CHARLES & COLVARD LTD
Form 10-Q
August 13, 2013

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

FORM 10-Q

(Mark One)
x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2013

OR

o Transition report pursuant to Section 13 of 15(d) of the Securities Exchange Act of 1934

For the transition period from ______ to ______

Commission File Number: 000-23329

Charles & Colvard, Ltd.
(Exact name of registrant as specified in its charter)

North Carolina (State or other jurisdiction of incorporation or organization)	56-1928817 (I.R.S. Employer Identification No.)
300 Perimeter Park Drive, Suite A Morrisville, North Carolina (Address of principal executive offices)	27560 (Zip Code)

(919) 468-0399
(Registrant’s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the 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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of August 9, 2013, there were 20,000,578 shares of the registrant’s common stock, no par value per share, outstanding.

CHARLES & COLVARD, LTD.

FORM 10-Q
For the Quarterly Period Ended June 30, 2013

TABLE OF CONTENTS

		Page Number
PART I – FINANCIAL INFORMATION		
Item 1.	Financial Statements	
	Condensed Consolidated Balance Sheets (unaudited) as of June 30, 2013 and December 31, 2012	3
	Condensed Consolidated Statements of Operations (unaudited) for the three and six months ended June 30, 2013 and 2012	4
	Condensed Consolidated Statements of Cash Flows (unaudited) for the six months ended June 30, 2013 and 2012	5
	Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	29
Item 4.	Controls and Procedures	29
PART II – OTHER INFORMATION		
Item 1.	Legal Proceedings	30
Item 1A.	Risk Factors	30
Item 6.	Exhibits	30
	Signatures	31

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2013 (unaudited)	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$9,271,219	$11,860,842
Accounts receivable, net	7,857,189	8,138,358
Interest receivable	1,585	694
Held-to-maturity investments	502,362	505,068
Inventory, net	9,031,685	8,442,430
Prepaid expenses and other assets	1,129,158	737,406
Deferred income taxes	1,211,772	1,211,772
Total current assets	29,004,970	30,896,570
Long-term assets:		
Inventory, net	27,353,831	24,353,580
Property and equipment, net	1,528,557	1,746,792
Intangible assets, net	379,454	346,732
Deferred income taxes	2,671,650	2,520,818
Other assets	13,266	12,199
Total long-term assets	31,946,758	28,980,121
TOTAL ASSETS	$60,951,728	$59,876,691
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$2,542,711	$2,112,585
Accrued cooperative advertising	308,000	200,000
Accrued expenses and other liabilities	533,902	574,522
Total current liabilities	3,384,613	2,887,107
Long-term liabilities:		
Accrued income taxes	389,540	383,730
Total liabilities	3,774,153	3,270,837
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value	53,340,844	53,318,044
Additional paid-in capital – stock-based compensation	9,193,253	8,459,020
Accumulated deficit	(5,356,522)	(5,171,210)
Total shareholders' equity	57,177,575	56,605,854
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$60,951,728	$59,876,691

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

CHARLES & COLVARD, LTD.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net sales	$6,512,500	$5,058,227	$13,017,574	$9,236,612
Costs and expenses:				
Cost of goods sold	3,389,315	1,642,759	6,271,293	3,670,445
Sales and marketing	2,532,995	1,583,895	4,779,204	3,085,816
General and administrative	1,344,408	1,285,294	2,193,785	2,642,466
Research and development	9,041	8,381	15,024	16,789
Loss on abandonment of assets	95,052	-	95,052	-
Total costs and expenses	7,370,811	4,520,329	13,354,358	9,415,516
(Loss) income from operations	(858,311)	537,898	(336,784)	(178,904)
Other income (expense):				
Interest income	6,972	17,823	14,474	41,688
Interest expense	(234)	(127)	(974)	(604)
Total other income, net	6,738	17,696	13,500	41,084
(Loss) income before income taxes	(851,573)	555,594	(323,284)	(137,820)
Income tax net benefit (expense)	359,988	(7,022)	137,972	310,546
Net (loss) income	$(491,585)	$548,572	$(185,312)	$172,726
Net (loss) income per common share:				
Basic	$(0.02)	$0.03	$(0.01)	$0.01
Fully diluted	$(0.02)	$0.03	$(0.01)	$0.01
Weighted average number of shares used in computing net (loss) income per common share:				
Basic	19,812,397	19,564,451	19,736,068	19,517,481
Fully diluted	19,812,397	19,972,267	19,736,068	19,905,582

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Six Months Ended June 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$(185,312)	$172,726
Adjustments to reconcile net (loss) income to net cash (used in) provided by operating activities:		
Depreciation and amortization	384,749	265,607
Amortization of bond premium	2,706	2,652
Stock-based compensation	743,633	569,230
Provision for uncollectible accounts	(60,805)	245,460
Provision for sales returns	(135,000)	170,000
Provision for inventory reserves	75,000	26,000
Benefit for deferred income taxes	(150,832)	-
Loss on abandonment of assets	95,052	-
Changes in assets and liabilities:		
Accounts receivable	476,974	215,840
Interest receivable	(891)	10,220
Inventory	(3,664,506)	734,983
Prepaid expenses and other assets, net	(392,819)	(174,519)
Accounts payable	430,126	(316,446)
Accrued cooperative advertising	108,000	100,000
Accrued income taxes	5,810	(358,493)
Other accrued liabilities	(40,620)	(247,293)
Net cash (used in) provided by operating activities	(2,308,735)	1,415,967
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(202,610)	(485,878)
Proceeds from call of long-term investments	-	2,500,000
Patent, license rights, and trademark costs	(91,678)	(40,498)
Net cash (used in) provided by investing activities	(294,288)	1,973,624
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	13,400	119,914
Net cash provided by financing activities	13,400	119,914
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,589,623)	3,509,505
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	11,860,842	6,701,701
CASH AND CASH EQUIVALENTS, END OF PERIOD	$9,271,219	$10,211,206
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$974	$604
Cash paid during the period for income taxes	$7,050	$11,800

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

CHARLES & COLVARD, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. DESCRIPTION OF BUSINESS

Charles & Colvard, Ltd. (the “Company”), a North Carolina corporation founded in 1995, manufactures, markets, and distributes Charles & Colvard Created Moissanite® jewels (hereinafter referred to as moissanite or moissanite jewels), finished jewelry featuring moissanite, and fashion jewelry for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide (“SiC”), is a rare mineral first discovered in a meteor crater. Because naturally occurring SiC crystals are too small for commercial use, larger crystals must be grown in a laboratory. Leveraging its advantage of being the sole source worldwide of created moissanite jewels, the Company’s strategy is to establish itself with reputable, high-quality, and sophisticated brands and to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond. The Company believes this is possible due to moissanite’s exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market. The Company sells loose moissanite jewels and finished jewelry at wholesale to distributors, manufacturers, and retailers and at retail to end consumers through its wholly owned operating subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying unaudited consolidated financial statements included in this Quarterly Report on Form 10-Q have been prepared in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information. However, certain information or footnote disclosures normally included in complete financial statements prepared in accordance with U.S. GAAP have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of the Company’s management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair statement of the results for the interim periods presented. The results for the three and six months ended June 30, 2013 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2013.

The consolidated financial statements as of and for the three and six months ended June 30, 2013 and 2012 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2012 is derived from the audited financial statements as of that date. The accompanying statements should be read in conjunction with the audited financial statements and related notes, together with Management’s Discussion and Analysis of Financial Condition and Results of Operations, contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 filed with the SEC on March 29, 2013 (the “2012 Annual Report”).

The accompanying consolidated financial statements as of and for the three and six months ended June 30, 2013 and 2012 include the accounts of the Company and its wholly owned subsidiaries Moissanite.com, LLC, formed in 2011; Charles & Colvard Direct, LLC, formed in 2011; and Charles & Colvard (HK) Ltd., the Company’s Hong Kong subsidiary that became a dormant entity in the second quarter of 2009 and the operations of which ceased in 2008. All intercompany accounts have been eliminated.

Significant Accounting Policies - In the opinion of the Company’s management, the significant accounting policies used for the three and six months ended June 30, 2013 are consistent with those used for the year ended December 31, 2012. Accordingly, please refer to the 2012 Annual Report for the Company’s significant accounting policies.

Use of Estimates - The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent

assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The most significant estimates impacting the Company's consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions, stock compensation expense, and cooperative advertising. Actual results could differ materially from those estimates.

Reclassifications - Certain amounts in the prior year's condensed consolidated financial statements have been reclassified to conform to the current year presentation.

Table of Contents

Recently Adopted/Issued Accounting Pronouncements - All new and recently issued, but not yet effective, accounting pronouncements have been deemed to be not relevant to the Company and therefore are not expected to have any impact once adopted.

3. SEGMENT INFORMATION AND GEOGRAPHIC DATA

The Company reports segment information based on the "management" approach. The management approach designates the internal reporting used by management for making operating decisions and assessing performance as the source of the Company's operating and reportable segments.

The Company manages its business primarily by its two distribution channels that it uses to sell its loose jewel and finished jewelry product lines. Accordingly, the Company determined its two operating and reporting segments to be wholesale distribution transacted through the parent entity and direct-to-consumer distribution transacted through the Company's wholly owned operating subsidiaries, Moissanite.com, LLC and Charles & Colvard Direct, LLC. The accounting policies of these segments are the same as those described in Note 2, "Basis of Presentation and Significant Accounting Policies," of this Quarterly Report on Form 10-Q and in the Notes to Consolidated Financial Statements in the 2012 Annual Report.

The Company evaluates the financial performance of its segments based on net sales; product line gross profit, or the excess of product line sales over product line cost of goods sold; and operating income (loss). The Company's inventories are maintained in the parent entity's wholesale distribution segment and are transferred without intercompany markup to the operating subsidiaries as product line cost of goods sold when sold to the end consumer. Product line cost of goods sold is defined as product cost of goods sold in each of the Company's wholesale distribution and direct-to-consumer distribution operating segments excluding non-capitalized expenses from the Company's manufacturing and production control departments, comprising personnel costs, depreciation, rent, utilities, and corporate overhead allocations; freight out; inventory valuation allowance adjustments; and other inventory adjustments, comprising costs of quality issues, damaged goods, and inventory write-offs.

The Company allocates certain general and administrative and information technology-related expenses from its parent entity to its two direct-to-consumer operating subsidiaries primarily based on net sales and headcount, respectively. Unallocated expenses, which also include interest and taxes, remain in the parent entity's wholesale distribution segment.

Summary financial information by reporting segment is as follows:

	Three Months Ended June 30,					
	2013			2012		
	Wholesale	Direct-to-Consumer	Total	Wholesale	Direct-to-Consumer	Total
Net sales						
Loose jewels	$3,984,058	$91,238	$4,075,296	$4,031,721	$54,100	$4,085,821
Finished jewelry	1,905,430	531,774	2,437,204	715,394	257,012	972,406
Total	$5,889,488	$623,012	$6,512,500	$4,747,115	$311,112	$5,058,227
Product line cost of goods sold						
Loose jewels	$1,334,472	$11,795	$1,346,267	$1,109,333	$7,340	$1,116,673
Finished jewelry	1,330,109	290,816	1,620,925	6,896	106,034	112,930
Total	$2,664,581	$302,611	$2,967,192	$1,116,229	$113,374	$1,229,603
Product line gross profit						

Loose jewels	$2,649,586	$79,443	$2,729,029	$2,922,388	$46,760	$2,969,148
Finished jewelry	575,321	240,958	816,279	708,498	150,978	859,476
Total	$3,224,907	$320,401	$3,545,308	$3,630,886	$197,738	$3,828,624
Operating income (loss)	$624,419	$(1,482,730)	$(858,311)	$1,219,750	$(681,852)	$537,898
Depreciation and amortization	$101,876	$90,486	$192,362	$98,985	$50,022	$149,007
Capital expenditures	$108,645	$5,968	$114,613	$128,849	$5,236	$134,085

7

Table of Contents

	Six Months Ended June 30,					
	2013			2012		
	Wholesale	Direct-to-Consumer	Total	Wholesale	Direct-to-Consumer	Total
Net sales						
Loose jewels	$8,278,212	$144,998	$8,423,210	$6,445,640	$93,598	$6,539,238
Finished jewelry	3,634,153	960,211	4,594,364	2,306,955	390,419	2,697,374
Total	$11,912,365	$1,105,209	$13,017,574	$8,752,595	$484,017	$9,236,612
Product line cost of goods sold						
Loose jewels	$3,050,412	$18,542	$3,068,954	$1,916,272	$12,014	$1,928,286
Finished jewelry	1,931,079	473,467	2,404,546	720,328	153,775	874,103
Total	$4,981,491	$492,009	$5,473,500	$2,636,600	$165,789	$2,802,389
Product line gross profit						
Loose jewels	$5,227,800	$126,456	$5,354,256	$4,529,368	$81,584	$4,610,952
Finished jewelry	1,703,074	486,744	2,189,818	1,586,627	236,644	1,823,271
Total	$6,930,874	$613,200	$7,544,074	$6,115,995	$318,228	$6,434,223
Operating income (loss)	$2,264,325	$(2,601,109)	$(336,784)	$1,161,620	$(1,340,524)	$(178,904)
Depreciation and amortization	$192,855	$191,894	$384,749	$177,725	$87,882	$265,607
Capital expenditures	$189,316	$13,294	$202,610	$369,118	$116,760	$485,878

	June 30, 2013			December 31, 2012		
	Wholesale	Direct-to-Consumer	Total	Wholesale	Direct-to-Consumer	Total
Total assets	$55,133,852	$5,817,876	$60,951,728	$58,823,642	$1,053,049	$59,876,691

A reconciliation of the Company's product line cost of goods sold to cost of goods sold as reported in the consolidated financial statements is as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Product line cost of goods sold	$2,967,192	$1,229,603	$5,473,500	$2,802,389
Non-capitalized manufacturing and production control expenses	208,389	332,259	608,640	738,388
Freight out	51,453	24,114	87,962	41,497
Inventory valuation allowances	94,000	72,000	75,000	26,000
Other inventory adjustments	68,281	(15,217)	26,191	62,171
Cost of goods sold	$3,389,315	$1,642,759	$6,271,293	$3,670,445

The Company's net inventories by product line maintained in the parent entity's wholesale distribution segment are as follows:

Table of Contents

	June 30, 2013	December 31, 2012
Loose jewels		
Raw materials	$2,845,538	$3,189,320
Work-in-process	8,736,576	3,650,322
Finished goods	17,255,067	19,074,526
Finished goods on consignment	108,405	75,131
Total	$28,945,586	$25,989,299
Finished jewelry		
Raw materials	$299,425	$259,366
Work-in-process	629,928	250,628
Finished goods	5,815,319	5,451,178
Finished goods on consignment	604,308	748,022
Total	$7,348,980	$6,709,194

Supplies inventories of approximately $91,000 and $98,000 at June 30, 2013 and December 31, 2012, respectively, included in finished goods inventories in the consolidated financial statements are omitted from inventories by product line because they are used in both product lines and are not maintained separately.

The Company recognizes sales by geographic area based on the country in which the customer is based. A portion of the Company's international wholesale distribution segment sales represents products sold internationally that may be re-imported to United States ("U.S.") retailers. Sales to international end consumers made by the Company's direct-to-consumer distribution segment are included in U.S. sales because products are shipped and invoiced to a U.S.-based intermediary party that assumes all international shipping and credit risks. The following presents certain data by geographic area:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net sales				
United States	$5,373,178	$4,028,212	$10,485,467	$7,419,159
International	1,139,322	1,030,015	2,532,107	1,817,453
Total	$6,512,500	$5,058,227	$13,017,574	$9,236,612

	June 30, 2013	December 31, 2012
Property and equipment, net		
United States	$1,528,557	$1,746,792
International	-	-
Total	$1,528,557	$1,746,792

	June 30, 2013	December 31, 2012
Intangible assets, net		
United States	$209,972	$152,038
International	169,482	194,694
Total	$379,454	$346,732

Table of Contents

4. INVESTMENTS

Investments consist of long-term U.S. government agency securities carried at amortized cost using the effective interest method. The Company classifies its marketable securities as held-to-maturity based upon management's positive intention and ability to hold these securities until their maturity dates.

The following table summarizes information about held-to-maturity investments at June 30, 2013:

	Amortized Cost	Gross Unrealized Gains	Estimated Fair Value
U.S. government agency securities	$502,362	$ 4,338	$506,700

As of June 30, 2013, the estimated fair value of the investments was greater than the amortized cost. Because management intends to hold the investments until their maturity dates, this unrealized gain was not recorded in the consolidated financial statements.

The maturities of held-to-maturity investments at June 30, 2013 were as follows:

	Less than 1 Year	Total
U.S. government agency securities	$502,362	$502,362

5. FAIR VALUE MEASUREMENTS

Under U.S. GAAP, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. U.S. GAAP also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are obtained from independent sources and can be validated by a third party, whereas unobservable inputs reflect assumptions regarding what a third party would use in pricing an asset or liability. The fair value hierarchy consists of three levels based on the reliability of inputs, as follows:

- Level 1 - quoted prices in active markets for identical assets and liabilities

- Level 2 - inputs other than Level 1 quoted prices that are directly or indirectly observable

- Level 3 - unobservable inputs that are not corroborated by market data

The Company evaluates assets and liabilities subject to fair value measurements on a recurring and non-recurring basis to determine the appropriate level to classify them for each reporting period. This determination requires significant judgments to be made by management of the Company. The instruments identified as subject to fair value measurements on a recurring basis are cash and cash equivalents, trade accounts receivable, held-to-maturity investments, trade accounts payable, and accrued expenses. All instruments other than held-to-maturity investments are reflected in the consolidated balance sheets at carrying value, which approximates fair value due to the short-term nature of these instruments. The estimated fair value of the Company's held-to-maturity investments as of June 30, 2013 utilized Level 2 inputs of similar investments traded on active securities exchanges.

Assets that are measured at fair value on a non-recurring basis include property and equipment and intangible assets, comprising patents, license rights, and trademarks. These items are recognized at fair value when they are considered to be impaired. Level 3 inputs are primarily based on the estimated future cash flows of the asset determined by market inquiries to establish fair market value of used machinery or future revenue expected to be generated with the assistance of patents, license rights, and trademarks.

Table of Contents

6. INVENTORIES

The Company’s total inventories, net of reserves, consisted of the following as of June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
Raw materials	$3,144,963	$3,448,686
Work-in-process	9,366,504	3,900,950
Finished goods	23,605,336	24,978,221
Finished goods on consignment	718,713	843,153
Less inventory reserves	(450,000)	(375,000)
Total	$36,385,516	$32,796,010
Current portion	$9,031,685	$8,442,430
Long-term portion	27,353,831	24,353,580
Total	$36,385,516	$32,796,010

Inventories are stated at the lower of cost or market on an average cost basis. Inventory costs include direct material and labor, inbound freight, purchasing and receiving costs, inspection costs, and warehousing costs. Any inventory on hand at the measurement date in excess of the Company’s current requirements based on historical and anticipated levels of sales is classified as long-term on the Company’s consolidated balance sheets. The Company’s classification of long-term inventory requires it to estimate the portion of on-hand inventory that can be realized over the next 12 months and does not include precious metal, labor, and other inventory purchases expected to be both purchased and realized over the next 12 months.

The Company’s work-in-process inventories include raw SiC crystals on which processing costs, such as labor and sawing, have been incurred; and components, such as metal castings and finished good moissanite jewels, that have been issued to jobs in the manufacture of finished jewelry. The Company’s moissanite jewel manufacturing process involves the production of intermediary shapes, called “preforms,” that vary depending upon the size and shape of the finished jewel. To maximize manufacturing efficiencies, preforms may be made in advance of current finished inventory needs but remain in work-in-process inventories. As of June 30, 2013 and December 31, 2012, work-in-process inventories issued to active production jobs approximated $4.75 million and $1.12 million, respectively.

The Company’s jewels do not degrade in quality over time and inventory generally consists of the shapes and sizes most commonly used in the jewelry industry. In addition, the majority of jewel inventory is not mounted in finished jewelry settings and is therefore not subject to fashion trends nor is obsolescence a significant factor. The Company has very small market penetration in the worldwide jewelry market, and the Company has the exclusive right in the U.S. through mid-2015 and in many other countries through mid-2016 to produce and sell created SiC for use in jewelry applications. In view of the foregoing factors, management has concluded that no excess or obsolete loose jewel inventory reserve requirements existed as of June 30, 2013.

In 2010, the Company began manufacturing finished jewelry featuring moissanite. Relative to loose moissanite jewels, finished jewelry is more fashion oriented and subject to styling trends that could render certain designs obsolete. The majority of the Company’s finished jewelry featuring moissanite is held in inventory for resale and consists of such basic designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets that tend not to be subject to significant obsolescence risk due to their classic styling. In addition, the Company manufactures small individual quantities of designer-inspired moissanite fashion jewelry as part of its sample line that are used in the selling process to its wholesale customers.

In 2011, the Company began purchasing fashion finished jewelry comprised of base metals and non-precious gemstones for sale through Lulu Avenue™, the direct-to-consumer home party division of its wholly owned operating subsidiary, Charles & Colvard Direct, LLC. This finished jewelry is fashion oriented and subject to styling trends that may change with each catalog season, of which there are several each year. Typically in the jewelry industry, slow-moving or discontinued lines are sold as closeouts or liquidated in alternative sales channels. The Company reviews the finished jewelry inventory on an ongoing basis for any lower of cost or market and obsolescence issues and has established an obsolescence reserve on its fashion finished jewelry at June 30, 2013 of $39,000. The Company concluded that no such finished jewelry inventory reserve requirements relating to the Company's fashion finished jewelry existed as of December 31, 2012 or relating to its new line of finished jewelry featuring moissanite existed as of June 30, 2013 or December 31, 2012.

Table of Contents

Periodically, the Company ships finished goods inventory to wholesale customers on consignment terms. Under these terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Finished goods on consignment at June 30, 2013 and December 31, 2012 are net of shrinkage reserves of $6,000 and $20,000, respectively, to allow for certain loose jewels and finished jewelry on consignment with wholesale customers that may not be returned or may be returned in a condition that does not meet the Company's current grading or quality standards.

Total net loose jewel inventories at June 30, 2013 and December 31, 2012, including inventory on consignment net of reserves, were $28.95 million and $25.99 million, respectively. The loose jewel inventories at June 30, 2013 and December 31, 2012 include shrinkage reserves of $88,000 and $36,000, respectively, including shrinkage reserves of $0 and $17,000 on inventory on consignment at June 30, 2013 and December 31, 2012, respectively. Loose jewel inventories at June 30, 2013 and December 31, 2012 also include recuts reserves of $134,000 and $109,000, respectively.

Total net jewelry inventories at June 30, 2013 and December 31, 2012, including inventory on consignment net of reserves, finished jewelry featuring moissanite manufactured by the Company since entering the finished jewelry business in 2010, and fashion finished jewelry purchased by the Company for sale through Lulu Avenue™, were $7.35 million and $6.71 million, respectively. Jewelry inventories consist primarily of finished goods, a portion of which the Company acquired as part of a January 2009 settlement agreement with a former manufacturer customer to reduce the outstanding receivable to the Company. Due to the lack of a plan to market this inventory at that time, a jewelry inventory reserve was established to reduce the majority of the acquired jewelry inventory value to scrap value, or the amount the Company would expect to obtain by melting the gold in the jewelry and returning to loose-jewel finished goods inventory those jewels that meet grading standards. The scrap reserve established for this acquired inventory at the time of the agreement is adjusted at each reporting period for the market price of gold and has generally declined as the associated jewelry is sold down. At June 30, 2013, the balance increased to $169,000 from $132,000 at December 31, 2012 as a result of a decrease in the market price of gold, offset in part by sell down of the inventory during the quarter. The reserve will increase when the market price of gold decreases so as to lower the net realizable value of the inventory due to the lower gold price. Because the finished jewelry the Company began manufacturing in 2010 after it entered that business was made pursuant to an operational plan to market and sell the inventory, it is not subject to this reserve. In addition, the finished jewelry inventories at June 30, 2013 and December 31, 2012 include shrinkage reserves of $20,000 and $98,000, respectively, including shrinkage reserves of $6,000 and $3,000 on inventory on consignment, respectively. The finished jewelry inventories at June 30, 2013 also include an inventory reserve for obsolescence of $39,000.

The need for adjustments to inventory reserves is evaluated on a period-by-period basis.

7. INCOME TAXES

The Company recognized an income tax net benefit of approximately $360,000 and $138,000 for the three and six months ended June 30, 2013, respectively, compared to an income tax expense of approximately $7,000 and an income tax net benefit of approximately $311,000 for the three and six months ended June 30, 2012, respectively.

During 2008, the Company recorded a full valuation allowance against certain deferred tax assets consisting primarily of net operating loss carryforwards. Due to continued uncertainty over sufficient future taxable income to fully utilize these deferred tax assets, the Company did not record an income tax expense for the pretax income earned during the three months ended June 30, 2012 or an income tax benefit for the pretax loss incurred during the six months ended June 30, 2012.

As of each reporting date, the Company's management considers new evidence, both positive and negative, that could impact its view with regard to future realization of deferred tax assets. For the year ended December 31, 2012,

cumulative positive taxable income over the last three tax years had been generated, offsetting the negative evidence of cumulative losses in previous years. The Company also determined that its expectations of future taxable income in upcoming tax years would be sufficient to result in full utilization of these net operating loss carryforwards and deferred tax assets prior to any statutory expiration. As a result, the Company's management determined that sufficient positive evidence existed as of December 31, 2012 to conclude that it is more likely than not that the majority of its deferred tax assets are realizable, and it reduced its valuation allowance accordingly. A valuation allowance remains against certain deferred tax assets relating to state net operating loss carryforwards from the Company's e-commerce and home party operating subsidiaries due to the timing uncertainty of when the subsidiaries will generate cumulative positive taxable income to utilize the associated deferred tax assets. A valuation allowance also remains against certain deferred tax assets relating to investment loss carryforwards because the Company's current investments are classified as held-to-maturity, indicating they will be redeemed at par value and will not generate gains sufficient or of the appropriate character to utilize the associated deferred tax assets.

Table of Contents

For the three months ended June 30, 2013, the Company recognized $358,000 of current period income tax benefit, offsetting an income tax expense recorded in the first quarter of 2013 of approximately $211,000. The resulting income tax net benefit of $147,000 for the six months ended June 30, 2013 represents an effective tax rate of 45.4% on the year-to-date pre-tax book loss. The effective tax rate for the six months ended June 30, 2013 differs from the federal statutory rate of 34.0% primarily due to the impact of state income taxes, stock-based compensation expense that is not deductible for tax purposes, and other book-to-tax reconciling items. This effective tax rate has increased from December 31, 2012 due to anticipation of higher taxable income in the current fiscal year, and an additional $7,000 of income tax expense was accrued and paid in the first quarter of 2013 related to the prior tax year, primarily for adjustment of the federal alternative minimum tax. Additionally, the Company recorded approximately $4,000 of income tax benefit for a discrete permanent tax deduction difference during the three and six months ended June 30, 2013 and approximately $2,000 and $6,000 of income tax expense for estimated tax, penalties, and interest associated with uncertain tax positions during the three and six months ended June 30, 2013, respectively.

During the three months ended June 30, 2012, the Company recognized approximately $7,000 of income tax expense for estimated tax, penalties, and interest associated with uncertain tax positions. During the six months ended June 30, 2012, the Company entered into a voluntary disclosure agreement with a taxing authority for which the Company had previously recorded a liability for an uncertain tax position. As a result of the agreement, the Company reduced its total recorded liabilities relating to uncertain tax positions by approximately $320,000 and recognized a corresponding income tax benefit. This benefit was offset by approximately $9,000 of income tax expense for estimated tax, penalties, and interest for other uncertain tax positions.

8. COMMITMENTS AND CONTINGENCIES

Lease Commitments

In March 2004, the Company entered into a seven-year lease, beginning in August 2004, for approximately 16,500 square feet of mixed-use space from an unaffiliated third party at a base cost with escalations throughout the lease term plus additional common-area expenses based on the Company's proportionate share of the lessor's operating costs. The lease provided for two rent holidays, during which no rent was payable, and a moving allowance. In January 2011, the Company amended the lease effective January 1, 2011 to extend the term through January 2017 in exchange for a reduced rental rate and 50% rent abatement in the first 12 months of the extended term. The amended lease includes 3% annual rent escalations and a one-time option to terminate the lease effective as of July 31, 2014. The Company recognizes rent expense on a straight-line basis, giving consideration to the rent holidays, the moving allowance paid to the Company, and the rent abatement. At the Company's option, the amended lease can be extended for one five-year period.

As of June 30, 2013, the Company's future minimum payments under this operating lease were as follows:

2013	$69,653
2014	143,486
2015	147,791
2016	152,224
2017	13,066
Total	$526,220

Rent expense for the three months ended June 30, 2013 and 2012 was approximately $77,000 and $49,000, respectively. Rent expense for the six months ended June 30, 2013 and 2012 was approximately $133,000 and $100,000, respectively.

Table of Contents

Purchase Commitments

On June 6, 1997, the Company entered into an amended and restated exclusive supply agreement with Cree, Inc. ("Cree"). The exclusive supply agreement had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the amended and restated exclusive supply agreement, the Company has committed to purchase from Cree a minimum of 50%, by dollar volume, of its raw material SiC crystal requirements. If the Company's orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. Effective February 8, 2013, the Company entered into an amendment to a prior letter agreement with Cree, which provides a framework for the Company's purchases of SiC crystals under the amended and restated exclusive supply agreement. Pursuant to this amendment, the Company agreed to purchase at least $4.00 million of SiC crystals in an initial new order. After the initial new order, the Company has agreed to issue non-cancellable, quarterly orders that must equal or exceed a set minimum order quantity. The total purchase commitment under the amendment until July 2015, including the initial new order, is dependent upon the grade of the material and ranges between approximately $7.64 million and approximately $18.56 million.

9. STOCK-BASED COMPENSATION

The following table summarizes the components of the Company's stock-based compensation included in net (loss) income:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Employee stock options	$161,227	$115,372	$300,497	$280,646
Restricted stock awards	335,740	164,449	443,136	288,584
Income tax benefit	(162,247)	(59,623)	(201,184)	(104,629)
Totals	$334,720	$220,198	$542,449	$464,601

No stock-based compensation was capitalized as a cost of inventory during the three and six months ended June 30, 2013 and 2012.

Stock Options - The following is a summary of the stock option activity for the six months ended June 30, 2013:

	Shares	Weighted Average Exercise Price
Outstanding, December 31, 2012	1,147,847	$ 2.31
Granted	176,002	$ 3.79
Exercised	(13,125)	$ 1.02
Forfeited	(71,460)	$ 2.12
Expired	(70,786)	$ 2.21
Outstanding, June 30, 2013	1,168,478	$ 2.56

The weighted average grant-date fair value of stock options granted during the six months ended June 30, 2013 was $2.68. The total fair value of stock options that vested during the six months ended June 30, 2013 was approximately $331,000. The fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option pricing model with the following weighted average assumptions for stock options granted during the six months ended June 30, 2013:

Dividend yield	0.0 %
Expected volatility	92.9%
Risk-free interest rate	0.83%
Expected lives (years)	5.0

Although the Company issued dividends in prior years, a dividend yield of zero was used due to the uncertainty of future dividend payments. Volatility is a measure of the amount by which a financial variable such as share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company estimates expected volatility giving primary consideration to the historical volatility of its common stock. The risk-free interest rate is based on the published yield available on U.S. Treasury issues with an equivalent term remaining equal to the expected life of the stock option. The expected lives of the stock options represent the estimated period of time until exercise or forfeiture and are based on historical experience of similar awards.

Table of Contents

The following table summarizes information about stock options outstanding at June 30, 2013:

Options Outstanding			Options Exercisable			Options Vested or Expected to Vest		
Balance as of 6/30/2013	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 6/30/2013	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 6/30/2013	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
1,168,478	7.72	$ 2.56	803,203	7.25	$ 2.23	1,122,013	7.66	$ 2.52

As of June 30, 2013, the unrecognized stock-based compensation expense related to unvested stock options was approximately $699,000, which is expected to be recognized over a weighted average period of approximately 24 months.

The aggregate intrinsic value of stock options outstanding, exercisable, and vested or expected to vest at June 30, 2013 was approximately $1.89 million, $1.59 million, and $1.87 million, respectively. This amount is before applicable income taxes and represents the closing market price of the Company's common stock at June 30, 2013 less the grant price, multiplied by the number of stock options that had a grant price that is less than the closing market price. This amount represents the amount that would have been received by the optionees had these stock options been exercised on that date. During the three and six months ended June 30, 2013, the aggregate intrinsic value of stock options exercised was approximately $6,000 and $37,000, respectively.

Restricted Stock - The following is a summary of the restricted stock activity for the six months ended June 30, 2013:

	Shares	Weighted Average Grant Date Fair Value
Unvested, December 31, 2012	191,843	$ 3.38
Granted	253,403	$ 3.95
Vested	(173,843)	$ 3.75
Canceled	-	$ -
Unvested, June 30, 2013	271,403	$ 3.68

As of June 30, 2013, the unrecognized stock-based compensation expense related to unvested restricted stock was approximately $934,000, which is expected to be recognized over a weighted average period of approximately 23 months.

Dividends - The Company has not paid any cash dividends in the current year through June 30, 2013.

10. NET (LOSS) INCOME PER COMMON SHARE

Basic net (loss) income per common share is computed by dividing net (loss) income by the weighted average number of common shares outstanding during the periods. Fully diluted net (loss) income per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of stock options that are computed using the treasury stock method.

Antidilutive stock awards are comprised of stock options and unvested restricted shares which would have been antidilutive in the application of the treasury stock method in accordance with “Earnings Per Share” topic of the Financial Accounting Standard Board Accounting Standards Codification.

Table of Contents

The following table reconciles the differences between the basic and fully diluted earnings per share presentations:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Numerator:				
Net (loss) income	$(491,585)	$548,572	$(185,312)	$172,726
Denominator:				
Weighted average common shares outstanding:				
Basic	19,812,397	19,564,451	19,736,068	19,517,481
Stock options	-	407,816	-	388,101
Fully diluted	19,812,397	19,972,267	19,736,068	19,905,582
Net (loss) income per common share:				
Basic	$(0.02)	$0.03	$(0.01)	$0.01
Fully diluted	$(0.02)	$0.03	$(0.01)	$0.01

For the three months ended June 30, 2013 and 2012, stock options to purchase approximately 289,000 and 313,000 shares, respectively, were excluded from the computation of fully diluted net (loss) income per common share because the exercise price of the stock options was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net (loss) income per common share. For the six months ended June 30, 2013 and 2012, stock options to purchase approximately 463,000 and 390,000 shares, respectively, were excluded from the computation of fully diluted net (loss) income per common share because the exercise price of the stock options was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net (loss) income per common share.

11. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments, and trade accounts receivable. The Company maintains cash, cash equivalents, and investments with high-quality financial institutions and invests in low-risk securities, primarily money market funds or long-term U.S. government agency obligations. At times, cash balances may exceed the Federal Deposit Insurance Corporation (“FDIC”) insurable limits of $250,000 per depositor at each financial institution. Amounts on deposit in excess of FDIC insurable limits at June 30, 2013 approximated $6.78 million.

Trade receivables potentially subject the Company to credit risk. The Company’s standard wholesale customer payment terms on trade receivables are generally between 30 and 90 days, though it may offer extended terms in limited circumstances and on significant orders from time to time. The Company believes its competitors and other vendors in the wholesale jewelry industry have also expanded their use of extended payment terms and, in aggregate, the Company believes that by expanding its use of extended payment terms, it has provided a competitive response in its market and that its net sales have been favorably impacted. The Company is unable to estimate the impact of this program on its net sales, but if it ceased providing extended payment terms in select instances, the Company believes it would not be competitive for some wholesale customers in the marketplace and that its net sales and profits would likely decrease. The Company extends credit to its customers based upon a number of factors, including an evaluation of the customer’s financial condition and credit history, the customer’s payment history with the Company, the customer’s reputation in the trade, and/or an evaluation of the Company’s opportunity to introduce its moissanite jewels or finished jewelry featuring moissanite to new or expanded markets. Collateral is not generally required from customers. The need for an allowance for doubtful accounts is determined based upon factors surrounding the credit risk of specific customers, historical trends, and other information. The Company has not experienced any significant

accounts receivable write-offs related to revenue arrangements with extended payment terms.

As of June 30, 2013, three customers accounted for 19%, 18%, and 13% of trade accounts receivable, respectively. As of December 31, 2012, one customer accounted for 30% of trade accounts receivable.

Table of Contents

A significant portion of sales is derived from certain customer relationships. The following is a summary of customers that represent greater than or equal to 10% of total gross sales:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Customer A	19%	11 %	12%	8 %
Customer B	19%	2 %	10%	1 %
Customer C	6 %	16 %	7 %	10 %
Customer D	6 %	14 %	9 %	13 %
Customer E	1 %	17 %	16%	30 %

12. SUBSEQUENT EVENTS

Departure of Chief Financial Officer

On August 5, 2013, Timothy L. Krist, Chief Financial Officer and Treasurer, resigned from his position with the Company, effective as of August 5, 2013.

In connection with his resignation, Mr. Krist entered into a Separation of Employment Agreement (the “Separation Agreement”), dated August 7, 2013. The terms of the Separation Agreement provide that Mr. Krist has the right to revoke the Separation Agreement until August 14, 2014.

Under the Separation Agreement, Mr. Krist is entitled to receive severance in an amount equal to one year of his current base annual salary (less applicable taxes and withholdings), payable in bi-weekly installment payments in accordance with the Company’s regular payroll schedule in exchange for a standard release of employment claims. The Company will also pay COBRA premiums for coverage of Mr. Krist and his eligible dependents for one year if Mr. Krist timely and properly elects continuation coverage. The Separation Agreement also contains such confidentiality provisions and other terms and conditions as are usual and customary for agreements of this type. All of Mr. Krist’s obligations under his Employment Agreement with the Company, dated June 23, 2009, regarding confidentiality, non-competition, proprietary information, and related matters will continue.

Item 2.