
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2004

Transition Report Pursuant to Section 13 or 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.)

3800 Gateway Boulevard, Suite 310, Morrisville, N.C. 27560
(Address of principal executive offices)

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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of July 31, 2004 there were 13,276,416 shares of the Registrant's Common Stock, no par value per share, outstanding.

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Charles & Colvard, Ltd. and Subsidiary
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Net sales	\$ 4,364,276	\$ 4,311,706	\$ 10,001,810	\$ 8,684,849
Cost of goods sold	1,493,236	1,392,576	3,239,875	3,091,017
Gross profit	2,871,040	2,919,130	6,761,935	5,593,832
Operating expenses:				
Marketing and sales	1,772,115	1,440,832	3,514,698	2,592,844
General and administrative	572,792	583,844	1,444,742	1,186,201
Research and development	4,163	5,842	7,175	7,592
Total operating expenses	2,349,070	2,030,518	4,966,615	3,786,637
Operating income	521,970	888,612	1,795,320	1,807,195
Interest income	26,906	28,989	51,236	63,909
Income before taxes	548,876	917,601	1,846,556	1,871,104
Income tax expense	260,385	415,370	1,002,708	836,422
Net income	\$ 288,491	\$ 502,231	\$ 843,848	\$ 1,034,682
Net income per share:				
Basic	\$ 0.02	\$ 0.04	\$ 0.06	\$ 0.08
Diluted	\$ 0.02	\$ 0.04	\$ 0.06	\$ 0.08
Weighted-average common shares:				
Basic	13,258,810	13,219,530	13,238,969	13,260,836
Diluted	13,608,548	13,521,463	13,546,164	13,584,854

See Notes to Condensed Consolidated Financial Statements.

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Charles & Colvard, Ltd. and Subsidiary
Condensed Consolidated Balance Sheets
(Unaudited)

	<u>June 30, 2004</u>	<u>December 31, 2003</u>
Assets		
Current Assets:		
Cash and equivalents	\$ 12,678,028	\$ 11,559,123
Accounts receivable	2,660,058	3,702,095
Interest receivable	7,555	6,792
Inventories (Note 2)	24,130,593	24,065,992
Inventory on consignment (Note 3)	1,132,497	—
Prepaid expenses	410,480	499,442
Deferred income taxes	235,179	235,179
	<hr/>	<hr/>
Total current assets	41,254,390	40,068,623
Long Term Assets:		
Equipment, net	471,788	453,836
Patent and license rights, net	319,378	274,890
Deferred income taxes	4,707,231	5,649,939
	<hr/>	<hr/>
Total long term assets	5,498,397	6,378,665
	<hr/>	<hr/>
Total assets	\$ 46,752,787	\$ 46,447,288
	<hr/>	<hr/>
Liabilities and Shareholders' Equity		
Current Liabilities:		
Accounts payable:		
Cree, Inc.	\$ 581,238	\$ 778,516
Other	565,613	538,943
Accrued payroll	359,227	164,943
Accrued expenses and other liabilities	189,722	392,659
Deferred gross profit	—	448,270
	<hr/>	<hr/>
Total current liabilities	1,695,800	2,323,331
Commitments (Note 5)		
Shareholders' Equity:		
Common stock (Note 4)	54,631,876	54,333,287
Additional paid-in capital – stock options	2,198,373	2,407,780
Accumulated deficit	(11,773,262)	(12,617,110)
	<hr/>	<hr/>
Total shareholders' equity	45,056,987	44,123,957
	<hr/>	<hr/>
Total liabilities and shareholders' equity	\$ 46,752,787	\$ 46,447,288
	<hr/>	<hr/>

See Notes to Condensed Consolidated Financial Statements.

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Charles & Colvard, Ltd. and Subsidiary
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2004	2003
Operating Activities:		
Net income	\$ 843,848	\$ 1,034,682
Adjustments:		
Depreciation and amortization	91,866	77,652
Stock option compensation	2,177	12,476
Loss on disposal of long term assets	37	—
Provision for deferred income taxes	942,708	792,422
Change in operating assets and liabilities:		
Net change in assets	(66,862)	(1,530,602)
Net change in liabilities	(627,531)	(473,218)
Net cash provided by (used in) operating activities	1,186,243	(86,588)
Investing Activities:		
Capital expenditures	(154,343)	(121,843)
Net cash used in investing activities	(154,343)	(121,843)
Financing Activities:		
Proceeds from exercise of stock options	321,939	28,412
Purchase of common stock	(234,934)	(748,003)
Net cash provided by (used in) financing activities	87,005	(719,591)
Net change in cash and equivalents	1,118,905	(928,022)
Cash and equivalents, beginning of period	11,559,123	13,282,245
Cash and equivalents, end of period	\$ 12,678,028	\$ 12,354,223

See Notes to Condensed Consolidated Financial Statements.

Charles & Colvard, Ltd. and Subsidiary
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Basis of Presentation

The accompanying unaudited financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information. However, certain information or footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the financial statements include all normal recurring adjustments which are necessary for the fair presentation of the results of the interim periods presented. Interim results are not necessarily indicative of results for the year. Certain reclassifications have been made to prior year's financial statements to conform to the classifications used in fiscal 2004. These financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2003, as set forth in the Company's Form 10-K, filed with the Securities and Exchange Commission on March 17, 2004.

In preparing financial statements that conform with accounting principles generally accepted in the United States of America, management must 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 amounts of revenues and expenses reflected during the reporting period. Actual results could differ from those estimates.

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary in Hong Kong, Charles & Colvard (HK) Ltd. These financial statements also include the accounts of a Charles & Colvard controlled company in China. All inter-company accounts have been eliminated.

All of the Company's activities are within a single business segment. The following tables present certain data by geographic area:

	Three Months Ended June 30,	
	2004	2003
Net Sales (based on destinations of our shipments)		
United States	\$ 3,622,097	\$ 3,706,564
International	742,179	605,142
Total	\$ 4,364,276	\$ 4,311,706

	Six Months Ended June 30,	
	2004	2003
Net Sales (based on destinations of our shipments)		
United States	\$ 8,565,833	\$ 7,504,443
International	1,435,977	1,180,406
Total	\$ 10,001,810	\$ 8,684,849

	June 30,	December 31,
	2004	2003
Equipment, Net		
United States	\$ 350,983	\$ 340,037
International (All in Asia)	120,805	113,799
Total	\$ 471,788	\$ 453,836

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2. Inventories

Inventories are stated at the lower of cost or market determined on a first in, first out basis. Inventory costs include direct material and labor, inbound freight, purchasing and receiving costs, inspection costs and warehousing costs. A significant amount of inventory must be maintained at all times to be prepared to react to possible customer demand for large purchases and for a variety of jewel styles. In addition, the Company has entered into certain agreements to consign inventory for new or expanding retail opportunities. These consignments will require a significant amount of inventory to be maintained. On average, using historical results as a basis, finished jewels are held in inventory up to 36 months prior to being sold.

The Company currently sells one grade of jewel. The grade is classified as “very good” and consists of near colorless jewels that meet certain standards. Only “very good” jewels are valued in inventory. There is a substantial amount of jewels, including colored jewels, that have not met the quality standards and are not valued in inventory. As market conditions change, including the influences of customer demand, there may be a market for a portion of this unvalued inventory that management may pursue in the future.

Despite the significant amount of jewels in our inventory, obsolescence is not a factor in our inventory valuation. Our jewels do not degrade over time and our inventory consists of the cuts and sizes most commonly used in the jewelry industry. All inventories are carefully reviewed for quality standards before they are entered into finished goods. As the quality of our raw material has improved, so have the standards used to evaluate our finished goods. To ensure our inventory meets our current standards, we review the inventory on an ongoing basis. We established a reserve in 2002 to allow for certain jewels of a slightly lesser quality in our finished goods inventory to be re-cut to increase their quality and/or to satisfy certain cuts/sizes demanded by the customer. The need for adjustment to this reserve is evaluated on a period-by-period basis.

Finished goods are shown net of a reserve for excess jewelry inventory of \$105,000 and \$130,000 at June 30, 2004 and December 31, 2003, respectively. The Company does not actively market its jewelry inventory. Jewelry inventory value is determined as the amount we would obtain by melting the gold in the jewelry and putting the jewels back into loose stone inventory. In addition, finished goods are shown net of a lower of cost or market reserve of \$400,000 at June 30, 2004 and December 31, 2003. This reserve was established to allow for the carat weight loss associated with the re-cutting of a portion of the finished goods inventory. There are certain shapes and sizes of jewels in inventory that will be re-cut to achieve higher quality standards. These jewels can be re-cut into shapes and sizes that have a higher demand without the purchase of additional raw material.

	June 30, 2004	December 31, 2003
Raw materials	\$ 1,546,700	\$ 1,133,805
Work-in-process	3,969,531	4,140,703
Finished goods	18,614,362	18,791,484
Total Inventory	<u>\$ 24,130,593</u>	<u>\$ 24,065,992</u>

3. Inventory on Consignment

Periodically, the Company sells product to customers on “memo” terms. For shipments on “memo” terms, the customer receives title to the goods and assumes the risk of loss; however, the customer has an absolute right of return for a specified period. The Company does not recognize revenue on these transactions until the earlier of (1) the customer informing the Company that it will keep the product or (2) the expiration of the memo period. Prior to 2004, these types of sales have not been significant and the Company recorded them as accounts receivable and deferred gross profit at the time of shipment. In 2004, the Company experienced a significant increase in “memo” sales and determined that, effective January 1, 2004, product shipped to our customers on “memo” terms that do not meet all of the relevant criteria for recording as a sale would be classified as inventory on consignment on the Company’s consolidated balance sheets. The \$1,132,000 of inventory on consignment at June 30, 2004 represents potential revenue of \$2,972,000 and potential gross profit of \$1,840,000.

4. Common Stock

In December 2003, the Board of Directors authorized a follow-on repurchase program for up to 900,000 shares of the Company’s common stock. At the discretion of management, the repurchase program can be implemented

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through open market or privately negotiated transactions at prices at or below prevailing prices. This program will expire in December 2004. During the three months ended June 30, 2004, there were 46,377 shares repurchased at an average price of \$5.07. There were no shares repurchased during the three months ended March 31, 2004. Management will determine the time and extent of any future repurchases based on its evaluation of market conditions and other factors.

5. Commitments

Operating Lease

The Company currently leases approximately 12,700 square feet of mixed use space from an unaffiliated third party at a base cost of approximately \$11,700 per month, plus contingent rentals based on the Company's proportionate share of the lessor's operating costs, as defined in the lease agreement. The lease expires August 31, 2004.

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 of \$11,355 per month, plus contingent rentals based on the Company's proportionate share of the lessor's operating costs. Terms of the lease provide for escalations of the base rent throughout the lease term, up to \$13,175 at August 1, 2010. The lease also provides for twelve different months (August 2004-September 2004 and August 2005-May 2006) throughout the term where no rent will be payable and a \$74,000 moving allowance to be paid to the Company. At the Company's discretion, the lease can be extended for three successive five year periods. Finally, the lease provides the Company the right to terminate the lease at the end of five years for \$192,000.

The future minimum lease payments of the Company, including its Hong Kong subsidiary, are as follows: \$122,000 for the remainder of 2004, \$163,000 in 2005, \$109,000 in 2006, \$145,000 in 2007, \$148,000 in 2008, \$152,000 in 2009, \$156,000 in 2010 and \$92,000 in 2011, totaling \$1,087,000. Rental expense incurred for operating leases and leases whose terms are less than one year in duration for the three and six months ended June 30, 2004 was \$74,000 and \$151,000, respectively. For the three and six months ended June 30, 2003, such expense was \$53,000 and \$107,000, respectively.

Purchase Commitment

On June 6, 1997, the Company entered into an Amended and Restated Exclusive Supply Agreement ("Exclusive Supply Agreement") with Cree, Inc. ("Cree"). The Exclusive Supply Agreement has an initial term of ten years which may be extended for an additional ten years by either party, if the Company orders in any 36-month period SiC crystals with an aggregate purchase price in excess of \$1 million. The Company has met this order threshold and expects to extend the term of the Exclusive Supply Agreement. In connection with the Exclusive Supply Agreement, the Company has committed to purchase a minimum of 50% (by dollar volume) of its requirements for SiC crystals from Cree. If the Company's orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. In December 2003, the Company agreed with Cree on a framework for purchases for 2004. The Company is obligated to purchase a minimum quantity of usable material on a quarterly basis if Cree meets certain minimum quality levels. For each quarter during 2004, the Company has committed to purchase between \$400,000 and \$1,600,000 of raw material depending upon the quality of material received. If Cree's material quality is consistent with that received in 2003, future purchases are expected to be at the high end of this range. During the three and six months ended June 30, 2004, we purchased \$1.5 million and \$2.7 million of raw material from Cree, respectively.

6. Stock Based Compensation

The Company measures compensation costs related to employee stock options using the intrinsic value of the equity instrument granted (i.e., the excess of the market price of the stock to be issued over the exercise price of the equity instrument at the date of grant) rather than the fair value of the equity instrument.

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In accordance with Accounting Principles Board (APB) Opinion No. 25, and the provision of Statement of Financial Accounting Standards (FAS) No. 123 as applicable to consultants, the Company recorded compensation expense relating to stock options granted with exercise prices less than market value or granted to consultants as follows:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Stock based compensation cost, net of income tax, included in reported net income	\$ 468	\$ 4,019	\$ 1,338	\$ 7,666

This compensation expense is included in general and administrative expenses in the accompanying Statements of Operations. Had compensation expense for all stock options been determined consistent with FAS 123, rather than APB 25, the Company's net income and income per share for the three and six months ended June 30, 2004 and 2003 would have been recorded to the pro forma amounts indicated below:

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net income:				
As reported	\$ 288,491	\$ 502,231	\$ 843,848	\$ 1,034,682
Deduct – total stock based compensation expense under fair value method for all awards, net of income tax	68,204	57,104	174,572	381,754
Pro forma net income	<u>\$ 220,287</u>	<u>\$ 445,127</u>	<u>\$ 669,276</u>	<u>\$ 652,928</u>
Basic and diluted net income per share:				
As reported	\$ 0.02	\$ 0.04	\$ 0.06	\$ 0.08
Pro forma	0.02	0.03	0.05	0.05

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

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended ("Exchange Act"). These forward-looking statements represent our judgment on future events. Our business is subject to business and economic risks and uncertainties that could cause our actual performance and results to differ materially from those expressed or implied by any of the forward-looking statements included herein. These risks and uncertainties include but are not limited to the Company's ability to manage growth effectively, dependence on Cree, Inc. ("Cree") for SiC crystals, dependence on a limited number of distributors such as K&G Creations, Reeves Park, and Stuller Settings, Inc., limited operating history and dependence on continued growth and consumer acceptance of the Company's products, in addition to the other risks and uncertainties described under the heading "Business Risks" in our Form 10-K for the year ended December 31, 2003, which was filed with the Securities and Exchange Commission on March 17, 2004, and other filings with the Securities and Exchange Commission.

Overview

We manufacture, market and distribute Charles & Colvard created moissanite jewels (also called moissanite) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name, silicon carbide (SiC), is a rare, naturally occurring mineral found primarily in meteorites. As the sole manufacturer of scientifically-made moissanite jewels, our strategy is to create a unique brand image which positions moissanite as a jewel in its own right, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity. Moissanite is being marketed as a new product category and business opportunity for the jewelry trade.

We began shipping moissanite to domestic retail jewelers and international distributors during the second quarter of 1998. During the second quarter of 2000, we changed our domestic distribution model to sell through jewel distributors and jewelry manufacturers rather than directly to retail stores.

In March 2000, we entered into distribution agreements with Stuller Settings, Inc. (Stuller) and Rio Grande, two of the largest suppliers of jewelry-related products to the jewelry industry, for the North American distribution of moissanite. We have also entered into several agreements with domestic jewelry manufacturers, including K&G Creations, which is currently our largest customer. Through these agreements with Stuller, Rio Grande and jewelry manufacturers and the brand awareness created by our marketing program, we have sought to rapidly increase the introduction of moissanite into the domestic jewelry market while maintaining average selling prices. Although these new distribution and marketing strategies enabled us to achieve profitability in each of the last three completed fiscal years we have no assurance that these strategies will be successful in the long-term.

In October 2000, we established a wholly-owned subsidiary in Hong Kong, Charles & Colvard (HK) Ltd., for the purpose of gaining better access to the important Far Eastern markets. The importance of having a presence in this market is twofold; Hong Kong is the headquarters city for a very large number of jewelry manufacturing companies with sales and distribution worldwide, and Hong Kong is the gateway to the markets of Mainland China. To enhance our presence in this market, we established a Charles & Colvard controlled company in China in August 2003.

In 2001, we dramatically cut marketing and sales expenses, primarily by discontinuing significant advertising and promotion expenses in favor of lower cost public relations and media editorial initiatives. Additionally, we lowered general and administrative costs through personnel reductions, and we realized significant savings by suspending all research and development efforts with Cree. Domestic sales accounted for approximately 82% of total sales in 2001 as we concentrated on growing our domestic business. Domestic distribution of moissanite expanded in 2001 into additional retail stores, including our first retail jewelry chain. Catalog sales of moissanite jewelry expanded significantly. We demonstrated that with appropriate product mix and product positioning, home shopping channels were a viable distribution channel for jewelry featuring moissanite. Primarily as a result of these efforts, we became profitable and generated positive cash flow from operations in 2001.

During 2002, we continued our focus on the domestic market, while investing limited resources in certain international markets that management believes represent the most potential. Our 2002 sales were 44% higher than sales in 2001 with sustained profitability and positive cash flow. In 2003, we increased our sales and marketing expenses to expand product awareness and provide support to retailers, thereby accelerating sales growth. The majority of the increased expenses were focused on the domestic market, however we also increased our marketing

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and sales investment in Hong Kong and China. Our sales were 4% higher in 2003 over 2002. We believe that our increased investment in sales and marketing expenses will lead to an increased growth rate in 2004 and beyond. For the six months ended June 30, our sales were 15% higher over the same period last year and we remained profitable. Although our goals for the remainder of 2004 are to continue increasing sales while sustaining profitability, we cannot be sure that either goal will be achieved.

In June 2004, we announced the planned national rollout of test distribution at one of the country's leading jewelry retailers. In a joint effort with our direct customers, Quadamas of Los Angeles, and Reeves Park of Minneapolis, we plan to launch a Charles & Colvard moissanite jewelry category at approximately four hundred and fifty retail doors. The jewelry is scheduled to be in the stores no later than October 1, 2004. It is planned that this retailer will also offer moissanite jewelry in its catalog and on its web based selling platform, with those activities slated to commence prior to the in-store program. We are treating this program as a test distribution. As a result, the program will be supported with extensive advertising and public relations activities, as well as by in-store events and promotions. The jewelry placed in this distribution will be on consignment with the retailer. Revenue will be recognized by the Company as the retailer reports the sell thru on a bi-weekly basis. It is anticipated that expenses for establishing and supporting this effort will occur in advance of our revenue reporting, and due to the size and importance of the program, could create short-term losses for the Company. We have not yet established specific advertising and public relations budgets for this test distribution.

Results of Operations

The following tables are intended to illustrate a tabular analysis of certain Consolidated Statement of Operations data as a percentage of sales for both periods presented. A detailed explanation of our results of operations follows these tables:

	Three Months Ended June 30,			
	2004		2003	
Sales	100%	\$ 4,364,276	100%	\$ 4,311,706
Gross profit	66%	2,871,040	68%	2,919,130
Marketing and sales expenses	41%	1,772,115	33%	1,440,832
General and administrative expenses	13%	572,792	14%	583,844
Operating income	12%	521,970	21%	888,612

	Six Months Ended June 30,			
	2004		2003	
Sales	100%	\$ 10,001,810	100%	\$ 8,684,849
Gross profit	68%	6,761,935	64%	5,593,832
Marketing and sales expenses	35%	3,514,698	30%	2,592,844
General and administrative expenses	14%	1,444,742	14%	1,186,201
Operating income	18%	1,795,320	21%	1,807,195

Three Months ended June 30, 2004 compared with Three Months ended June 30, 2003.

Net sales were \$4,364,276 for the three months ended June 30, 2004 compared to \$4,311,706 for the three months ended June 30, 2003, an increase of \$52,570 or 1%. Shipments of moissanite jewels increased to approximately 23,900 carats from 23,500 carats in the same period of 2003. The average selling price per carat decreased by 5% primarily due to a product mix in which a greater percentage of smaller size jewels, which have a lower price per carat, were sold. Domestic sales accounted for approximately 83% and 86% of sales during the three months ended June 30, 2004 and 2003, respectively.

Domestic net sales and carat shipments each decreased by 2% and international net sales and carat shipments increased by 23% and 28% respectively, for the three months ended June 30, 2004 as compared to the three months ended June 30, 2003. Decreased domestic shipments are attributable to lower volume of sales to customers supplying TV shopping channels, partially offset by new specialty retailers adding moissanite jewelry to their product offerings. Increased international shipments into Hong Kong, Singapore and Thailand were offset by decreased shipments into Vietnam. Our three largest customers, K&G Creations, Reeves Park, and Stuller, accounted for 35%, 19%, and 18%, respectively, of our sales during the three months ended June 30, 2004. K&G Creations and Reeves Park, domestic manufacturing customers, provide moissanite jewels and jewelry to a large and

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diversified customer base, including television shopping channels and traditional retail stores. Stuller, the largest supplier to domestic independent jewelers, provides both moissanite jewels and a limited line of moissanite jewelry to its customers. While we believe our current relationship with these customers is good, and alternate manufacturers and distributors are available to serve their customer base, a loss of any of these customers could cause a material adverse effect on our results of operations in a particular period.

Our gross profit margin was 65.8% for the three months ended June 30, 2004 compared to 67.7% for the three months ended June 30, 2003. The decreased gross margin percentage was primarily caused by a 5% decrease in the average selling price per carat. Future gross margins will fluctuate based upon our average selling price per carat and the costs being relieved from inventory under our first-in, first-out accounting policy.

Marketing and sales expenses were \$1,772,115 for the three months ended June 30, 2004 compared to \$1,440,832 for the three months ended June 30, 2003, an increase of \$331,283 or 23%. As a percentage of sales, these expenses increased to 41% from 33% in the same period of 2003. The primary reasons for the increase are \$298,000 of increased advertising expenses to promote customer sales opportunities at new and existing retailers, \$83,000 of increased costs associated with our offices in Hong Kong and China, partially offset by \$141,000 of decreased co-op advertising expense. Our co-op advertising program reimburses a portion of our customers' marketing costs based on the amount of their purchases from us, and is subject to the customer providing us documentation of all advertising performed that includes the Company's products. The decrease in this expense was primarily caused by one of our major customers not participating in the co-op program. This customer is supported by our direct advertising, rather than through a co-op program. In the second half of 2004, in connection with our test distribution discussed in the "overview" above, we plan to continue to increase spending on sales and marketing expenses to support our efforts to increase sales growth. Subject to the Company's sales level, this increase in expenses could cause short-term operating losses for the Company in a given quarter.

General and administrative expenses were \$572,792 for the three months ended June 30, 2004 compared to \$583,844 for the three months ended June 30, 2003, a decrease of \$11,052 or 2%. As a percentage of sales, these expenses decreased to 13% from 14% in the same period of 2003. The decrease is primarily attributable to a \$59,000 reduction in the amount accrued for our Executive Compensation Plan. Based on our performance during the three months ended June 30, 2004, the amount estimated to be paid under this plan at year-end was reduced by this amount.

Interest income was \$26,906 for the three months ended June 30, 2004 compared to \$28,989 for the three months ended June 30, 2003, a decrease of \$2,083 or 7%. This decrease resulted from a lower interest rate earned on our cash balances, partially offset by a higher average cash balance.

Our effective income tax rate for the three months ended June 30, 2004 was 47% compared to 45% for the three months ended June 30, 2003. Our statutory tax rate is 38.5% and consists of the Federal income tax rate of 34% and North Carolina income tax rate of 4.5%, net of the federal benefit. Our effective income tax rate is higher than our statutory rate primarily due to our inability to currently recognize an income tax benefit for our operating losses in Hong Kong and China. We cannot recognize this income tax benefit due to the uncertainty of generating sufficient future taxable income in these countries to offset the existing losses. The increase in our effective income tax rate from 45% to 47% is due to \$52,000 of increased losses of our Hong Kong and China offices over the same period last year.

Six Months ended June 30, 2004 compared with Six Months ended June 30, 2003.

Net sales were \$10,001,810 for the six months ended June 30, 2004 compared to \$8,684,849 for the six months ended June 30, 2003, an increase of \$1,316,961 or 15%. Shipments of moissanite jewels increased 15% to approximately 55,800 carats from 48,600 carats in the same period of 2003. The average selling price per carat was relatively flat (decreased by 1%) as we sold a comparable product mix in the same period last year. Domestic sales accounted for approximately 86% of sales during the six months ended June 30, 2004 and 2003. Domestic carat shipments increased by 15% and international carat shipments increased by 16%.

Increased domestic shipments are attributable to expanded distribution into a number of new retailers (including King's Jewelry and HSN.com) and increased volume with our existing retailers, partially offset by lower volume of sales to customers supplying TV shopping channels. Increased international shipments into Singapore, Hong Kong, Taiwan and Korea were offset by decreased shipments into Thailand. Our three largest customers, K&G Creations,

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Reeves Park, and Stuller, accounted for 38%, 24%, and 14%, respectively, of our sales during the six months ended June 30, 2004. K&G Creations and Reeves Park, domestic manufacturing customers, provide moissanite jewels and jewelry to a large and diversified customer base, including television shopping channels and traditional retail stores. Stuller, the largest supplier to domestic independent jewelers, provides both moissanite jewels and a limited line of moissanite jewelry to its customers. While we believe our current relationship with these customers is good, and alternate manufacturers and distributors are available to serve their customer base, a loss of any of these customers could cause a material adverse effect on our results of operations in a particular period.

Our gross profit margin was 67.6% for the six months ended June 30, 2004 compared to 64.4% for the six months ended June 30, 2003. The increased gross margin percentage was primarily caused by lower cost inventory items being relieved from inventory under our first-in, first-out accounting policy. Future gross margins will fluctuate based upon our average selling price per carat and the costs being relieved from inventory under our first-in, first-out accounting policy.

Marketing and sales expenses were \$3,514,698 for the six months ended June 30, 2004 compared to \$2,592,844 for the six months ended June 30, 2003, an increase of \$921,854 or 36%. As a percentage of sales, these expenses increased to 35% from 30% in the same period of 2003. The primary reasons for the increase are \$501,000 of increased advertising expenses to promote customer sales opportunities at new and existing retailers, \$158,000 of increased costs associated with our offices in Hong Kong and China, and \$105,000 of increased compensation expense. The increased compensation expense in 2004 includes \$66,000 of accrued costs related to our Executive Compensation Plan. There were no costs recorded in 2003 under this plan as the Company did not meet its 2003 internal sales and profit goals. In the second half of 2004, in connection with our test distribution discussed in the "overview" above, we plan to continue to increase spending on sales and marketing expenses to support our efforts to increase sales growth. Subject to the Company's sales level, this increase in expenses could cause short-term operating losses for the Company in a given quarter.

General and administrative expenses were \$1,444,742 for the six months ended June 30, 2004 compared to \$1,186,201 for the six months ended June 30, 2003, an increase of \$258,541 or 22%. As a percentage of sales, these expenses remained constant at 14%. The increase is primarily due to \$136,000 of accrued compensation cost in 2004 due to our Executive Compensation Plan and \$78,000 of increased legal fees. There were no costs recorded in 2003 under the Executive Compensation Plan as the Company did not meet its 2003 internal sales and profit goals. The increased legal fees primarily relate to increased governance costs related to compliance with the Sarbanes-Oxley Act and related regulations.

Net interest income was \$51,236 for the six months ended June 30, 2004 compared to \$63,909 for the six months ended June 30, 2003, a decrease of \$12,763 or 20%. This decrease resulted from a lower interest rate earned on our cash balances.

Our effective income tax rate for the six months ended June 30, 2004 was 54% compared to 45% for the six months ended June 30, 2003. Our statutory tax rate is 38.5% and consists of the Federal income tax rate of 34% and North Carolina income tax rate of 4.5%, net of the federal benefit. Our effective income tax rate is higher than our statutory rate primarily due to our inability to currently recognize an income tax benefit for our operating losses in Hong Kong and China. We cannot recognize this income tax benefit due to the uncertainty of generating sufficient future taxable income in these countries to offset the existing losses. The increase in our effective income tax rate from 45% to 54% is due to \$123,000 of increased losses of our Hong Kong and China offices over the same period last year and additional income tax expense associated with the profit on inter-company sales to our subsidiary that are not included in book income.

Liquidity and Capital Resources

At June 30, 2004, we had \$12.7 million of cash and cash equivalents and \$39.6 million of working capital. Cash and inventory account for 92% of our current assets. Our principal sources of liquidity are cash on hand and cash generated by operations. During the six months ended June 30, 2004, \$1,186,243 of cash was provided by operations. The primary reason for the increased cash was pretax income of \$1,846,556 partially offset by a \$1,197,098 increase in inventory. In addition, we used \$154,343 of cash for capital expenditures and patent and license rights costs.

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Accounts receivable decreased \$1,042,000 from December 31, 2003 primarily due to a change in the presentation of sales on “memo” terms. Effective January 1, 2004, the Company determined that certain “memo” sales that do not meet all of the appropriate criteria to be recorded as a sale would be classified as consigned inventory. For jewels shipped on “memo” terms, the customer receives title to the goods and assumes the risk of loss; however, the customer has an absolute right of return for a specified period. As a result, we do not record revenue for shipments on “memo” terms until the earlier of (1) the customer informing the Company that it will keep the product or (2) the expiration of the memo period. The volume and magnitude of “memo” sale transactions increased during the six months ended June 30, 2004 and is expected to be of increasing importance to our business, as our products become more readily accepted in the domestic and international jewelry markets. For example, the test distribution with the major retailer discussed above will utilize significant inventory on consignment to facilitate the test with the growing importance of memo sale transactions, at June 30, 2004, we have not recorded receivables and deferred gross profit for shipments on “memo” terms. At December 31, 2003, \$889,000 of our receivables related to sales on “memo” terms and the \$448,000 of gross profit associated with these sales was shown as deferred gross profit on our consolidated balance sheets. The \$1,132,000 of inventory associated with these shipments at June 30, 2004 is now reflected on the consolidated balance sheets as “Inventory on consignment” and represents potential revenue of \$2,972,000 and potential gross profit of \$1,840,000. Since “memo” transactions were not material in prior periods, the Company has not reclassified the Company’s December 31, 2003 balance sheet.

On average, using historical results as a basis, finished jewels are held in inventory up to 36 months prior to being sold. As sales increase, we expect the number of months finished jewels are held in inventory to decrease. Prior to 2001 the buildup in the Company’s inventory was a material use of the company’s cash flow. Management considered this investment in inventory essential to be able to meet the orders of its expanding customer base and to fulfill the new and expanding requests from our customers for consigned inventory. It is management’s opinion that total inventory should decrease slightly over time from current levels due to forecasted sales increases, and that inventory turnover should increase, thereby not requiring a significant use of working capital and providing a source of future cash flow. However, the Company will maintain inventories to support its forecasted increases in demand for its product.

In December 2003, we agreed with Cree on a framework for purchases for 2004. The Company is obligated to purchase a minimum quantity of usable material on a quarterly basis if Cree meets certain minimum quality levels. For each quarter during 2004, the Company has committed to purchase between \$400,000 and \$1,600,000 of raw material depending upon the quality of material received. If Cree’s material quality is consistent with that received in 2003, future purchases are expected to be at the high end of this range. During the three and six months ended June 30, 2004, we purchased \$1.5 million and \$2.7 million of raw material from Cree, respectively.

In December 2003, the Board of Directors authorized a follow-on repurchase program for up to 900,000 shares of the Company’s common stock. At the discretion of management, the repurchase program can be implemented through open market or privately negotiated transactions at prices at or below prevailing prices. This program will expire in December 2004. During the three months ended June 30, 2004, there were 46,377 shares repurchased at an average price of \$5.07. There were no shares repurchased during the three months ended March 31, 2004. Management will determine the time and extent of any future repurchases based on its evaluation of market conditions and other factors.

Based on our cash and cash equivalents and other working capital, management believes that our existing capital resources are adequate to satisfy our capital requirements for at least the next 12 months.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

We believe that our exposure to market risk for changes in interest rates is not significant because our investments are limited to highly liquid instruments with maturities of three months or less. At June 30, 2004, we had approximately \$12.1 million of short-term investments, primarily money market funds, classified as cash and equivalents. All of our transactions with international customers and suppliers are denominated in U.S. dollars.

Item 4: Controls and Procedures

(a) Evaluation of disclosure controls and procedures

As of June 30, 2004, the Company’s Chief Executive Officer and the Chief Financial Officer evaluated the

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effectiveness of the Company's disclosure controls and procedures in accordance with Rule 13a-15 under the Exchange Act. Based on their evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures enable the Company to record, summarize and report in a timely manner the information that the Company is required to disclose in its Exchange Act reports.

(b) Changes in internal control over financial reporting

There were no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Part II - Other Information

Item 2(e). Purchase of Equity Securities

Charles & Colvard made the following purchases of its common stock during the three months ended June 30, 2004:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly-Announced Plan</u>	<u>Maximum Number of Shares That May Yet be Purchased Under the Plan (1)</u>
April 1, 2004 – April 30, 2004	—	—	—	900,000
May 1, 2004 – May 31, 2004	46,377	\$ 5.07	46,377	853,623
June 1, 2004 – June 30, 2004	—	—	—	853,623
Total	46,377	\$ 5.07	46,377	

- (1) In December 2003, the Board of Directors authorized the repurchase of up to 900,000 shares of the Company's common stock through open market or privately negotiated transactions at prices at or below prevailing prices. This plan expires in December 2004. On May 17, 2004, the Company announced that pursuant to this authority it had entered into a written stock repurchase agreement with Raymond James & Associates, Inc. to provide for the repurchase of certain amounts of the Company's stock in accordance with rules 10b5-1 and 10b5-18 of the Securities and Exchange Act of 1934. At current trading prices, no additional purchases are expected to be made pursuant to the Raymond James Agreement. However, management is still authorized to make additional share repurchases pursuant to the Board of Director's authority expiring December 2004.

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

The Annual Meeting of Shareholders of Charles & Colvard Ltd. was held on May 11, 2004. At the meeting, the shareholders voted on the election of directors and the ratification of the selection of independent auditors. The following seven nominees were each elected to the Board for a one-year term: Walter J. O'Brien, Jr., Frederick A. Russ, Robert S. Thomas, George A. Thornton III, Laura C. Kendall, Lisa A. Gavales, and Geraldine L. Sedlar. Additionally, the appointment of Deloitte & Touche LLP as independent auditors for the Company for the fiscal year ending December 31, 2004 was ratified. The number of votes cast for, against or withheld, as well as the number of abstentions, for each proposal are as follows:

A. Election of Directors

<u>Director Nominee</u>	<u>Votes For</u>	<u>Votes Withheld</u>
Walter J. O'Brien, Jr.	11,226,710	676,046
Frederick A. Russ	11,289,280	613,476
Robert S. Thomas	11,832,646	70,110
George A. Thornton III	11,854,231	48,525
Laura C. Kendall	11,865,456	37,300
Lisa A. Gavales	11,863,556	39,200
Geraldine L. Sedlar	11,865,416	37,340

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B. Ratification of Appointment of Deloitte & Touche LLP as auditors for fiscal year ending December 31, 2004.

	<u>Votes For</u>	<u>Votes Against</u>	<u>Abstentions</u>
Ratification of Appointment of Deloitte & Touche LLP	11,873,661	22,160	6,935

Item 6: Exhibits and Reports on Form 8-K

(a) Exhibits

<u>Exhibit No.</u>	<u>Description</u>
10.63	Employment Agreement, dated August 1, 2004, between Dennis Reed, Vice President of Sales and Charles & Colvard. +
31.1	Certification of Principal Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* The registrant has requested that certain portions of this exhibit be given confidential treatment.

+ Denotes a management contract or compensatory plan arrangement

(b) Reports on Form 8-K

On April 28, 2004, a Form 8-K was furnished under Item 12 to report, the Company's financial results for the three months ended March 31, 2004.

On May 18, 2004, a Form 8-K was furnished under Item 9 to announce that its Board of Directors has approved a written stock repurchase agreement with Raymond James & Associates, Inc., to provide for the repurchase of certain amounts of the Company's stock in accordance with Rules 10b5-1 and 10b5-18 of the Securities and Exchange Act of 1934.

On June 18, 2004, a Form 8-K was furnished under Item 9 to report expanded distribution with leading retailers and sales guidance for the second quarter of 2004.

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Signatures

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

Charles & Colvard, Ltd.

Date: August 10, 2004

/s/ Robert S. Thomas

Robert S. Thomas
President & Chief Executive Officer
(Principal Executive Officer)

Date: August 10, 2004

/s/ James R. Braun

James R. Braun
Vice President of Finance & Chief Financial Officer
(Principal Accounting Officer)

EMPLOYMENT AGREEMENT

THIS EMPLOYMENT AGREEMENT (the "Agreement") is made and entered into effective as of August 1, 2004 by and between Charles & Colvard, Ltd., a North Carolina company with its principal office at 3800 Gateway Boulevard, Suite 310, Morrisville, North Carolina, 27560 (the "Company"), and Dennis Reed, an individual currently residing at 101 Kalvesta Drive, Morrisville, North Carolina, 27560 ("Employee").

Statement of Purpose

The Company wishes to obtain the services of Employee on the terms and conditions and with the benefits set forth in this Agreement. Employee desires to be employed by the Company on such terms and conditions and to receive such additional consideration as set out herein.

Therefore, in consideration of the mutual covenants contained in this Agreement, the grant of certain options to purchase common stock of the Company and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the Company and Employee agree as follows:

1. Employment. The Company hereby agrees to employ Employee, and Employee hereby accepts such employment, on the terms and conditions set forth in this Agreement.

2. Term of Employment. The term of Employee's employment under this Agreement shall commence as of the date of this Agreement and shall continue for one year. Termination of employment shall be governed by Paragraph 7 of this Agreement, and unless terminated by either party as provided in Paragraph 7, this Agreement shall automatically, at the expiration of each then existing term, renew for successive additional one year terms (such annual period being hereinafter referred to as the "Term").

3. Position and Duties. The Employee shall serve as Vice President of Sales of the Company. Employee will, under the direction of the President and CEO of the Company, faithfully and to the best of his ability perform the duties as set out on Exhibit A hereto and such additional duties as may be reasonably assigned by the President and Board of Directors. Employee agrees to devote his entire working time, energy and skills to the Company while so employed.

4. Compensation and Benefits. Employee shall receive compensation and benefits for the services performed for the Company under this Agreement as follows:

(a) Base Salary. Employee shall receive a base salary of \$165,000.00, payable in regular and equal semi-monthly installments ("Base Salary").

(b) Employee Benefits. Employee shall receive such benefits as are made available to the other employees of the Company, including, but not limited to, life,

medical and disability insurance, retirement benefits and such vacation as is provided to the other employees of the Company (the "Employee Benefits"). Employer reserves the right to reduce, eliminate or change such Employee Benefits, in its sole discretion, subject to any applicable legal and regulatory requirements.

(c) Incentive Compensation. Employee may participate in such incentive plans as may be approved by the Board of Directors from time-to-time. The specific incentive compensation plans for 2004 are as set out on Exhibit B hereto.

5. Reimbursement of Expenses. The Company shall reimburse Employee for all reasonable out-of-pocket expenses incurred by Employee specifically and directly related to the performance by Employee of the services under this Agreement

6. Withholding. The Company may withhold from any payments or benefits under this Agreement all federal, state or local taxes or other amounts as may be required pursuant to applicable law, government regulation or ruling.

7. Termination of Employment.

(a) Death of Employee. If the Employee shall die during the Term, this Agreement and the employment relationship hereunder will automatically terminate on the date of death.

(b) Termination for Just Cause. The Company shall have the right to terminate the Employee's employment under this Agreement at any time for Just Cause, which termination shall be effective immediately. Termination for "Just Cause" shall include termination for the Employee's personal dishonesty, gross incompetence, willful misconduct, breach of a fiduciary duty involving personal profit, intentional failure to perform stated duties, willful violation of any law, rule, regulation (other than traffic violations or similar offenses), written Company policy or final cease-and-desist order, conviction of a felony or of a misdemeanor involving moral turpitude, unethical business practices in connection with the Company's business, misappropriation of the Company's assets (determined on a reasonable basis), disability or material breach of any other provision of this Agreement. The determination of whether "Just Cause" exists for termination shall be made by the Board of Directors of the Company in its sole discretion. For purposes of this subsection, the term "disability" means the inability of Employee, due to the condition of his physical, mental or emotional health, to satisfactorily perform the duties of his employment hereunder for a continuous three month period; provided further that if the Company furnishes long term disability insurance for the Employee, the term "disability" shall mean that continuous period sufficient to allow for the long term disability payments to commence pursuant to the Company's long term disability insurance policy. In the event the Employee's employment under this Agreement is terminated for Just Cause, the Employee shall have no right to receive compensation or other benefits under this Agreement for any period after such termination.

(c) Termination Without Cause. The Company may terminate the Employee's employment other than for "Just Cause," as described in Subsection (b) above, at any time upon written notice to the Employee, which termination shall be effective immediately. In the event the Company terminates Employee pursuant to this Subsection (c), the Employee will continue to receive the compensation due him hereunder ("Termination Compensation") until the end of the Term, so long as the Employee complies with Sections 8, 9 and 10 of the Agreement. Such amounts shall be payable at the times such amounts would have been paid in accordance with Section 4. In addition, Employee shall continue to participate in the same group hospitalization plan, health care plan, dental care plan, life or other insurance or death benefit plan, and any other present or future similar group employee benefit plan or program for which officers of the Company generally are eligible, on the same terms as were in effect prior to Employee's termination, either under the Company's plans or comparable coverage, for all periods Employee receives Termination Compensation. Notwithstanding anything in this Agreement to the contrary, if Employee breaches Sections 8, 9 or 10 of this Agreement, the Employee will not be entitled to receive any further compensation or benefits pursuant to this Section 7(c).

(d) Change of Control Situations. In the event of a Change of Control of the Company at any time after the date hereof, Employee may voluntarily terminate employment with Company up until six (6) weeks after the Change of Control for "Good Reason" and, subject to Section 7(f), (y) be entitled to receive in a lump sum (i) any compensation due but not yet paid through the date of termination and (ii) in lieu of any further salary payments from the date of termination to the end of the then existing term, an amount equal to the Termination Compensation times 2.99, and (z) shall continue to participate in the same group hospitalization plan, health care plan, dental care plan, life or other insurance or death benefit plan, and any other present or future similar group employee benefit plan or program for which officers of the Company generally are eligible, or comparable plans or coverage, for a period of two years following termination of employment by the Employee, on the same terms as were in effect either (A) at the date of such termination, or (B) if such plans and programs in effect prior to the Change of Control of Company are, considered together as a whole, materially more generous to the officers of Company, then at the date of the Change of Control. Any equity based incentive compensation (including but not limited to stock options, SARs, etc.) shall fully vest and be immediately exercisable in full upon a Change in Control, notwithstanding any provision in any applicable plan. Any such benefits shall be paid by the Company to the same extent as they were so paid prior to the termination or the Change of Control of Company.

“Good Reason” shall mean the occurrence of any of the following events without the Employee’s express written consent:

- (i) the assignment to the Employee of duties inconsistent with the position and status of the Employee with the Company immediately prior to the Change of Control;
- (ii) a reduction by the Company in the Employee’s pay grade or base salary as then in effect, or the exclusion of Employee from participation in Company’s benefit plans in which he previously participated as in effect at the date hereof or as the same may be increased from time to time during the Term;
- (iii) an involuntary relocation of the Employee more than 50 miles from the location where the Employee worked immediately prior to the Change in Control or the breach by the Company of any material provision of this Agreement; or
- (iv) any purported termination of the employment of Employee by Company which is not effected in accordance with this Agreement.

A “Change of Control” shall be deemed to have occurred if (i) any person or group of persons (as defined in Section 13(d) and 14(d) of the Securities Exchange Act of 1934) together with its affiliates, excluding employee benefit plans of Company, becomes, directly or indirectly, the “beneficial owner” (as defined in Rule 13d-3 promulgated under the Securities Exchange Act of 1934) of securities of Company representing 20% or more of the combined voting power of Company’s then outstanding securities; or (ii) during the then existing term of the Agreement, as a result of a tender offer or exchange offer for the purchase of securities of Company (other than such an offer by the Company for its own securities), or as a result of a proxy contest, merger, consolidation or sale of assets, or as a result of any combination of the foregoing, individuals who at the beginning of any year period during such term constitute the Company’s Board of Directors, plus new directors whose election by Company’s shareholders is approved by a vote of at least two-thirds of the outstanding voting shares of the Company, cease for any reason during such year period to constitute at least two-thirds of the members of such Board of Directors; or (iii) the shareholders of the Company approve a merger or consolidation of the Company with any other corporation or entity regardless of which entity is the survivor, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or being converted into voting securities of the surviving entity) at least 60% of the combined voting power of the voting securities of the Company or such surviving entity outstanding immediately after such merger or consolidation; or (iv) the shareholders of the Company approve a plan of complete liquidation or winding-up of the Company or an agreement for the sale or disposition by the Company of all or substantially all of the Company’s assets; or (v) any event which the Company’s Board of Directors determines should constitute a Change of Control.

(e) Employee's Right to Payments. In receiving any payments pursuant to this Section 7, Employee shall not be obligated to seek other employment or take any other action by way of mitigation of the amounts payable to the Employee hereunder, and such amounts shall not be reduced or terminated whether or not the Employee obtains other employment.

(f) Reduction in Agreement Payments. Notwithstanding anything in this Agreement to the contrary, if any of the payments provided for under this Agreement (the "Agreement Payments"), together with any other payments that the Employee has the right to receive (such other payments together with the Agreement Payments are referred to as the "Total Payments"), would constitute a "parachute payment" as defined in Section 280G(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code") (a "Parachute Payment"), the Agreement Payments shall be reduced by the smallest amount necessary so that no portion of such Total Payments would be Parachute Payments. In the event the Company shall make an Agreement Payment to the Employee that would constitute a Parachute Payment, the Employee shall return such payment to the Company (together with interest at the rate set forth in Section 1274(b)(2)(B) of the Code). For purposes of determining whether and the extent to which the Total Payments constitute Parachute Payments, no portion of the Total Payments the receipt of which Employee has effectively waived in writing shall be taken into account.

8. Covenant Not to Compete. Employee agrees that during his employment with the Company and for a period of one (1) year following the termination of his employment with the Company, for whatever reason:

(a) Employee shall not, directly or indirectly, own any interest in, manage, operate, control, be employed by, render advisory services to, or participate in the management or control of any business that operates in the same business as the Company, which Employee and the Company specifically agree as the business of fabricating (wafering, preforming and faceting), marketing and distributing moissanite gemstones or other diamond simulants to the gem and jewelry industry (the "Business"), unless Employee's duties, responsibilities and activities for and on behalf of such other business are not related in any way to such other business's products which are in competition with the Company's products. For purposes of this section, "competition with the Company" shall mean competition for customers in the United States and in any country in which the Company is selling the Company's products at the time of termination. Employee's ownership of less than one percent of the issued and outstanding stock of a corporation engaged in the Business shall not by itself be deemed to be a violation of this Agreement. Employee recognizes that the possible restriction on his activities which may occur as a result of his performance of his obligations under Paragraph 8(a) are substantial, but that such restriction is required for the reasonable protection of the Company.

(b) Employee shall not, directly or indirectly, influence or attempt to influence any customer of the Company to discontinue its purchase of any product of the Company

which is manufactured or sold by the Company at the time of termination of Employee's employment or to divert such purchases to any other person, firm or employer.

(c) Employee shall not, directly or indirectly, interfere with, disrupt or attempt to disrupt the relationship, contractual or otherwise, between the Company and any of its suppliers.

(d) Employee shall not, directly or indirectly, solicit any employee of the Company to work for any other person, firm or employer.

9. Confidentiality. In the course of his employment with the Company, Employee will have access to confidential information, records, data, customer lists, lists of product sources, specifications, trade secrets and other information which is not generally available to the public and which the Company and Employee hereby agree is proprietary information of the Company ("Confidential Information"). During and after his employment by the Company, Employee shall not, directly or indirectly, disclose the Confidential Information to any person or use any Confidential Information, except as is required in the course of his employment under this Agreement. All Confidential Information as well as records, files, memoranda, reports, plans, drawings, documents, models, equipment and the like, including copies thereof, relating to the Company's business, which Employee shall prepare or use or come into contact with during the course of his employment, shall be and remain the Company's sole property, and upon termination of Employee's employment with the Company, Employee shall return all such materials to the Company.

10. Proprietary Information. Employee shall assign to the Company, its successors or assigns, all of Employee's rights to copyrightable works and inventions which, during the period of Employee's employment by the Company or its successors in business, Employee makes or conceives, either solely or jointly with others, relating to any subject matter with which Employee's work for the Company is or may be concerned ("Proprietary Information"). Employee shall promptly disclose in writing to the Company such copyrightable works and inventions and, without charge to the Company, to execute, acknowledge and deliver all such further papers, including applications for copyrights and patents for such copyrightable works and inventions, if any, in all countries and to vest title thereto in the Company, its successors, assigns or nominees. Upon termination of Employee's employment hereunder, Employee shall return to the Company or its successors or assigns, as the case may be, any Proprietary Information. The obligation of Employee to assign the rights to such copyrightable works and inventions shall survive the discontinuance or termination of this Agreement for any reason.

11. Entire Agreement. This Agreement contains the entire agreement of the parties with respect to Employee's employment by the Company and supersedes any prior agreements between them, whether written or oral.

12. Waiver. The failure of either party to insist in any one or more instance, upon performance of the terms and conditions of this Agreement, shall not be construed as a waiver or a relinquishment of any right granted hereunder or of the future performance of any such term or condition.

13. Notices. Any notice to be given under this Agreement shall be deemed sufficient if addressed in writing and delivered personally, by telefax with receipt acknowledged, or by registered or certified U.S. mail to the address first above appearing, or to such other address as a party may designate by notice from time to time.

14. Severability. In the event that any provision of any paragraph of this Agreement shall be deemed to be invalid or unenforceable for any reason whatsoever, it is agreed such invalidity or unenforceability shall not affect any other provision of such paragraph or of this Agreement, and the remaining terms, covenants, restrictions or provisions in such paragraph and in this Agreement shall remain in full force and effect and any court of competent jurisdiction may so modify the objectionable provision as to make it valid, reasonable and enforceable.

15. Amendment. This Agreement may be amended only by an agreement in writing signed by each of the parties hereto.

16. Arbitration. Any controversy or claim arising out of or relating to this Agreement, or breach thereof, shall be settled by arbitration in Raleigh, North Carolina in accordance with the expedited procedures of the Rules of the American Arbitration Association, and judgment upon the award may be rendered by the arbitrator and may be entered in any court having jurisdiction thereof.

17. Governing Law. This Agreement shall be governed and construed in accordance with the laws of the State of North Carolina. Each of the parties hereto irrevocably submits to the exclusive jurisdiction of the courts located in North Carolina for the purposes of any suit, action or other proceeding contemplated hereby or any transaction contemplated hereby.

18. Benefit. This Agreement shall be binding upon and inure to the benefit of and shall be enforceable by and against the Company, its successors and assigns, and Employee, his heirs, beneficiaries and legal representatives. It is agreed that the rights and obligations of Employee may not be delegated or assigned except as may be specifically agreed to by the parties hereto.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

Charles & Colvard, Ltd.

By: */s/ Robert S. Thomas*

Robert S. Thomas, President

EMPLOYEE

/s/ Dennis Reed

Dennis Reed

Position Description
Vice President Sales

Summary

Develops the policies, procedures, and objectives for sales of the Company's products. Leads and directs the activities of the sales personnel. Continually evaluates the Company's sales efforts and develops and implements programs to strengthen the Company's sales efforts. Provides sales expertise to other members of the Company's management team and coordinates the Company's sales efforts with other Company activities including, but not limited to, marketing and manufacturing.

Primary Responsibilities

1. Directs activities of the sales function of the Company to achieve Company objectives for sales volume and market penetration. Responsible for advancing the Company's performance management system, especially in sales.
2. Directs activities of the sales function. This includes competitive analysis, product and consumer research, establishing sales budgets and quotas, product pricing and distribution.
3. Leads and directs activities of the Company's sales force and any representatives and/or distributors of the Company's products. Provides leadership, training (including coaching), management, and sales support. Coordinates field sales efforts to enhance ability of sales personnel to work effectively and achieve goals.
4. Directs product and customer service activities. Responsible for maintaining satisfactory customer perception of Company services and products by working with the marketing staff to insure that the Company's branding and positioning strategy is consistent with the Company's sales activities.
5. Works closely with members of the management team, especially manufacturing, to ensure that the product mix and availability is synchronized with customer demand.
6. Analyzes actual sales and marketing performance against budgeted sales volume and market penetration levels.
7. Manages all sales promotion activities, including planning and executing the Company's participation in industry trade shows. Responsible for the coordination of all sales efforts with the marketing department and public relations and advertising agencies of record.
8. Establishes and maintains contact with potential customers and actively participates in the selling effort to support key accounts and with a high level of sales.
9. Responsible for submitting annual projected sales forecast, including the necessary product mix, and budget for inclusion in the Company's annual business plan for approval by the Company's Board of Directors. Is accountable for the execution of the sales plan as presented in the annual business plan, which includes the management of the sales budgets for both planned sales income and planned sales expenses.
10. Presents updates to the Board of Directors during quarterly meetings and management briefings.
11. Performs such activities consistent with the position of Vice President of Sales as may be reasonably delegated by the CEO, COO, President, or the Board of Directors of the Company.

2004 Officer & Director Compensation Plan

Eligible Employees

- CEO
- CFO
- Vice President of Sales
- Vice President of Manufacturing
- Vice President Brand Development and Industry Relations
- Director of Domestic Sales
- Director of International Sales
- Director of Information Technology

Bonus Pool

A bonus pool is to be established which will consist of stock options and cash. The pools will be funded upon the Company achieving its annual operating goals. These goals will be consistent with the Company's business plan as approved by the Board of Directors.

Cash Pool: The Sales Directors receive cash compensation based on specific goals, and will be excluded from the cash portion of this proposed plan. The Director of Information Technology participates in the quarterly bonus pool for non-officer employees.

The cash portion of the bonus pool will be based on:

- Operating income—if the pre-bonus, operating income goal is met, 5% of the operating income will be added to the pool
- Sales (shipments)—if the goal above is met and the shipments goal is met, an additional 5% of operating income will be added to the pool
- If both goals are met, 15% of all pre-bonus, operating income exceeding the goal will be added to the pool

If the operating income goal is not met, the bonus will be entirely discretionary, and be determined by the Compensation Committee of the Board of Directors, based upon the recommendations of the CEO.

The maximum amount any one person can earn under the bonus plan shall be limited to \$500,000 annually during their first three years of employment, \$1,000,000 annually during the next three years of employment and \$2,500,000 annually thereafter.

2004 Officer & Director Compensation Plan (cont'd)

Option Pool

The option pool shall be 143,000 options annually and be awarded based solely on achieving the operating income goal.

Pool Sharing

The cash and options in the pool shall be distributed, as soon as practical after the results of the annual audit by the outside auditors of the Company. The proposed distribution of the pool is as follows:

	<u>Cash Portion</u>	<u>Options</u>
· CEO	35.00%	40,000
· CFO	16.25%	20,000
· Vice President of Manufacturing	16.25%	20,000
· Vice President of Sales	16.25%	20,000
· Vice President Brand Development and Industry Relations	16.25%	20,000
· Director of Domestic Sales		7,000
· Director of International Sales		7,000
· Director of Information Technology		9,000

I, Robert S. Thomas, certify that:

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

August 10, 2004

/s/ Robert S. Thomas

Robert S. Thomas
President & Chief Executive Officer

I, James R. Braun, certify that:

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

August 10, 2004

/s/ James R. Braun

James R. Braun
Vice President of Finance & Chief Financial Officer

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

In connection with the Quarterly Report of Charles & Colvard, Ltd. (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert S. Thomas, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ Robert S. Thomas

Robert S. Thomas
President and Chief Executive Officer
August 10, 2004

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

In connection with the Quarterly Report of Charles & Colvard, Ltd. (the "Company") on Form 10-Q for the period ending June 30, 2004 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James R. Braun, Vice President of Finance and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ James R. Braun

James R. Braun
Vice President of Finance and Chief Financial Officer
August 10, 2004

A signed original of this written statement required by Section 906 has been provided to Charles & Colvard, Ltd. and will be retained by Charles & Colvard, Ltd. and furnished to the Securities and Exchange Commission or its staff upon request.