Form 10-K for the year ended December 31, 2004 to make certain corrections to the Company's Form 10-K filed with the Securities and Exchange Commission on April 4, 2005, as it has been subsequently amended, as follows and to restate the 10-K, as amended.

- Amendment No. 2 has been incorporated into the text of this 10-K/A along with conforming updates to Item 1, Certain Risk Factors and Item 9A, Controls and Proceedures to facilitate publication of the Annual Report.

- In Item 1, Relationship with and Reliance on EKI, disclosure relating to the issuance of a warrant to EKI for 1,000,000 shares and that issuance of 44,387 additional shares in May 2005 was added, as well as minor editing for clarity. This disclosure also appears in Item 7, MD&A, Liquidity and Capital Resources and Subsequent Events.

- In Item 6, the table entitled "Selected Financial Data" has been adjusted for clarity and consistency in presentation of liabilities from year to year.

- In Item 7, Management's Discussion and Analysis, certain redundant paragraphs comparing the year ended December 31, 2003 to the year ended December 31, 2002 were eliminated in order to conform the text to the Company's Annual Report on Form 10-K for the year ended December 31, 2003. In the section titled Luquidity and Capital Resources, the table titled Contractual Obligations, a line item has been added to clarify the Payable to Related Party as a short term obligation.

- Disclosure under Items 10-14 of Part III was added.

- On the Company's Conslidated Balance Sheet, adjustments were made to the long term liabilities headings to more properly compare 2003 to 2004 results.

- In the Notes to the Company's Consolidated Financial Statements a correction was made to the note entitled "Stock Options" to correct the size of the pool of options reserved for issuance. A sentence was added to the note entitled "Stock Warrants" to clarify the number of warrants outstanding and to correct a typographical error in a warrant expiration date. A heading was added to the table now entitled "Quarterly Financial Data (Unaudited)".

- References to the Company's Proxy Statement were updated to reflect the anticipated meeting date of July 21, 2005.

As used herein, the terms "EarthShell" and the "Company" shall mean EarthShell Corporation unless the context otherwise indicates and the term "Proxy Statement" shall mean the Proxy Statement for the Company's 2005 Annual Meeting of Stockholders to be held on July 21, 2005.

i

# PART I

## ITEM 1. BUSINESS

### The Company

EarthShell(R) Corporation ("EarthShell" or the "Company") was organized in November 1992 to engage in the commercialization of a proprietary composite material technology, designed with the environment in mind, for the manufacture of disposable packaging to be used in the foodservice industry. Current and future products include hinged-lid containers, plates, bowls, foodservice wraps, cups, and cutlery ("EarthShell Packaging").

The EarthShell composite material is primarily made from abundantly available and low cost natural raw materials such as limestone and starch from annually renewable crops such as corn and potatoes. The Company believes that foodservice disposables made of this material will offer certain significant environmental benefits, will have comparable or superior performance characteristics, such as greater strength and rigidity, and can be commercially produced and sold at prices that are competitive with comparable conventional paper and plastic foodservice disposables.

The Company's objective is to establish EarthShell Packaging(R) as the preferred disposable packaging material for the foodservice industry throughout the world based on comparable performance, environmental superiority and competitive pricing. EarthShell's approach for achieving this objective has been to: (i) license the EarthShell technology to strategically selected manufacturing or operating partners to manufacture, market, distribute and sell EarthShell Packaging; (ii) demonstrate customer acceptance and demand for EarthShell Packaging through key market leaders and environmental groups; and (iii) demonstrate the manufacturability and improved economics with initial strategic partners.

## Industry Overview

Based on industry studies, the Company believes that the annual spending on foodservice disposable packaging is approximately $12 billion in the U.S. and over $28 billion globally. According to industry studies of the U.S. market, approximately 54% of the total foodservice disposable packaging is purchased by quick-service restaurants and 46% by other institutions such as hospitals, stadiums, airlines, schools, restaurants (other than quick-service restaurants), and retail stores. The Company believes that of the foodservice disposables purchased in the U.S. by quick-service restaurants and other institutions, approximately 45% are made of coated or plastic laminated paper and 55% are made of non-paper materials such as plastic, polystyrene or foil. A breakdown of the various components of the global market for foodservice disposables is as follows:

| | Market Size | |
|---|---|---|
| | $ | % |
| | ($ in millions) | |
| Commercial Products | | |
| Plates, Bowls ............................ | $ 4,500 | 16% |
| Hinged-Lid Containers .................... | 1,750 | 6 |
| Commercial Prototypes | | |
| Wraps .................................... | 2,000 | 7 |
| Hot Cups ................................. | 3,000 | 11 |
| Concept Prototypes | | |
| Cold Cups ................................ | 5,500 | 20 |
| Containers, Trays ........................ | 4,000 | 14 |
| Straws, Cup Lids ......................... | 3,000 | 11 |
| Pizza Boxes .............................. | 2,250 | 8 |
| Cutlery .................................. | 2,000 | 7 |
| Total .................................... | $28,000 | 100% |

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1

In addition to the U.S., the Company believes the market opportunity for EarthShell Packaging is particularly strong in Europe and parts of Asia due to heightened environmental concerns and government regulations. In Europe, environmental legislation, such as the so-called "Green Dot" laws have created an opportunity for environmentally preferable products. Meanwhile, new regulations in many Asian countries have mandated a reduction in polystyrene production stimulating an increased demand for foodservice packaging manufactured from acceptable alternative materials. Furthermore, improvements in the Asian and European composting and recycling infrastructure are expected to facilitate the use of environmentally preferable products.

## Products

EarthShell Packaging is based on a patented composite material technology licensed on an exclusive worldwide basis from E. Khashoggi Industries LLC, the largest stockholder of the Company, and, on a limited exclusive, worldwide basis, from its wholly-owned subsidiaries (collectively "EKI"). The Company's licensed field of use of the technology is for the development, manufacture and sale of disposable packaging for use in the foodservice industry and for certain specific food packaging applications.

Traditional foodservice disposables, wraps, and paperboard are currently manufactured from a variety of materials, including paper and plastic. The Company believes that none of these materials fully addresses three of the principal challenges facing the foodservice industry; namely performance, price, and environmental impact. The Company believes that EarthShell Packaging addresses the combination of these challenges better than traditional alternatives and therefore will be able to achieve a significant share of the foodservice disposable packaging market.

EarthShell Packaging can be categorized into four types: laminated foamed products, flexible wraps, injection-molded products and paperboard substitutes. To date, the EarthShell technology has been used to produce limited commercial quantities of plates, bowls, and hinged-lid containers intended for use by all segments of the foodservice disposable packaging market, including quick-service restaurants, food and facilities management companies, the U.S. government, universities/colleges, and retail operations. These products were developed using detailed environmental assessments and carefully selected raw materials and processes to minimize the harmful impact on the environment without sacrificing competitive price or performance.

## Environment

EarthShell's foodservice disposable products were developed over many years based on environmental models to reduce the environmental concerns of foodservice disposable packaging through the careful selection of raw materials, manufacturing processes and suppliers. For example, EarthShell Packaging reduces risk to wildlife compared to polystyrene foam packaging because it biodegrades when exposed to moisture in nature and can be composted in a commercial facility (where available) or even in consumers' backyards. EarthShell Packaging and the designs approach for its manufacture and disposal has received support from many governmental and non-governmental organizations.

## Performance

The Company believes that it has demonstrated that its laminated foam products, including hinged-lid containers, plates and bowls meet the critical performance requirements of the marketplace, including strength, graphic capabilities, insulation, shipping, handling and packaging. The Company believes its foodservice wraps also meet critical performance requirements of the marketplace, including flexibility, folding characteristics, graphic capabilities, insulation, shipping, handling and packaging. Finally, the Company believes that its paperboard substitute product, which is currently under development, may be manufactured using the same basic raw materials as the foam laminate disposables and wraps and will be readily accepted by the market when available.

Some examples of where EarthShell Packaging plates, bowls, and hinged-lid containers have been used include:

2

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|---|---|
| Quick-Service Restaurants | McDonald's Corporation ("McDonalds") |
| Facilities Management | Sodexho<br>Bon Appetit<br>Aramark |
| Government | U.S. Department of the Interior<br>U.S. Department of Defense<br>Environmental Protection Agency |
| Universities | University of California, Davis<br>Hampshire College<br>Allegheny College |
| Retail | Wal-Mart Stores<br>Green Earth Office Supply |

## Cost

Since EarthShell Packaging is uniquely engineered from readily available, low-cost natural raw materials such as limestone and starch, the Company believes EarthShell products can be manufactured cost-effectively at commercial production levels.

## Business Strategy

The Company's objective is to establish EarthShell Packaging as the preferred foodservice disposable packaging in the foodservice industry. The Company's strategies to achieve this objective are to:

o Develop products which deliver comparable or greater performance, are competitively priced and offer environmental advantages as compared to traditional packaging alternatives

o Demonstrate customer demand as well as product performance and positioning

o Educate the market and build awareness for the EarthShell brand

o Prove manufacturability and economics of EarthShell Packaging

o License the EarthShell technology to strategic manufacturing partners to manufacture, market, distribute and sell EarthShell Packaging o Expand the business by replicating the EarthShell model across multiple operating partners to increase capacity

The Company believes that the use of EarthShell Packaging by key foodservice operators will accelerate the acceptance of the products by other users. To this end, the Company has worked with major purchasers of foodservice disposables in the development and testing of products in order to demonstrate superior product performance, highlight cost-benefit and build demand for EarthShell Packaging. The Company also expects that the EarthShell Packaging brand name will appear on EarthShell products.

The Company's strategy includes licensing the EarthShell technology to, or joint venturing with, strategically selected manufacturing or operating partners for the manufacture, marketing, distribution and sale of EarthShell Packaging. During 2004, the company terminated its license agreements with Sweetheart/Solo and with Huhtamaki as those relationships had not progressed as planned. The Company entered into three new license agreements -- with Meridian Business Solutions ("MBS") for the U.S. market, another with EarthShell Hidalgo S.A. de C.V. ("ESH") for a segment of the Mexican market, and with Hood Packaging ("Hood") to be the exclusive manufacturer of EarthShell food wraps for the North American market. The Company is seeking additional qualified licensees and will provide each of its licensees with technical and ongoing support to facilitate the application of the EarthShell technology, further refine the manufacturing processes and reduce production costs. The Company will monitor product quality at licensee operations.



Over the past several years, the Company has garnered support and achieved commercial validation for EarthShell Packaging from key environmental groups and foodservice purchasers. The Company has also devoted resources to the optimization of product design and the development of cost-effective manufacturing processes. In cooperation with former manufacturing partners, the Company financed and built initial commercial demonstration production capacity and sold limited quantities of plates, bowls, and hinged-lid containers. Having demonstrated the manufacturability of EarthShell foam products, the Company has now ceased commercial demonstration production activities and is relying on its equipment manufacturing partners to demonstrate and guarantee the long-term manufacturability of EarthShell Packaging(R).

EarthShell believes it has a high quality and cost-effective product and a profitable business model necessary to take advantage of a significant market opportunity. With the introduction of commercial production capacity by its licensees and commercial sales of its products in 2005, EarthShell expects its products to continue to gain acceptance in the marketplace and believes it is well-poised to support capacity expansion and market penetration by its licensees leading to growth of the Company's royalty revenue.

## Licensing Business Model

The licensing business model enables the Company to concentrate on the continuing development of quality food service packaging products with reduced impact on the environment. This approach contemplates that manufacturing, marketing, distribution and sale of EarthShell Packaging will be the responsibility of the Company's manufacturing licensees. EarthShell believes that its licensing business model will enable it to generate a sustainable royalty revenue stream. Beyond the revenue opportunities, the Company believes the licensing business model has positive implications for the Company's cost structure. As the Company has moved from product and process development toward the product commercialization phase and has reduced its investment in demonstration manufacturing operations, it has been able to significantly reduce monthly operating costs and reposition itself to take advantage of the operating leverage provided by the licensing model.

EarthShell Packaging will be exclusively manufactured by licensed manufacturing partners. Given the low cost of the raw materials required, these strategic manufacturing partners should have a financial incentive to produce EarthShell Packaging rather than comparable traditional paperboard/polystyrene products even after making the required royalty payments to EarthShell. As the first turnkey commercial manufacturing equipment is successfully placed in service by its first licensee, the Company expects that other licensees will then move quickly to invest to build additional new manufacturing capacity.

While the Company believes it will be successful in developing cost competitive products with its partners, delays in developing such products could adversely impact the introduction and market acceptance of EarthShell Packaging and could have an adverse effect on the Company's business, financial condition and results of operations.

Strategic Manufacturing and Distribution Relationships

The Company believes that it has demonstrated that the performance of EarthShell plates, bowls and hinged-lid containers is commercially competitive and that there is a customer base that is willing to buy them. The critical task for 2005 is the installation and start-up of commercial manufacturing capacity by the Company's licensees to supply EarthShell products to the marketplace. The Company's current licensees are committing capital to purchase equipment to provide EarthShell Packaging products or otherwise develop the EarthShell products or production capacity. The Company intends to proliferate the use of EarthShell Packaging in the U.S. and international markets through agreements with additional licensed partners.

Meridian Business Solutions. In May 2004, the Company entered into a ten year license agreement with MBS for the United States and granted to MBS a priority license to supply certain retail and government market segments. MBS has paid EarthShell $500,000 in technology fees to date. Under the terms of the license agreement, in order to retain its priority in its market segments, MBS must acquire manufacturing capacity to supply its market segments and meet other minimum performance criteria. As the machinery orders are finalized and the manufacturing equipment is built and put into service, MBS will pay an additional $1.5 million in technology fees. All of the technology fees thus paid will be credited against future royalties. At present, since EarthShell has a limited number of initial licensees, MBS potentially represents more than 10% of EarthShell's revenue base. Once MBS is in production and paying royalties to EarthShell, loss of MBS as a licensee could have a material adverse consequence.

4

EarthShell Hidalgo. In November of 2004, the Company entered into a ten year license agreement with ESH as the Company's exclusive licensee for the country of Mexico. To date, they have paid the Company a $1,000,000 technology fee that will be credited against future royalty obligations. Under the terms of the license agreement, in order to retain its priority in its market segments, ESH must acquire manufacturing capacity to supply its market segments and meet other minimum performance criteria. At present, since EarthShell has a limited number of initial licensees, ESH potentially represents more than 10% of EarthShell's revenue base. Once ESH is in production and paying royalties to EarthShell, loss of ESH as a licensee could have a material adverse consequence.

Hood Packaging. In February 2004, the Company entered into a definitive license agreement with Hood Packaging under which Hood became the exclusive manufacturer/distributor of EarthShell food wraps for the North American market, subject to maintaining certain monthly and annual performance targets. Hood is currently working on refining the manufacturing process prior to introducing wraps into selected markets.

## Manufacturing

The current EarthShell manufacturing process for laminated foamed products consists of blending the component ingredients of a proprietary composite material in a mixer, depositing the mixture into heated cavity molds, heating the molded mixture for approximately one minute, removing the product, trimming excess material, and applying functional coatings with desired graphics. EarthShell Packaging uses readily available natural raw materials, such as limestone, potato or corn starch, as well as natural fiber and functional coatings. The Company believes that these raw materials are currently available from multiple existing suppliers in quantities sufficient to satisfy projected demand.

Over the past several years, the Company has devoted resources to develop manufacturing machinery and to demonstrate the commercial viability of its manufacturing processes to enable its operating partners to compete effectively with conventional disposable foodservice packaging and to transfer the operational and financial responsibility of its production lines to its operating partners. In cooperation with former manufacturing partners, the Company financed and built initial commercial production capacity. To date, the Company has produced limited amounts of EarthShell Packaging bowls, plates and hinged-lid containers at production volumes that are low relative to the intended and necessary capacities of the manufacturing lines that are required to achieve efficiencies and cost effectiveness. Although the manufacturing processes currently being used to manufacture EarthShell Packaging are based on generally available methods and equipment, it has taken much longer and has cost much more than anticipated to integrate the machinery in an automated fashion and to refine the manufacturing processes and equipment to operate at commercially viable levels. Having demonstrated the manufacturability of EarthShell foam products, the Company has now ceased commercial demonstration production activities and is relying on its equipment manufacturing partners to demonstrate and guarantee the long-term manufacturability of EarthShell Packaging(R).

Detroit Tool & Engineering ("DTE"). DTE was one of the initial equipment manufacturers to work with EarthShell in developing its first generation commercial manufacturing equipment. In 2002, EarthShell granted a license to DTE to become an approved EarthShell equipment supplier. In early 2005, the Company extended the license through 2007 with exclusivity to manufacture equipment for production of shallow draw products. Building on previous experience with EarthShell manufacturing, DTE designed and built a modular and integrated, turn-key manufacturing line for the production of EarthShell plates and bowls, comprising four plate and four bowl manufacturing modules and has demonstrated to EarthShell's satisfaction that this equipment is fully capable of continuous commercial service. This equipment was planned for delivery, installation and start-up in early 2004 with one of EarthShell's licensees. However, due to a change in EarthShell licensees, as well as a reorganization of DTE that was completed in late 2004, the placement of this equipment was delayed. As of early 2005, these first eight commercial modules have been moved from DTE's fabrication floor and partially installed in a manufacturing hall owned by DTE and in close proximity to the fabrication facility. The Company is negotiating a license agreement with a new licensee which has expressed an interest in acquiring this equipment from DTE and beginning manufacturing operations. Currently, the Company expects that this equipment will be placed in service during 2005.

## Patents, Proprietary Rights and Trademarks

The technology that the Company licenses from EKI is the subject of numerous issued and pending patents in the U.S. and internationally. The Company believes the patents and pending patent applications provide broad protection covering foam laminate EarthShell Packaging, material composition and the manufacturing processes. As of December 31, 2004, EKI had over 130 U.S. and international patents and has pending patent applications relating to the compositions, products and manufacturing processes used to produce EarthShell Packaging(R) food and beverage containers. Patents currently issued do not begin to expire until 2012 and provide some protection until 2020. Pending patents, if granted, would extend protection through 2022. Sixteen of the issued U.S. patents and five of the pending U.S. patents relate specifically to molded food and beverage containers manufactured from the new composite material, the formulation of the new composite material used in virtually all of the EarthShell Packaging are currently under development. The Company and EKI will continue to seek domestic and international patent protection for further developments in the technology and will vigorously enforce rights against any person infringing on the technology.



The Company owns the EarthShell trademark and certain other trademarks, and has been licensed by EKI to use the trademark ALI-ITE for the composite material.

## Relationship with and Reliance on EKI

The Company has an exclusive, worldwide, royalty-free license in perpetuity to use and license the EKI technology to manufacture and sell disposable, single-use containers for packaging or serving food or beverages intended for consumption within a short period of time (less than 24 hours).

On July 29, 2002, the Company entered into an amendment to its Amended and Restated License Agreement with EKI (the "License Agreement") expanding the field of use for the EarthShell technology to include noodle bowls used for packaging instant noodles, a worldwide market that the Company estimates to be approximately $1 billion. Because the noodle bowl development was made at no cost to EarthShell and is an incremental field of use, EarthShell will pay to EKI 50% of any royalty or other consideration it receives in connection with the sale of products within this particular field of use.

In addition, on July 29, 2002 the Company entered into a License & Information Transfer Agreement with bio-tec Biologische Naturverpackungen GmbH & Co. KG and bio-tec Biologische Naturverpackungen Forschungs und Entwicklungs GmbH, together known as "Biotec", a wholly owned subsidiary of EKI, to utilize the Biotec technology for foodservice disposable packaging applications, including food wraps and cutlery (the "Biotec Agreement"). EKI had previously granted to the Company priority rights to license certain product applications on an exclusive basis from Biotec in consideration for the Company's payment of a $100,000 minimum monthly payment to Biotec. In addition, in consideration of the monthly payment, Biotec agreed to render technical services to the Company at Biotec's cost plus 5%. The licensing fee and services arrangements were continued in the Biotec Agreement. Under the terms of the Biotec Agreement, Biotec is entitled to receive 25% of any royalties or other consideration that the Company receives in connection with the sale of products utilizing the Biotec technology, after applying a credit for all minimum monthly payments received to date. In connection with the issuance of EarthShell's 2006 Convertible Debentures, Biotec agreed to subordinate the licensee fee payments due from EarthShell until the debentures were retired. During this period, the license fees due to Biotec were accrued. In September of 2004, as part of an overall restructuring of its debt, EarthShell and Biotec entered into an agreement to convert $1.475 million of the $2.475 million of accrued license fees as of September 1, 2004, plus accrued interest into 491,778 shares of EarthShell common stock and to eliminate, for two years, the $100,000 per month minimum license fee. In December of 2004, the agreement was amended and EarthShell paid to Biotec $125,000, leaving a balance owing of $875,000. (See MD&A Liquidity and Capital Resources)

During 2002 and January 2003, EKI made a series of loans to the Company totaling approximately $5.8 million. In connection with the issuance and sale in March 2003 of the Company's 2% secured convertible debentures due in 2006 (the "2006 Debentures") to a group of institutional investors, EKI agreed to subordinate the repayment of these loans to the payment in full of the Company's obligations under the 2006 Debentures. In addition, EKI and Biotec agreed to subordinate certain payments referenced above to which they were otherwise entitled under the License Agreement and the Biotec Agreement to the satisfaction in full of the Company's obligations under the 2006 Debentures. They further agreed not to assert any claims against the Company for breaches of the License Agreement or the Biotec Agreement until such time as the Company's obligations under the 2006 Debentures were satisfied in full. EKI and Biotec also agreed to allow the Company to pledge its interest in the License Agreement to secure its obligations under the 2006 Debentures, and certain additional concessions were made by EKI and Biotec to permit the Company greater flexibility in selling its rights under the License Agreement and the Biotec Agreement to third parties in an insolvency context. (These rights terminated upon the satisfaction in full of the obligations under the 2006 Debentures in October of 2004.) In consideration for its willingness to subordinate the payments and advances that were owed to it, the Company issued to EKI in March 2003 a warrant to acquire 83,333 shares of the Company's common stock at a price of $6.00 per share with a ten year term.

In October 2004, in connection with the settlement of the March 2006 Debentures, EKI converted all of its outstanding loans to EarthShell ($2,755,000) into unregistered common stock at $3 per share and $532,644 of accumulated interest at $4 per share for a total of 1,051,494 shares received by EKI. As of December 31, 2004, the loans from EKI to EarthShell had all been retired. In May of 2005, an additional 44,387 shares were issued to EKI pursuant to a 90 day price protection clause, which provided for an adjustment in the effective conversion price of the interest portions of the EKI loans from $4 per share to $3 per share.

In May of 2005, the Company granted a warrant to EKI to purchase one million shares of the Company's common stock at $3 per share in consideration of EKI's continued support of the Company since its inception, including providing bridge loans at below market terms from time to time. The warrant expires in May of 2015.

6

Under the terms of the License Agreement and the Amended and Restated Patent Agreement for the Allocation of Patent Costs between the Company and EKI, any patents granted in connection with the EarthShell technology are the property of EKI, and EKI may obtain a benefit therefrom, including the utilization and/or licensing of the patents and related technology in a manner or for uses unrelated to the license granted to the Company in the foodservice disposables field of use. Effective January 1, 2001, EarthShell assumed direct responsibility to manage and maintain the patent portfolio underlying the License Agreement with EKI and continues to pay directly all relevant costs.

Competition

Competition among food and beverage container manufacturers in the foodservice industry is intense. Virtually all of these competitors have greater financial and marketing resources at their disposal than does the Company, and many have established supply, production and distribution relationships and channels. Companies producing competitive products may reduce their prices or engage in advertising or marketing campaigns designed to protect their respective market shares and impede market acceptance of EarthShell Packaging. In addition, some of the Company's licensees and joint venture partners manufacture paper, plastic or foil packaging that may compete with EarthShell Packaging.

Several paper and plastic disposable packaging manufacturers and converters and others have made efforts to increase the recycling of these products. Increased recycling of paper and plastic products could lessen their harmful environmental impact, one major basis upon which the Company intends to compete. A number of companies have introduced or are attempting to develop biodegradable starch-based materials, plastics, or other materials that may be positioned as potential environmentally superior packaging alternatives. It is expected that many existing packaging manufacturers may actively seek to develop competitive alternatives to the Company's products and processes. While the Company believes its patents uniquely position it to incorporate a proportion of low cost, inorganic fillers with its material, which, relative to other starch-based or specialty polymers, will result in lower material costs, the development of competitive, environmentally attractive, disposable foodservice packaging could render the Company's technology obsolete and could have an adverse effect on the business, financial condition and results of operations of the Company.

## Certain Risk Factors

Although the Company earned its first revenues in 2004 and is no longer classified as a "developmental stage company", it has limited operating history, therefore, it remains subject to the inherent challenges and risks of establishing a new business enterprise. To date, production volumes of EarthShell Packaging products have been low relative to intended and necessary capacity of the manufacturing lines. The success of future operations depends upon the ability of licensees to manufacture products made with EarthShell Packaging in sufficient quantities so as to be commercially feasible and then to distribute and sell those products at competitive costs. Consistent commercially feasible production volumes had not been achieved and assured competitive cost figures had not yet been proven as of December 31, 2004.

As of December 31, 2004, the Company had reported operating revenues of $.1 million and aggregate net losses of approximately $7.3 million for the year. Although the Company hopes to achieve break-even cash flow by the end of the year, the Company does not expect to operate profitably during fiscal year 2005. Although the Company is actively seeking third party financing to meet its operating and capital needs, there is no assurance that additional funding will be available to the Company, and, even if it is available, such financing may be (i) extremely costly, (ii) dilutive to existing stockholders and/or (iii) restrictive to the Company's ongoing operations. If additional financing cannot be obtained, the Company would have to cease business operations. Management plans to address the Company's current financing needs, in part, by raising cash through either the sale of licenses, the generation of royalty revenues or the issuance of debt or equity securities. In addition, the Company expects cash to be generated during fiscal year 2005 through royalty payments from licensees. However, the Company cannot assure that additional financing will be available to it, or if available, that the terms will be satisfactory, that it will receive any royalty payments in 2005. Management will also continue to in its efforts to reduce expenses, but cannot assure that it will be able to reduce expenses sufficiently in order to continue its business operations.

Management has identified the following material weaknesses in the Company's internal controls over financial reporting:

- The Company has inadequate segregation of critical duties within each of its accounting processes and a lack of sufficient monitoring controls over these processes to mitigate this risk. The responsibilities assigned to one employee include maintaining the vendor master file, processing payables, creating and voiding checks, reconciling bank accounts, making bank deposits and processing payroll.

- The departure of the Company's Controller in November 2004 resulted in the accounting and reporting functions being centralized under the Chief Financial Officer, with no additional personnel in the Company having an adequate knowledge of accounting principles and practices. As a result, certain transactions had not been recorded in a timely manner and several adjustments to the financial statements that were considered material to the financial position at December 31, 2004 and results of operations for the year then ended were recorded.

- There are weaknesses in the Company's information technology controls which makes the Company's financial data vulnerable to error or fraud. Specifically, there is a lack of documentation regarding the roles and responsibilities of the IT function, lack of security management and monitoring and inadequate segregation of duties involving IT functions.

Additionally, at the conclusion of our independent auditor's examination of the Company's internal control over financial reporting, our independent auditor noted several other areas of operations which could be improved, although our auditors did not believe these items constituted material weaknesses. The Company's management is currently taking steps to address these material weaknesses. However, the Company cannot assure that management will be able to timely correct such weaknesses nor be able to correct them at all. Accordingly, Management cannot provide reasonable assurance that the Company's financial reporting and the preparation of its financial statements conform to generally accepted accounting principles.

The Company's common stock is no longer traded on the NASDAQ Small Cap Market. SEC regulations generally define a "penny stock" to be any non-Nasdaq equity security that has a market price of less than $5.00 per share, subject to certain exceptions. Based upon the price of EarthShell common stock as currently traded, EarthShell common stock is subject to Rule 15g-9 under the Securities and Exchange Act of 1934 which imposes additional sales practice requirements on broker-dealers which sell securities to persons other than established customers and "accredited investors." For transactions covered by this rule, a broker-dealer must make a special suitability determination for the purchaser and have received a purchaser's written consent to the transaction prior to sale. Consequently, this rule may have a negative effect on the ability of stockholders to sell common shares of the Company in the secondary market.



The Company's current business model is to license the manufacturing and distribution of EarthShell Packaging foodservice disposables to licensees. Agreements with the licensees permit them to manufacture and sell other foodservice disposable packaging products that are not based on EarthShell Packaging. The licensees may also manufacture paper or polystyrene packaging which could compete with EarthShell products, and they may not devote sufficient resources or otherwise be able successfully to manufacture, distribute or market EarthShell Packaging. Their failure to do so would be grounds for termination of exclusivity provisions in their license agreement, but might also delay the rollout of EarthShell Packaging into the marketplace.

The success of the Company depends substantially on its ability to design, develop and manufacture foodservice disposables that are not as harmful to the environment as conventional disposable foodservice containers made from paper, plastic and polystyrene. Although EarthShell Packaging offers a number of environmental advantages over conventional packaging products, it may also possess characteristics that consumers or environmental groups could perceive as negative for the environment. In particular, EarthShell Packaging may result in more solid waste by weight, and manufacturing them may release greater amounts of some pollutants than the manufacture of some other packaging would release.

The Company does not own the technology necessary to manufacture EarthShell Packaging and is dependent upon the License Agreement to use that technology. The licensed technology is limited to the development, manufacture and sale of specified foodservice disposables for use in the foodservice industry, and there is no right to exploit opportunities to apply this technology or improve it outside this field of use. If EKI were to file for or be declared bankrupt, the Company would likely be able to retain its rights under the License Agreement with respect to U.S. patents; however, it is possible that steps could be taken to terminate its rights under the License Agreement with respect to international patents. EKI is the controlling stockholder of the Company, and conflicts could arise with regard to performance under the license agreement, corporate opportunities or time devoted to the business of the Company by officers and directors who are common to both EKI and the Company.

As disclosed in Item 9A of this Annual Report on Form 10-K/A, as permitted by the SEC, the Company filed Management's Annual Report on Internal Control Over Financial Reporting and the related report of its independent registered public accounting firm by amendment to this Annual Report on Form 10-K within 45 days after the date the Annual Report on Form 10-K was required to be filed. This report on Internal Control Over Financial Reporting and the related report of the Company's independent auditor disclosed certain material weaknesses in internal control over financial reporting. While the Company is working to remedy the material weaknesses reported, the determination that the Company has failed to achieve and maintain an effective system of internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act and the SEC's related rules could have a material adverse effect on our business and stock price.

## Government Regulation

The manufacture, sale and use of EarthShell Packaging are subject to regulation by the U.S. Food and Drug Administration (the "FDA"). The FDA's regulations are concerned with substances used in food packaging materials, not with specific finished food packaging products. Thus, food and beverage containers are in compliance with FDA regulations if the components used in the food and beverage containers: (i) are approved by the FDA as indirect food additives for their intended uses and comply with the applicable FDA indirect food additive regulations; or (ii) are generally recognized as safe for their intended uses and are of suitable purity for those intended uses.

The Company believes that EarthShell Packaging plates, bowls and hinged-lid containers and all other current and prototype EarthShell Packaging products of the Company are in compliance with all requirements of the FDA and do not require additional FDA approval. The Company cannot be certain, however, that the FDA will agree with these conclusions.

## Employees

As of January 1, 2005, the Company had 9 employees. The Company's employees are not represented by a labor union, and the Company believes it has a good relationship with its employees.

Available Information

The Company's internet website is www.earthshell.com. The Company makes available free of charge on its website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, reports filed pursuant to Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and amendments to those reports as soon as reasonably practicable after such materials are electronically filed or furnished to the SEC. Materials the Company files with the SEC may be read and copied at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. This information may also be obtained by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission also maintains an internet website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at www.sec.gov. The Company will provide a copy of any of the foregoing documents to shareholders upon request.



ITEM 2. PROPERTIES

In November 2004, the Company relocated its offices to its current location at 3916 State Street in Santa Barbara, California. The office space is shared with EKI under a month to month sublease. The Company's monthly lease payment for approximately 2,000 square feet of office space and is approximately $4,000. In addition, the Company leases 3,353 square feet of office space in Lutherville, Maryland, on a month to month basis. The Company's monthly lease payment with respect to this space is $5,780.

The Company believes it will be able to lease comparable space at a comparable price when these leases expire.

ITEM 3. LEGAL PROCEEDINGS

The Company is engaged in litigation with two equipment suppliers seeking to collect a total of approximately $600,000 for manufacturing equipment in connection with the Company's former Goettingen, Germany manufacturing line that is no longer in service. The entire amount claimed in the litigation has already been accrued as part of the Company's accounts payable. The Company believes that it has good defenses and counterclaims inasmuch as the equipment did not reach the performance requirements specified in the purchase contracts, and expects to settle the respective matters soon.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's common stock is currently listed on the Bulletin Board published by the National Quotation Bureau, Inc., and prior to March 8, 2004 traded on the Nasdaq SmallCap Market. The Company's common stock trades under the symbol "ERTH.OB." For the periods indicated, the following table presents the range of high and low closing sale prices for the Company's common stock.

| | First | Second | Third | Fourth | Total Year |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| 2004 | | | | | |
| Market price per common share | | | | | |
| High ...................... | $ 2.52 | $ 2.03 | $ 3.75 | $ 2.97 | $ 3.75 |
| Low ....................... | 1.49 | 0.45 | 1.75 | 1.95 | 0.45 |
| 2003 | | | | | |
| Market price per common share | | | | | |
| High ...................... | $ 7.80 | $ 7.08 | $ 5.64 | $ 4.56 | $ 7.80 |
| Low ....................... | 4.20 | 4.32 | 3.72 | 1.33 | 1.33 |

The Company's common stock sales prices have been restated, where applicable, to reflect the one-for-twelve reverse split of the Company's common stock effective as of October 31, 2003. Quotations since the Company's stock began trading on the OTC Bulletin Board may reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

The number of stockholders of record of the Company's common stock at March 28, 2005 was 1,185. At March 31, 2005, Mr. Essam Khashoggi, directly or indirectly, owned approximately 36% of the outstanding common stock of the Company.



The Company does not intend to declare or pay cash dividends on its common stock in the foreseeable future nor has it paid dividends in the past two years.

Recent Sales of Unregistered Securities

(1) In November 2004, as part of an overall restructuring of its debt, EarthShell issued an aggregate of 491,778 shares of its common stock to Biotec in exchange for the cancellation of $1.475 million of accrued license fees EarthShell owed Biotec, which transaction computed to a $3.00 per share conversion price.

(2) In November 2004, in connection with the restructuring of its debt and settlement of the 2006 Debentures, EarthShell issued an aggregate of 1,051,494 shares of its common stock to EKI of the 2006 Debentures in exchange for the cancellation of $3.288 million of principal and interest due under then outstanding loans.

(3) Pursuant to various agreements dated September 29 and 30, 2004 in connection with the restructuring of its debt and settlement of the 2006 Debentures, EarthShell issued an aggregate of 512,500 additional shares of its common stock to the holders of the 2006 Debentures in settlement of the Company's default under the 2006 Debentures.

(4) In October 2004, as part of an overall restructuring of its debt, EarthShell issued an aggregate of 900,000 shares of its common stock to MBS at $3.00 per share for an aggregate offering price of $2.7 million.

EarthShell claimed an exemption from registration under the Securities Act for the sales and issuance of its common stock in the transactions described in paragraphs (1) through (4) above by virtue of Section 4(2) of the Securities Act in that such sales and issuances did not involve a public offering. EarthShell believed that the recipients of common stock in each of these transactions intended to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were affixed to the share certificates and instruments issued in such transactions. These sales and issuances were made without general solicitation or advertising and each purchaser was a sophisticated investor. All recipients had adequate access, through their relationships with the Company, to information about the Company. There were no underwriters involved in any of these sales and issuances.



ITEM 6. SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with the Company's Financial Statements and Notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Annual Report on Form 10-K/A.

Selected Financial Data

(in thousands, except per share data)

| | For the Year Ended December 31 | | | | |
|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2001 | 2000 |
| Statement of Operations Data | | | | | |
| Revenues ...................... | $ 138 | -- | -- | -- | -- |
| Research and development expenses ..................... | 1,170 | $ 9,547 | $ 26,890 | $ 47,148 | $ 37,265 |
| General and administrative expenses ..................... | 3,749 | 5,786 | 9,590 | 9,634 | 6,843 |
| Depreciation and amortization .. | 42 | 380 | 3,099 | 5,874 | 5,704 |
| Gain on sale of property and equipment ................... | (168) | (452) | (441) | -- | -- |
| Interest expense (income), net . | 1,068 | 1,791 | 132 | (356) | (1,264) |
| Related party patent expenses .. | -- | -- | -- | -- | 362 |
| Debenture conversion cost ...... | -- | 166 | 321 | -- | -- |
| Net loss ...................... | 7,257 | 18,517 | 39,591 | 62,302 | 48,912 |
| Average shares outstanding ..... | 15,047 | 13,267 | 11,277 | 9,353 | 8,452 |
| Balance Sheet Data | | | | | |
| Cash and cash equivalents ...... | $ 272 | $ 1,902 | $ 111 | $ 828 | $ 7,792 |
| Working capital (deficit) ...... | (7,289) | (9,438) | (8,315) | (6,941) | 2,107 |
| Total assets .................. | 483 | 2,287 | 18,024 | 19,886 | 48,474 |
| Total long-term obligations .... | 1,475 | 4,408 | -- | -- | -- |
| Deficit accumulated during development stage ........... | (321,607) | (314,351) | (295,834) | (256,243) | (193,941) |
| Stockholders' equity (deficit) . | (8,755) | (12,269) | (3,473) | 11,536 | 42,296 |
| Shares outstanding ............ | 18,235 | 14,129 | 12,055 | 9,860 | 8,709 |
| Per Common Share | | | | | |
| Basic and diluted loss per share | $ 0.48 | $ 1.40 | $ 3.51 | $ 6.66 | $ 5.79 |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Selected Financial Data and the Company's Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report on Form 10-K/A. Such consolidated financial statements and information have been prepared to reflect the Company's operations for the three years ended December 31, 2004 and the assets and liabilities of the Company as of December 31, 2004 and 2003.

Information in this Annual Report on Form 10-K/A including but not limited to "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 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 which may be discussed elsewhere in this Annual Report on Form 10-K/A.



## Overview

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(R) is based on patented composite material technology (collectively, the "EarthShell Technology"), licensed on an exclusive, worldwide basis from E. Khashoggi Industries LLC and its wholly owned subsidiaries.

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(R), including hinged-lid sandwich containers, plates, bowls, foodservice wraps, and cups, is primarily made from commonly available natural raw materials such as natural ground limestone and potato starch. EarthShell believes that EarthShell Packaging(R) has comparable or superior performance characteristics and can be commercially produced and sold at prices that are competitive with comparable paper and plastic foodservice disposables.

EarthShell was a development stage enterprise through the first quarter of 2004. With the recognition of the Company's first revenues resulting from the receipt of $500,000 in technology fees in connection with granting a license to a strategic partner in the second quarter of 2004, the Company was no longer a development stage enterprise.

## Critical Accounting Assumptions

Going Concern Basis. The consolidated 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. The Company has incurred significant losses since inception, has minimal revenues and has a working capital deficit of $7,289,431 at December 31, 2004. These factors, along with others, may indicate that the Company will be unable to continue as a going concern for a reasonable period of time. The Company will have to raise additional funds to meet its current obligations and to cover operating expenses through the year ending December 31, 2005. If the Company is not successful in raising additional capital it may not be able to continue as a going concern for a reasonable period of time. Management plans to address this need by raising cash through either the sale of licenses, the generation of royalty revenues or the issuance of debt or equity securities. In addition, the Company expects cash to be generated in 2005 through royalty payments from licensees. However, the Company cannot assure that additional financing will be available to it, or, if available, that the terms will be satisfactory, that it will receive any royalty payments in 2005. Management will also continue in its efforts to reduce expenses, but can not assure that it will be able to reduce expenses below current levels. The consolidated 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.

Estimated Net Realizable Value of Property and Equipment. The Company evaluates the recoverability of property and equipment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. If there is an indication that the carrying value of an asset may not be recoverable and the estimated future cash flows (undiscounted and without interest charges) from the use of the asset are less than the carrying value, a write-down is recorded to reduce the related asset to its estimated fair value. At one time, the Company had been engaged in the development of manufacturing equipment to validate acceptance of EarthShell products and their pricing. To this end, the Company previously developed manufacturing lines in Owings Mills, Maryland, Goleta, California and in Goettingen, Germany. The Company recognized impairment charges on its equipment amounting to $4.0 million and $9.8 million in 2003 and 2002, respectively.

Revenue Recognition. The Company recognizes revenue when persuasive evidence of an arrangement exists, the price is fixed or readily determinable and collectibility is probable. The Company recognizes revenue in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements," (SAB 101). EarthShell's revenues consist of technology fees that are recognized ratably over the life of the related agreements and royalties based on product sales by licensees that are recognized in the quarter that the licensee reports the sales.

12

## Results of Operations

Year Ended December 31, 2004 Compared with the Year Ended December 31, 2003

The Company's net loss decreased $11.2 million to $7.3 million from $18.5 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively.

Revenues. The Company recorded revenues of $0.1 million for the year ended December 31, 2004. These revenues reflect amortization of the $3.0 million of technology fees payable under the sublicense agreements that were entered into with MBS and with ESH in the second and fourth quarters of 2004 over the ten years of the agreements. The amortization of the technology fees will result in the recognition of $0.3 million in revenues per year during the lives of the agreements. Prior to this, the Company had no recognized revenue as it was a development stage company.

Research and Development Expenses. Total research and development expenses are comprised of Related party license fee and research and development expenses and Other research and development expenses. Total research and development expenditures for the development of EarthShell Packaging(R) decreased $8.3 million to $1.2 million from $9.5 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively.

- Related party license fee and research and development expenses are comprised of the $.1 million minimum monthly licensing fee for the use of the EarthShell technology and for technical services, both of which were payable to EKI, a stockholder of the Company, or Biotec, a wholly-owned subsidiary of EKI. Related party license fee and research and development expenses decreased $0.5 million to $0.8 million from $1.3 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. The decrease was primarily due to a decrease in the license fee as a result of an agreement with Biotec to eliminate the $0.1 million per month minimum licensing fee from September 2004 through August 2006.

- Other research and development expenses are comprised of personnel costs, travel and direct overhead for development and demonstration production, as well as impairment charges on manufacturing property and equipment constructed for demonstration production purposes. Other research and development expenses decreased $7.8 million to $0.4 million from $8.2 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. The reduction was due to the non-recurrence of the following 2003 activities: the winding down of on-going demonstration manufacturing in Goleta, California in the first quarter of 2003, the start-up in mid-May of a new manufacturing line for plates and bowls built and financed by Detroit Tool and Engineering Company (DTE) at their Lebanon, Missouri facility, expenses incurred to vacate the Company's demonstration manufacturing facility in Goleta at the expiration of the lease on May 31, 2003, costs incurred in connection with testing of the Goettingen, Germany manufacturing equipment during the third quarter, the write down of the Goettingen manufacturing equipment to $1 as of December 31, 2003 due to the uncertainty of the proceeds to be realized upon sale of the equipment, and the losses of the Company's joint venture. In early August 2003, the Company discontinued its day-to-day support of manufacturing activities at DTE. In keeping with its business model, in 2004 the Company primarily focused on the licensing of its foam analog material and other technologies to new licensees, and these licensees and future licensees will install and run equipment to produce EarthShell Packaging(R) in their own facilities.

Other General and Administrative Expenses. Other general and administrative expenses are comprised of personnel costs, travel and direct overhead for marketing, finance and administration. Total general and administrative expenses decreased $2.0 million to $3.8 million from $5.8 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. This was primarily the result of efforts to significantly reduce general and administrative expenses throughout 2003 and 2004, which resulted in reductions in the following expenses: personnel costs by $0.7 million (due to a reduction in headcount from 14 employees at December 31, 2003 to 9 employees at December 31, 2004), professional fees and services by $0.8 million, facility and support costs by $0.3 million, business insurance costs by $0.2 million, travel and entertainment expenses by $0.1 million and franchise taxes by $0.1 million. In addition, the Company was able to reduce previously provided expense accruals by approximately $0.6 million due to their favorable resolution in the third quarter of 2004. Most of the credit to general and administrative expenses related to the favorable resolution of property tax disputes within the states of California and Maryland. The expense reductions were partially offset by approximately $0.8 million of accounts payable settlement gains in 2003. The settlement gains were the result of a program began by the Company in the second quarter of 2003 to satisfy vendors for outstanding aged invoices.



Depreciation and Amortization Expense. Depreciation and amortization expense decreased $0.34 million to $0.04 million from $0.38 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. The decrease in depreciation expense is primarily attributable to taking the remainder of EarthShell's manufacturing and development assets out of service as of the end of 2003.

Interest Expense. Interest expense is comprised of Related party interest expense and Other interest expense.

o Related party interest expense was $0.4 million for both the year ended December 31, 2004 and the year ended December 31, 2003. Related party interest expense includes interest accrued on outstanding loans made to the Company by EKI under the Loan Agreement (see "Related Party Transactions"), accretion of the discount related to the warrants issued to EKI in conjunction with the March 2003 financing transactions, plus accrued interest payable on amounts owed to EKI for monthly licensing fees that were accrued rather than being paid in accordance with the terms of the subordination agreements entered into in connection with the 2006 Debentures (see "Related Party Transactions"). During the third quarter of 2004, agreements were negotiated with EKI to convert all outstanding loans and accrued but unpaid interest into common stock of the Company and to restructure the unpaid licensing fees under the Biotec License Agreement (see "Item 1 Business Relationship with and Reliance on EKI"). Therefore, there will be no Related party interest expense for these items subsequent to December 31, 2004.

o Other interest expense decreased $0.7 million to $0.7 million from $1.4 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. Other interest expense for 2004 is primarily comprised of accretion of the discount and interest accrued on the 2006 Debentures. Other interest expense for 2003 was primarily comprised of accretion of discount on the 2006 Debentures and a beneficial conversion charge in the amount of $0.4 million due to a change in the 2007 Debentures conversion price. In addition, Other interest expense for 2003 also included accretion of the discount on the 2007 Debentures and accrued interest payable on the 2006 and 2007 Debentures.

Gain on Sale of Property and Equipment. Gain on the sale of property and equipment decreased $0.3 million to $0.2 million from $0.5 million for the year ended December 31, 2004 compared to the year ended December 31, 2003, respectively. The gains in both 2004 and 2003 were realized due to the sale of non-essential machine shop equipment and excess office furniture and equipment over their net book value, most of which was fully depreciated. In addition, 2003 also included proceeds received from the sale of production line equipment that was previously impaired and therefore had a net book value of zero.

Premium due to Debenture Default. At September 30, 2004, the Company was in non-compliance with certain covenants of the 2006 Debentures. Two of the debenture holders, including the debenture holder with the largest ownership position, notified the Company in writing that the Company was in default and requested that the Company repurchase the entire principal amount of the 2006 Debentures held at the price specified in the debenture, along with any accrued and unpaid interest. The debenture contains a provision for repurchase of the debenture at a premium if the repurchase is due to an event of default, and the Company accrued the amount of the premium specified in the debenture.

Other Income. Other income for the year ended December 31, 2004 was zero compared to $0.4 million for the year ended December 31, 2003. The 2003 other income represents the net gain realized in the third quarter of 2003 from reducing the balance of the warrant obligation to its estimated fair value of zero. The warrant obligation was initially recorded in connection with the March 2003 financing transactions (see "Convertible Debentures").

(Gain) Loss on Extinguishment of Debentures. There was a gain on extinguishment of debentures of $.1 million for the year ended December 31, 2004 compared to a loss on extinguishment of debentures was $1.7 million for the year ended December 31, 2003. The $0.1 million gain for the year ended December 31, 2004 relates to interest payable on the 2006 Debentures that was not paid by the Company upon conversion of the Debentures. In connection with the March 2003 financing transactions, the Company prepaid $5.2 million aggregate principal amount of the 2007 Debentures, resulting in a prepayment penalty of approximately $0.2 million. The Company also issued to the holders of the prepaid 2007 Debentures 52,083 shares of common stock, valued at approximately $0.2 million based upon the closing price of the Company's common stock of $4.56 per share on March 5, 2003. In addition, one of the holders of the 2007 Debentures exchanged $2.0 million aggregate principal amount of 2007 Debentures for $2.0 million aggregate principal amount of 2006 Debentures. In connection with the prepayment and exchange transactions, the Company incurred cash transaction costs of approximately $0.3 million, excluding the prepayment penalty. In addition, the Company incurred a charge of approximately $0.9 million for the prorated portion of the original discount attributed to the $7.2 million of the 2007 Debentures repaid and exchanged. Therefore, the Company recognized a $1.7 million loss upon extinguishment of the 2007 debentures through the prepayment and exchange (see "Convertible Debentures").



Debenture Conversion Cost. Debenture Conversion Cost was $0.2 million for the year ended December 31, 2003. The expense represents the prorated portion of the original discount attributed to the 2007 Debentures whose conversion was forced by the Company in the respective periods.

Year Ended December 31, 2003 Compared with the Year Ended December 31, 2002

The Company's net loss decreased $21.1 million to $18.5 million from $39.6 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively.

Research and Development Expenses. Total research and development expenses are comprised of Related party license fee and research and development expenses and Other research and development expenses. Total research and development expenditures for the development of EarthShell Packaging(R) decreased $17.4 million to $9.5 million from $26.9 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively.

- Related party license fee and research and development expenses are comprised of the $100,000 minimum monthly licensing fee for the use of the EarthShell technology and for technical services, both of which were payable to EKI, a stockholder of the Company, or Biotec, a wholly owned subsidiary of EKI. It should be noted that payment of these related party expenses has been deferred pursuant to subordination agreements entered into by the EKI entities in connection with the convertible debenture financing concluded in March of 2003. Related party license fee and research and development expenses decreased $0.2 million to $1.3 million from $1.5 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The decrease was entirely due to a decrease in technical services provided to the Company by Biotec.

- Other research and development expenses are comprised of personnel costs, travel and direct overhead for development and demonstration production, as well as impairment charges on manufacturing property and equipment constructed for demonstration production purposes. Other research and development expenses decreased $17.2 million to $8.2 million from $25.4 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The decrease in other research and development expenses was primarily due to concluding the demonstration manufacturing of hinged-lid containers in Owings Mills, Maryland at the end of the second quarter of 2002. While the majority of the expenses incurred in 2002 related to the Owings Mills demonstration manufacturing, it also included expenses related to the commencement of demonstration manufacturing of bowls and plates in Goleta, California. Other research and development expenses incurred in 2003 primarily related to the ongoing demonstration manufacturing in Goleta through mid-April and to the start-up in mid-May of a new manufacturing line for plates and bowls built and financed by Detroit Tool and Engineering Company (DTE) at their Lebanon, Missouri facility. In early August 2003, the company discontinued its day-to-day support of manufacturing activities at DTE. In keeping with its business model, the Company will hereafter focus primarily on the licensing of its foam analog material and other technologies, and all future manufacturing and production will be the responsibility of current or new licensees as they install and run equipment to produce EarthShell Packaging(R) in their own facilities. The decrease in other research and development expenses was also due to a $5.8 million reduction in property and equipment impairment charges, to $4.0 million in 2003 from $9.8 million in 2002.

Other General and Administrative Expenses. Other general and administrative expenses are comprised of personnel costs, travel and direct overhead for marketing, finance and administration. Total general and administrative expenses decreased $3.8 million to $5.8 million from $9.6 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. This was primarily the result of efforts to significantly reduce general and administrative expenses in 2003, which resulted in reductions in the following expense categories: legal fees, including patent prosecution and maintenance fees, by $0.9 million, personnel costs by $0.7 million, professional fees and services by $0.4 million, travel costs by $0.3 million, facility costs by $0.3 million and business insurance costs by $0.2 million. In addition, in the second quarter of 2003 the Company began a program to satisfy vendors for outstanding invoices and recognized gains from settling various old trade accounts payable at a discount. As a result of negotiations, in 2003 the Company settled and paid outstanding accounts payable of approximately $1.5 million at a discount of approximately $0.8 million.

15

Depreciation and Amortization Expense. Depreciation and amortization expense decreased $2.7 million to $0.4 million from $3.1 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The decrease in depreciation expense is primarily attributable to the decrease in property and equipment as a result of the impairment of demonstration manufacturing property and equipment in 2002.

Interest Income. Interest income totaled $0.1 million for each of the years ended December 31, 2003 and December 31, 2002.

Interest Expense. Interest expense is comprised of Related party interest expense and Other interest expense.

- Related party interest expense increased $0.3 million to $0.4 million from $0.1 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The increase was due to an increase in accrued interest payable on outstanding loans made to the Company by

EKI from September 2002 through January 2003 that were outstanding throughout all of 2003, accretion in 2003 of the discount related to the warrants issued in conjunction with the March 2003 financing transactions, plus accrued interest payable on amounts owed to EKI for monthly licensing fees that were not paid in accordance with the terms of the subordination agreements entered into in connection with the 2006 Debentures (see Related Party Transactions).

o Although the outstanding loans and monthly licensing fees will accrue approximately $0.4 million in annual interest expense, payment of the interest is subordinated to the 2006 Debentures. Therefore, the related party interest expense will continue to accrue but will not be paid in cash until the 2006 Debentures have been converted or the obligation satisfied in full.

o Other interest expense increased $1.2 million to $1.4 million from $0.2 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. Other interest expense for 2003 is primarily comprised of accretion of the discount on the 2006 Debentures and a beneficial conversion charge in the amount of $0.4 million due to a change in the 2007 Debentures conversion price. In addition, Other interest expense for 2003 also included accretion of the discount on the 2007 Debentures and accrued interest payable on the 2006 and 2007 Debentures. Other interest expense for 2002 was comprised of accretion of the discount and accrued interest payable on the 2007 Debentures. Interest expense from accretion of the discount and accrued interest payable for the 2006 Debentures will be approximately $0.8 million per year until they are repaid or are converted into common stock.

Other Income. Other income was $0.4 million for the year ended December 31, 2003. This represents the net gain realized in the third quarter of 2003 from reducing the balance of the warrant obligation to its estimated fair value of zero. Management believes the estimated fair value of the warrant at December 31, 2003 is zero. The warrant obligation was initially recorded in connection with the March 2003 financing transactions (see Convertible Debentures).

Loss on Extinguishment of Debentures. Loss on extinguishment of debentures was $1.7 million for the year ended December 31, 2003. In connection with the March 2003 financing transactions, the Company prepaid $5.2 million aggregate principal amount of the 2007 Debentures, resulting in a prepayment penalty of approximately $0.2 million. The Company also issued to the holders of the prepaid 2007 Debentures 52,083 shares of common stock, valued at approximately $0.2 million based upon the closing price of the Company's common stock of $4.56 per share on March 5, 2003. In addition, one of the holders of the 2007 Debentures exchanged $2.0 million aggregate principal amount of 2007 Debentures for $2.0 million aggregate principal amount of 2006 Debentures. In connection with the prepayment and exchange transactions, the Company incurred cash transaction costs of approximately $0.3 million, excluding the prepayment penalty. In addition, the Company incurred a charge of approximately $0.9 million for the prorated portion of the original discount attributed to the $7.2 million of the 2007 Debentures repaid and exchanged. Therefore, the Company recognized a $1.7 million loss upon extinguishment of the 2007 debentures through the prepayment and exchange.



Gain on Sale of Property and Equipment. Gain on the sale of property and equipment increased $0.1 million to $0.5 million from $0.4 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The gain in both 2003 and 2002 represents the excess of proceeds received from the sale of non-essential machine shop equipment and excess office furniture and equipment over their net book value. In addition, 2003 also includes proceeds received from the sale of production line equipment that was previously impaired and therefore had a net book value of zero.

Debenture Conversion Cost. Debenture Conversion Cost decreased $0.1 million to $0.2 million from $0.3 million for the year ended December 31, 2003 compared to the year ended December 31, 2002, respectively. The expense represents the prorated portion of the original discount attributed to the 2007 Debentures whose conversion was forced by the Company in the respective periods.

## Liquidity and Capital Resources

Cash Flow. The Company's principal uses of cash for the year ended December 31, 2004 were to fund operations, repay convertible debentures, and pay accounts payable and accrued expenses. Net cash used in operations was $2.7 million and $15.7 million for the years ended December 31, 2004 and 2003, respectively. Net cash provided by investing activities was $.2 million and $4.0 million for the years ended December 31, 2004 and 2003, respectively. Net cash provided by financing activities was $.9 million and $13.5 million for the years ended December 31, 2004 and 2003, respectively. As of December 31, 2004, the Company had cash and related cash equivalents totaling $.3 million.

Capital Requirements. Due to the fact that construction of the initial commercial production lines was largely completed in 2002 and the Company decided to discontinue all demonstration manufacturing activities in 2003, the Company only made one minor capital expenditure during the year ended December 31, 2004. The Company does not expect to make significant capital expenditures in the year 2005.

Contractual Obligations. The following table summarizes the Company's known obligations to make future payments pursuant to certain contracts as of December 31, 2004, as well as an estimate of the timing in which these obligations are expected to be satisfied:

| Contractual Obligations | Payments due by period (in thousands) Total | Less than 1 year | 1-3 years |
|---|---|---|---|
| Long-term debt - principal payments only | | | |
| Capital leases | -- | -- | -- |
| Operating leases | -- | -- | -- |
| Payable to Related Party | $ 875 | $ 875 | -- |
| Other long-term liability | $ 726 | $ 314 | $412 |
| Totals | $1,601 | $1,189 | $412 |

Sources of Capital. As part of the Company's initial public offering on March 27, 1998, the Company issued 877,193 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 416,667 and 1,250,000 shares, respectively, of the Company's common stock. During the years ended December 31, 2002, 2001 and 2000 the Company sold approximately 0.1 million, 1.1 million and 0.4 million shares of common stock in private transactions under such registration statements and received net proceeds from such sales of approximately $2.3 million $30.6 million and $10.5 million, respectively. All shares available under such registration statements had been sold as of December 2002.

In December of 2001 the Company filed an additional shelf registration statement providing for the sale of up to $50 million of securities, including secured or unsecured debt securities, preferred stock, common stock, and warrants. These securities could be offered, separately or together, in distinct series, and 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. On August 12, 2002, the Company issued $10 million in aggregate principal amount of convertible debentures, due August 2007, (the "2007 Debentures") and warrants to purchase 0.2 million shares of common stock to institutional investors for proceeds of $10.0 million. During the year ended December 31, 2002, the Company sold 1.9 million shares of common stock under such registration statement and received net proceeds from such sales of $19.6 million. During the year ended December 31, 2003, the Company issued 432,974 shares for the conversion of $1.8 million of 2007 Debentures. The remainder of the 2007 Debentures were prepaid or exchanged for 2006 Debentures during 2003.

17

On March 5, 2003, the Company issued to a group of institutional investors 416,667 shares of common stock and $10.55 million in aggregate principal amount of secured convertible debentures due in March 2006 (the "2006 Debentures"), for which the Company received proceeds of approximately $9.0 million, net of financing costs of approximately $1.5 million. In connection with the March 2003 financing transactions, the Company issued 54,167 shares of common stock to the lead purchaser of the 2006 Debentures and two warrants to a placement agent, both of whom received the instruments as compensation for their services rendered in connection with the transaction. (See Stock Warrants) In 2003, $5.75 million principal amount of the 2006 Debentures was converted into 958,334 shares of common stock. At December 31, 2003, the outstanding principal balance of 2006 Debentures was $6.8 million. The remaining shares under the December 2001 shelf registration described above were used to secure shares potentially issuable upon conversion of the 2006 Debentures.

Although the Company was in compliance with all covenants of the 2006 Debentures at December 31, 2003, on March 8, 2004 the Company's common stock was delisted from the Nasdaq SmallCap Market because the Company's market capitalization failed to meet the minimum required standard for continued listing. In addition, the Company did not make interest payments related to the 2006 Debentures as required on January 31, 2004. These actions put the Company in non-compliance with its covenants under the 2006 Debentures. From July through October 2004 the Company worked to negotiate settlements with each of the remaining debenture holders to retire the debentures, to resolve the defaults, and to restructure its long-term debt as follows.

18

Debenture Purchase Agreements. As of September 30, 2004, the Company entered into agreements with each of the holders (collectively, the "Holders") of the 2006 Debentures due March 5, 2006 to amend and restate the Debenture Purchase Agreements entered into in July 2004 by EarthShell and the Holders (as amended and restated, the "Debenture Purchase Agreements" and the transactions contemplated therein, collectively, the "Debenture Transactions"). The 2006 Debentures were in default and their outstanding principal balance totaled $6.5 million prior to their repurchase. Collectively, the Debenture Purchase Agreements required (i) E. Khashoggi Industries, LLC ("EKI") to pay $1 million cash (EarthShell was obligated to reimburse EKI for this cash payment as discussed below), (ii) the Holders to convert the 2006 Debentures in accordance with their terms, resulting in the issuance by EarthShell of 1,091,666 shares of its common stock, which shares were previously registered for resale by the Company in connection with the issuance of the 2006 Debentures, (iii) EarthShell to issue to the Holders an aggregate of 512,500 additional shares EarthShell common stock and (iv) EarthShell to pay $2.3 million to one of the Holders from 33% of any equity funding received by the Company (excluding the first $2.7 million funded by MBS) or 50% of the royalties received by EarthShell in excess of $250,000 per month (determined on a cumulative basis commencing July 1, 2004). EarthShell has the right to convert the unpaid portion of the $2.3 million into shares of the Company's common stock at a price equal to the lesser of $3.00 per share or the price per share price that EarthShell subsequently receives upon the issuance of its common stock (or other convertible security) during the three year period commencing September 30, 2004. The 512,500 shares of common stock issued to the Holders on October 6, 2004 are not registered for resale under the Securities Act. The consideration for the repurchase of the Debentures has been paid or issued, and the 2006 Debentures have been retired by EarthShell.

Receipt of Proceeds from Sale of Common Stock to MBS. On August 5, 2004, EarthShell and Meridian Business Solutions, LLC ("MBS") entered into a Stock Purchase Agreement (the "Stock Purchase Agreement") pursuant to which MBS agreed to fund $5 million to EarthShell in exchange for EarthShell's issuance of a total of 1,666,666 shares of common stock at a price of $3.00 per share. On August 20, 2004, EarthShell received $500,000 from MBS, for which the Company issued 166,666 shares of its common stock to MBS. On October 1, 2004, EarthShell received an additional $1.2 million of the $5 million committed by MBS, and the Company issued 400,000 shares of its common stock to MBS. On October 11, 2004, MBS purchased an additional 333,333 shares for which it had paid $.5 million as of December 31, 2004 and $.5 million was still due. Subsequent to December 31, 2004, MBS paid an additional $25,000 leaving the balance due at March 31, 2005 of $.475 million. The shares of common stock issued to MBS are not registered for resale under the Securities Act of 1933, as amended (the "Securities Act"), and the Company has agreed to file a registration statement to register the shares within 60 days of a request by MBS. The cash received from MBS was used, in part, to fund the repurchase of the 2006 Debentures(as defined below) and to restructure the Company's long-term debt.

EKI Agreements. In connection with its purchase of the 2006 Debentures from the Holders, on September 30, 2004, EKI entered into an agreement with EarthShell to sell the 2006 Debentures it purchased back to the Company for $1 million cash, the cash price paid by EKI for the purchased 2006 Debentures (the "EKI Debenture Purchase Agreement"). In connection therewith, immediately after its acquisition, EKI sold the purchased 2006 Debentures to the Company and, as discussed above, the Company retired the 2006 Debentures shortly thereafter. In addition, on September 30, 2004, the Company and EKI agreed to convert certain existing loans from EKI to the Company into shares of EarthShell's common stock (the "EKI Conversion Agreement"). This transaction closed after the closing of the Debenture Transactions and, pursuant to the EKI Conversion Agreement, EKI converted the $2,755,000 principal amount of such debt into shares of EarthShell's common stock at a conversion price of $3 per share. In addition, under the terms of the EKI Conversion Agreement, EKI converted the accrued and unpaid interest on such loans into shares of EarthShell's common stock at a conversion price equal to the greater of (i) $3 per share, and (ii) the maximum per share price (not to exceed $4 per share) obtained by the Company upon the sale of its common stock to any investor during the three month period following the closing. In May of 2005, an additional 44,387 shares were issued to EKI pursuant to a 90 day price protection clause, which provided for an adjustment in the effective conversion price of the interest portions of the EKI loans from $4 per share to $3 per share. The 1,051,494 shares of common stock issued to EKI as a result of this conversion agreement will not be registered for resale under the Securities Act.

Biotec Agreement. EarthShell also reached agreement to amend its existing agreements with its affiliates, bio-tec Biologische Naturverpackungen GmbH & Co. and bio-tec Biologische Naturverpackungen Forschungs und Entwicklungs GmbH (collectively, "Biotec"; and such agreement, the "Biotec Amendment"). Under the terms of the Biotec Amendment, EarthShell has agreed to satisfy the approximate $2.5 million in indebtedness owed to Biotec by (i) paying $750,000 to Biotec in 2004 (ii) converting approximately $1.47 million principal amount of the Biotec debt into shares of EarthShell's common stock at a conversion price of $3 per share and (iii) at EarthShell's option, on the first anniversary of the closing, pay $250,000 to Biotec or convert the remaining $250,000 Biotec debt into 133,333 shares of EarthShell's common stock at a conversion price of $3 per share. In consideration for the above, Biotec also agreed to suspend the monthly license fees payable by EarthShell for two years after the date of the closing. The common stock to be issued pursuant to the Biotec Amendment will not be registered for resale under the Securities Act. As of December 31, 2004, the Company had paid to Biotec $125,000 in cash and converted approximately $1.48 million into 491,778 shares of unregistered commons stock, and the balance owing to Biotec is $875,000 (see Relationship with and Reliance on EKI).

Pursuant to transactions described more fully in Item 5 under the subheading "Recent Sales of Unregistered Securities" and in this Management's Discussion and Analysis, in connection with the settlement of the 2006 Debentures and the related restructuring of the Company's debt, the Company provided registration rights with respect to newly issued unregistered shares of its common stock. Such registration rights required the Company to, among other things, file a registration statement with the SEC in December 2004 registering the resale of such shares of common stock. Under certain of the agreements, the Company's not filing such a registration statement (or the registration statement not being declared effective) within the required timeframe provides the holders of the registrable securities with a right to liquidated damages which, in the aggregate, may amount to approximately $50,000 per month until the registration statement is filed. If the Company fails to pay such liquidated damages, the Company must also pay interest on such amount at a rate of 10% per year (or such lesser amount as is permitted by law).

Because this registration statement was not filed as planned, in December 2004 the Company became obligated on the direct financial obligation described above. In light of the Company's current liquidity and financial position any such claim could have a negative effect on the Company. While none of the holders of registrable securities have made a formal claim for liquidated damages to date, there can be no assurance that such holders will not do so in the future. The Company plans to file an appropriate registration statement as soon as practical following the filing of this Annual Report on Form 10-K/A.

During 2002 and 2003, the Company's largest shareholder, EKI, made various simple interest working capital loans to the Company. These loans were interest bearing at a rate of 7% or 10% per annum, and were payable on demand. As of December 31, 2003, the outstanding principal balance of these loans was $2,755,000. In connection with the sale of the March 2006 Debentures, subordinated the payments and advances that were owed to it, and in consideration, the Company issued to EKI a warrant in March 2003, expiring in ten years, to acquire 83,333 shares of the Company's common stock for $6.00 per share. As disclosed above, as part of the settlement of the March 2006 Debentures in October of 2004, EKI agreed to convert all of its outstanding loans to EarthShell ($2,755,000) into unregistered common stock at $3 per share and $532,644 of accumulated interest into unregistered common stock at $4 per share for a total of 1,051,494 shares received by EKI. As of December 31, 2004, the loans from EKI were paid in full.

During 2004, the Company entered into license agreements for which it received a total of $1.5 million in technology fees. In May 2004, the Company entered into its license agreement with MBS, which calls for a total of $2.0 million in technology fees payable in $.5 million increments based on certain milestones during the startup of manufacturing operations and prior to the beginning of royalty generation. To date the Company has received $.5 million. In November of 2004, the Company entered into a license agreement with ESH and received technology fees of $1 million.

The Company expects to generate additional cash in 2005 through royalty payments from licensees. The Company believes that the cash from this borrowing, combined with projected revenues, will be sufficient to fund its operations through the year ending December 31, 2005. If the Company is not successful at generating license revenues during the year, the Company will have to raise additional funds to meet its current obligations and to cover operating expenses. If the Company is not successful in raising additional capital it may not be able to continue as a going concern for a reasonable period of time. Management plans to address this need by raising cash through either the issuance of debt or equity securities. However, the Company cannot assure that it will receive any royalty payments in 2005, that additional financing will be available to it, or, if available, that the terms will be satisfactory. Management will also continue in its efforts to reduce expenses, but can not assure that it will be able to reduce expenses below current levels.

Off-Balance Sheet Arrangements. The Company does not have any off-balance sheet arrangements as of December 31, 2004 and has not entered into any transactions involving unconsolidated, limited purpose entities.

Subsequent Events

Subsequent to December 31, 2004, on March 23, 2005, the Company entered into a Security Agreement with Cornell Capital Partners, LP. Pursuant to the Security Agreement, the Company shall issue promissory notes to Cornell Capital Partners, LP in the original principal amount of $2,500,000. The $2,500,000 was disbursed as follows: $1,150,000 on March 28, 2005 and $1,350,000 on May 27, 2005. The promissory notes are secured by the assets of the Company and shares of stock of another entity pledged by an affiliate of that entity. The promissory notes have a one-year term and accrue interest at 12% per year.



Subsequent to December 31, 2004 and on March 23, 2005, EarthShell entered into a Standby Equity Distribution Agreement with Cornell Capital Partners, LP. Pursuant to the Standby Equity Distribution Agreement, the Company may, at its discretion, periodically sell to Cornell Capital Partners, LP shares of common stock for a total purchase price of up to $10.0 million. For each share of common stock purchased under the Standby Equity Distribution Agreement, Cornell Capital Partners LP will pay the Company 98% of the lowest volume weighted average price of the Company's common stock as quoted by Bloomberg, LP on the Over-the-Counter Bulletin Board or other principal market on which the Company's common stock is traded for the 5 days immediately following the notice date. The price paid by Cornell Capital Partners, LP for the Company's stock shall be determined as of the date of each individual request for an advance under the Standby Equity Distribution Agreement. Cornell Capital Partners, LP will also retain 5% of each advance under the Standby Equity Distribution Agreement. Cornell Capital Partner's obligation to purchase shares of the Company's common stock under the Standby Equity Distribution Agreement is subject to certain conditions, including the Company obtaining an effective registration statement for shares of common stock sold under the Standby Equity Distribution Agreement and is limited to $500,000 per weekly advance.

In May of 2005, an additional 44,387 shares were issued to EKI pursuant to a 90 day price protection clause, which provided for an adjustment in the effective conversion price of the interest portions of the EKI loans from $4 per share to $3 per share.

In May of 2005, the Company granted a warrant to EKI to purchase one million shares of the Company's common stock at $3 per share in consideration of EKI's continued support of the Company since its inception, including providing bridge loans at below market terms from time to time. The warrant expires in May of 2015.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of EarthShell is responsible for establishing and maintaining adequate internal control over financial reporting and for the assessment of the effectiveness of internal control over financial reporting. As defined by the SEC, internal control over financial reporting is a process designed by, or supervised by, the Company's principal executive and principal financial officers, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.

The Company's internal control over financial reporting is supported by written 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 Company's assets; (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 the Company's management and directors; 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.

A material weakness is a significant deficiency (within the meaning of PCAOB Auditing Standard No. 2), or a combination of significant deficiencies, that results in there being more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis by employees in the normal course of their assigned functions.



In making its assessment of internal control over financial reporting, management used the framework set forth in the report entitled "Internal Control--Integrated Framework" published by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission to evaluate the effectiveness of the Company's internal control over financial reporting. Because of the material weaknesses described below, management believes that, as of December 31, 2004, the Company did not maintain effective internal control over financial reporting based on those criteria.

The Company's independent auditors have issued an attestation report on management's assessment of the Company's internal control over financial reporting. That report appears on page 6.

During 2004, the Company operated with a significantly reduced number of personnel compared to prior years. The Company's management has implemented and documented internal control over financial reporting which it believed would be considered sufficient, given the resources available to it. However, during the fourth quarter of 2004, the Company's Controller resigned, and has not been replaced to this date, leaving the Company's Chief Financial Officer as the only accounting professional employed by the Company. This resulted in the loss of segregation of responsibilities that are typical to effective financial reporting control methodology. The Company has employed certain mitigating controls designed to offset the inherent control weaknesses that result from a lack of segregation of responsibilities.

Material Weaknesses Identified

The Company's assessment of its internal control over financial reporting identified the following material weaknesses:

- The Company has inadequate segregation of critical duties within each of its accounting processes and a lack of sufficient monitoring controls over these processes to mitigate this risk. The responsibilities assigned to one employee include maintaining the vendor master file, processing payables, creating and voiding checks, reconciling bank accounts, making bank deposits and processing payroll.

- The departure of the Company's Controller in November 2004 resulted in the accounting and reporting functions being centralized under the Chief Financial Officer, with no additional personnel in the Company having an adequate knowledge of accounting principles and practices. As a result, certain transactions had not been recorded in a timely manner and several adjustments to the financial statements that were considered material to the financial position at December 31, 2004 and results of operations for the year then ended were recorded.

- There are weaknesses in the Company's information technology controls which makes the Company's financial data vulnerable to error or fraud. Specifically, there is a lack of documentation regarding the roles and responsibilities of the IT function, lack of security management and monitoring and inadequate segregation of duties involving IT functions.

Additionally, at the conclusion of our independent auditor's examination of the Company's internal control over financial reporting, our independent auditor noted several other areas of operations which could be improved. Our auditors did not believe these items constituted material weaknesses.

Remediation Steps to Address the Material Weaknesses

In consultation with its independent auditors, as of the date of this report, the Company has begun taking the following remediation steps, among others, to enhance its internal control over financial reporting and reduce control deficiencies in general, including the material weaknesses enumerated above:

- management is actively seeking qualified candidates to perform the Controller responsibilities;

- management has engaged an outside firm to perform the Internal Audit functions. This outside firm will report to the Audit Committee of the Board of Directors; and

- management employs an outside firm to monitor and maintain the Company's information systems. This group will be directed to develop and implement Company-wide information management control procedures.



REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of EarthShell Corporation:

We have audited management's assessment, included in the accompanying "Management's Annual Report on Internal Controls over Financial Reporting," that EarthShell Corporation (the "Company") did not maintain effective internal control over financial reporting as of December 31 ,2004, because of the effect of pervasive material weaknesses in the design and operation of the Company's system of internal controls, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organization 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. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of 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 included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and 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.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The Company has pervasive material weaknesses in the design and operation of its system of internal controls over financial reporting. The following material weaknesses have been identified and included in management's assessment:

(1) Inadequate segregation of duties involving the authorization, recording, custody, and periodic reconciliation of accounting transactions.



(2) Insufficient staffing of accounting personnel with adequate knowledge of accounting principles generally accepted in the United States. This inadequate staffing in the accounting department resulted in transactions not being recorded in a timely manner. In addition, there was inadequate application of accounting principles generally accepted in the United States in relation to the valuation of the gain on settlements of debt obligations in 2004, the classification of certain debts in the financial statements and the proper recording of liabilities as of December 31, 2004. This weakness resulted in the recording of several adjustments to the financial statements that were considered material to the financial position at December 31, 2004 and results of operations for the year then ended.

(3) A pervasive lack of general controls over the information technology system which could have a material effect on the financial statements.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2004 financial statements, and this report does not affect our report dated March 4, 2005 on those financial statements.

In our opinion, management's assessment that EarthShell Corporation did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, EarthShell Corporation has not maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We do not express an opinion or any other form of assurance on management's statements referring to the corrective actions taken by the Company after the date of management's assessment.

/s/ Farber & Hass LLP
April 26, 2005
Camarillo, California



ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's treasury function controls all decisions and commitments regarding cash management and financing arrangements. Treasury operations are conducted within a framework that has been authorized by the board of directors.

As of December 31, 2004, the Company had significantly reduced its long-term debt obligations. There remain a few settlements of accounts payable obligations that will be paid out over terms from 18 months to 36 months, the long term portion of which may be exposed to interest rate risk. As of December 31, 2004, these long-term fixed rate debt obligations totaled approximately $.4 million. While generally an increase in market interest rates will decrease the value of this debt, and decreases in rates will have the opposite effect, we are unable to estimate the impact that interest rate changes will have on the value of the substantial majority of this debt as there is no active public market for this debt.



ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See Index to Consolidated Financial Statements and Schedules.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not Applicable.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures. The Company's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Report (the "Evaluation Date"). Based on such evaluation, such officers have concluded that, as of the Evaluation Date, the Company's disclosure controls and procedures were effective in ensuring that (i) information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and (ii) information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(b) Changes in Internal Control Over Financial Reporting. During the Company's fiscal quarter ended December 31, 2004, other than the departure of the Company's former Controller (described in Management's Report on Internal Control Over Financial Reporting on page 21) no changes in the Company's internal control over financial reporting have come to management's attention during the Company's last fiscal quarter that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting. However, as permitted under Release No. 50754 dated November 30, 2004, the Company has included management's annual report on internal control over financial reporting and the related attestation report of the Company's registered public accounting firm in this Amendment to the Company's annual report on Form 10-K/A. See "Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting" and Management's Report on Internal Control Over Financial Reporting on pages 23 and 21, respectively.

ITEM 9B. OTHER INFORMATION

Pursuant to transactions described more fully in Item 5 under the subheading "Recent Sales of Unregistered Securities" and in Management's Discussion and Analysis, in connection with the settlement of the March 2006 Debentures and the related restructuring of the Company's debt, the Company provided registration rights with respect to newly issued unregistered shares of its common stock. Such registration rights required the Company to, among other things, file a registration statement with the SEC in December 2004 registering the resale of such shares of common stock. Under certain of the agreements, the Company's not filing such a registration statement (or the registration statement not being declared effective) within the required timeframe provides the holders of the registrable securities with a right to liquidated damages which, in the aggregate, may amount to approximately $50,000 per month until the registration statement is filed. If the Company fails to pay such liquidated damages, the Company must also pay interest on such amount at a rate of 10% per year (or such lesser amount as is permitted by law).

Because this registration statement was not filed, in December 2006 the Company became obligated on the direct financial obligation described above. In light of the Company's current liquidity and financial position any such claim could have a negative effect on the Company. While none of the holders of registrable securities have made a formal claim for liquidated damages to date, there can be no assurance that such holders will not do so in the future. The Company plans to file an appropriate registration statement as soon as practical following the filing of this Annual Report on Form 10-K/A.



# PART III

## ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

### Directors

The Board of Directors of the Company is currently comprised of six members. All directors are elected each year at the annual meeting of stockholders. The following table se