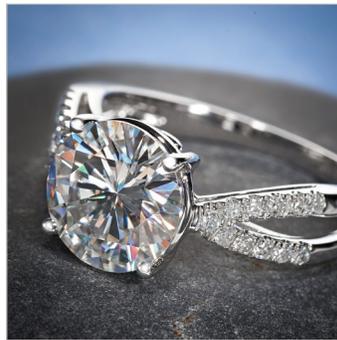




CHARLES & COLVARD®



2014
ANNUAL REPORT

OUR FAMILY OF BRANDS

CHARLES & COLVARD®

CLASSIC  MOISSANITE™
Created by CHARLES & COLVARD

FOREVER  BRILLIANT®
Created by CHARLES & COLVARD

— ● ● —
SURVIVOR
COLLECTION™

Hearts
& ARROWS
FOREVER  BRILLIANT®

MOISSANITE  COM
by CHARLES & COLVARD

LULU  AVENUE®

Dear Shareholders,

As your new CEO and new Executive Chairman, we wanted to take this opportunity to address you, our shareholders, specifically by reviewing the past year and outlining our business objectives for 2015.

Last year was an exciting and challenging year for Charles & Colvard. We are thankful to Randy McCullough who initiated several emerging business channels, and for his many years of service to the company.

We were successful in strengthening our balance sheet in 2014 by selling existing inventory and increasing our cash position. We expect inventory to be a continued source of cash flow in 2015. We signed a new, exclusive long-term supply agreement with Cree to purchase silicon carbide crystals, the crystals from which we produce our Forever Brilliant® moissanite gems. We saw our direct-to-consumer businesses contribute significant growth. In addition, our operational capabilities increased when we moved into our new, state-of-the-art facility during the summer of 2014.

In 2015, our objectives are to strengthen our relationships with our long-term customers, improve customer service, make significant progress on our inventory position, and continue gaining traction with our growing and loyal audiences. These include the wide variety of women who can buy any jewelry of choice, yet continue to select our gems, as well as successful and entrepreneurial women who are embracing our brands – some of whom are also electing to become our Lulu Avenue® Style Advisors.

We will continue to drive toward new channels, and new opportunities to promote The World's Most Brilliant Gem®.

As your new management team, we want to let you know that we are sincerely optimistic about the future and look forward to reporting to you on our progress. Thank you for your continued support.

Sincerely,



A handwritten signature in black ink, appearing to read "H. Marvin Beasley".

H. Marvin Beasley
President and Chief Executive Officer



A handwritten signature in black ink, appearing to read "Neal I. Goldman".

Neal I. Goldman
Executive Chairman of the Board of Directors

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

FORM 10-K

(Mark One)

Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2014

OR

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.)

170 Southport Drive
Morrisville, North Carolina
(Address of principal executive offices)

27560
(Zip Code)

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

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

Title of each class	Name of each exchange on which registered
Common Stock, no par value per share	The NASDAQ Stock Market LLC

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 No

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input checked="" type="checkbox"/>

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

As of June 30, 2014, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates of the registrant was \$39,773,833 based on the closing sales price as reported on the NASDAQ Global Select Market.

As of March 9, 2015, there were 20,404,833 shares of the registrant's common stock, no par value per share, outstanding.

DOCUMENT INCORPORATED BY REFERENCE

Certain portions of the Proxy Statement for the registrant's 2015 Annual Meeting of Shareholders to be held on May 20, 2015 are incorporated by reference into Part III of this Annual Report on Form 10-K.

CHARLES & COLVARD, LTD.

FORM 10-K

For the Fiscal Year Ended December 31, 2014

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K 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, or the Exchange Act. Statements expressing expectations regarding our future and projections relating to products, sales, revenues, and earnings are typical of such statements and are made under the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about our plans, objectives, representations, and contentions and are not historical facts and typically are identified by use of terms such as “may,” “will,” “should,” “could,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “continue,” and similar words, although some forward-looking statements are expressed differently.

All forward-looking statements are subject to the risks and uncertainties inherent in predicting the future. You should be aware that although the forward-looking statements included herein represent management’s current judgment and expectations, our actual results may differ materially from those projected, stated, or implied in these forward-looking statements as a result of many factors including, but not limited to, our dependence on consumer acceptance and growth of sales of our products resulting from our strategic initiatives; dependence on a limited number of customers; the impact of the execution of our business plans on our liquidity; our ability to fulfill orders on a timely basis; the financial condition of our major customers and their willingness and ability to market our products; dependence on Cree, Inc. as the sole supplier of the raw material; our current wholesale customers’ potential perception of us as a competitor in the finished jewelry business; intense competition in the worldwide jewelry industry; general economic and market conditions, including the current economic environment; risks of conducting business in foreign countries; the pricing of precious metals, which is beyond our control; the potential impact of seasonality on our business; our ability to protect our intellectual property; the risk of a failure of our information technology infrastructure to protect confidential information and prevent security breaches; possible adverse effects of governmental regulation and oversight; and the failure to evaluate and integrate strategic opportunities, in addition to the other risks and uncertainties described in more detail in “Risk Factors” in Part I, Item 1A of this Annual Report on Form 10-K. Forward-looking statements speak only as of the date they are made. We undertake no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur except as required by the federal securities laws, and you are urged to review and consider disclosures that we make in the reports that we file with the Securities and Exchange Commission, or SEC, that discuss other factors relevant to our business.

PART I

Item 1. Business

General

Charles & Colvard, Ltd., a North Carolina corporation founded in 1995 (which may be referred to as Charles & Colvard, we, us, or our), manufactures, markets, and distributes *Charles & Colvard Created Moissanite*[®] jewels (which we refer to as moissanite or moissanite jewels), finished jewelry featuring moissanite, and fashion finished jewelry for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide, or 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 our advantage of being the original and leading worldwide source of created moissanite jewels, our strategy is to establish Charles & Colvard with reputable, high-quality, and sophisticated brands and to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond. We believe this is possible due to moissanite’s exceptional brilliance, fire, durability, and rarity like no other jewel available on the market. We sell loose moissanite jewels and finished jewelry at wholesale to distributors, manufacturers, and retailers and at retail to end consumers through our wholly owned operating subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC.

During 2014, we began managing our business primarily through our three distribution channels that we use to sell our product lines, loose jewels and finished jewelry. Accordingly, we determined our three operating and reportable segments to be wholesale distribution transacted through our parent entity, and our two direct-to-consumer distribution channels transacted through our wholly owned operating subsidiaries, Moissanite.com, LLC and Charles & Colvard Direct, LLC. Previously, the two direct-to-consumer operating segments had been aggregated into a single reportable segment for reporting purposes, but they are now each being presented as a separate reportable

segment. Certain amounts from 2013 have been reclassified to conform to the current year presentation as a result of this change in reportable segments. See Note 3 to our consolidated financial statements included in Item 8, “Financial Statements and Supplementary Data” of this Annual Report on Form 10-K for a discussion of financial information by reportable segment and by geographic area.

United States, or U.S., sales represented 86% and 73% of total consolidated net sales for the years ended December 31, 2014 and 2013, respectively. Our largest customer during the year ended December 31, 2014 accounted for 28% of our total consolidated sales compared to 19% during the year ended December 31, 2013. A second customer accounted for 10% of our total consolidated sales during the year ended December 31, 2014 but did not account for more than 10% of our total consolidated sales during the year ended December 31, 2013. No additional customers accounted for more than 10% of total consolidated sales in 2014 or 2013.

Our future growth strategy is closely linked to our statement of purpose: “We will grow by providing consumers an affordable luxury experience.” We plan to accomplish this by growing our core loose jewel and finished jewelry wholesale distribution segment with key distributors, jewelry manufacturers, and retailers while working to develop and expand our two direct-to-consumer distribution segments, which are our e-commerce and home-party direct selling businesses through our wholly owned subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC, respectively. We plan to support these initiatives by increasing consumer awareness, clearly communicating to the consumer the value proposition of our products, and developing and distributing leading global brands for our moissanite jewel and finished jewelry featuring moissanite with an unrelenting focus on design.

- *Wholesale* - We will continue to focus on our core business of manufacturing and distributing the loose moissanite jewel and finished jewelry featuring moissanite through wholesale sales channels, because this is currently the primary way we reach consumers and we believe there is substantial opportunity to capture a larger share of the jewelry market. Our wholesale loose jewel business has historically been the largest percentage of our total sales, and this trend has continued despite significant growth in our wholesale finished jewelry business that we launched in 2010. For the years ended December 31, 2014 and 2013, our wholesale distribution segment represented 81% and 90% of our total consolidated net sales, respectively, of which wholesale loose jewel sales comprised 59% and 71%, respectively, of total net wholesale distribution segment sales and wholesale finished jewelry sales comprised 41% and 29%, respectively, of total net wholesale distribution segment sales. Our wholesale finished jewelry business continues to expand through select retailers and television shopping networks, and we believe there is significant opportunity to further expand these sales channels.
- *Direct-to-consumer e-commerce* - Our direct-to-consumer e-commerce website, *Moissanite.com*, features an intuitive site design with robust functionality to enhance the customer experience and convert traffic into sales. We continue to expand the website’s jewelry collections and its loose moissanite jewel assortment by featuring a variety of colors and shapes, and we are investing resources in targeted advertising and marketing campaigns. In 2014, we continued fine-tuning such marketing efforts to maximize return on investment, increasing product assortment, and building new site functionality designed to increase sales conversion rates. We believe our direct-to-consumer e-commerce sales channel will not only add to our top-line revenues in a significant manner, but will also play a key role in our campaign to increase overall consumer awareness of moissanite. We also envision e-commerce as a part of a broader effort to establish online connections with consumers that build our brands and our business with retail partners. For the years ended December 31, 2014 and 2013, our direct-to-consumer e-commerce segment represented 13% and 9% of our total consolidated net sales, respectively, of which loose jewel sales comprised 18% and 14%, respectively, of total net direct-to-consumer e-commerce segment sales and finished jewelry sales comprised 82% and 86%, respectively, of total net direct-to-consumer e-commerce segment sales.
- *Direct-to-consumer home parties* - According to the Direct Selling Association, the U.S. direct sales business is an estimated \$32 billion market, dominated primarily by women at 74% of the nearly 17 million direct-sales representatives nationwide. Direct sales offers a flexible earning opportunity as well as a social outlet. Since sales of moissanite are highest when the consumer is educated about its attributes and has the opportunity to see and touch it, we believe social selling and home parties are an excellent venue for selling our product and expanding consumer awareness. In April 2012, we test launched *Lulu Avenue*[®], a home party brand featuring over 200 jewelry styles blending fashion and moissanite jewelry. In October 2012, our direct-to-consumer home party business, *Lulu Avenue*[®], began to integrate the custom designs of a well-known jewelry designer into the current jewelry line. The first phase of the integration was completed

in March 2013. In April 2013, we hired a President of *Lulu Avenue*[®] whose focus is on the scale-up of the sales force, and in 2014, we continued to invest in finance, sales and customer service personnel to support our back office technology and supply chain efforts of *Lulu Avenue*[®]. Our direct-to-consumer home party sales segment has provided sales growth for the years ended December 31, 2014 and 2013 representing 6% and 1% of our total consolidated net sales, respectively, with nearly all of those sales being fashion finished jewelry and finished jewelry featuring moissanite. We believe this segment will play a role in our campaign to increase overall consumer awareness of moissanite.

Moissanite

Moissanite is a rare, naturally occurring mineral that is generally very small in size, dark green or black in color, and not a commercially viable source of gemstone material. Therefore, we expect only lab-grown SiC crystals to provide a sustainable source of moissanite for jewels.

In addition to carat size, important characteristics of a gemstone are beauty, durability, and rarity. The beauty of a gemstone is characterized by its color, brilliance, and fire. The brilliance of a gemstone is measured by its refractive index, or the extent to which, when coupled with the facet design, the gemstone reflects light. The fire of a gemstone, or the breaking of light rays into spectral colors, is measured by its dispersion. Durability is determined by a gemstone's hardness, or resistance to scratching; and toughness, or resistance to chipping or cleaving. Rarity is the availability or perceived availability of a gemstone.

Moissanite jewels have a unique combination of brilliance, fire, durability, and rarity. Moissanite's beauty is objectively derived from its refractive index, which is higher than other gemstones, including diamond, and its hardness is greater than all known gemstone materials except diamond. As a result, moissanite jewels, like diamond, can be cut with sharp, well-defined, and highly polished facets that accentuate their brilliance and fire. The cutting specifications (facet arrangement and proportions) for moissanite jewels are designed to maximize the brilliance and fire of the material. Additionally, we evaluate the finished jewels to exacting standards with automated video-imaging equipment and specially trained quality control personnel. Due to the rare natural occurrence of moissanite and both the proprietary and technical limitations in producing mass quantities of gem-grade moissanite, we believe that moissanite is among the rarest of jewels.

To date, we have focused our development, manufacturing, and distribution efforts on near-colorless moissanite jewels, although we have produced and sold limited quantities of green, blue, yellow, and pink moissanite jewels.

The following table compares the physical properties of moissanite jewels with other fine gemstone materials:

Description	Refractive Index	Dispersion	Hardness (Mohs Scale) ⁽²⁾	Toughness
Charles & Colvard Created Moissanite [®]	2.65-2.69	0.104	9 ¼	Excellent
Diamond	2.42	0.044	10	Excellent*
Ruby	1.77	0.018	9	Excellent**
Sapphire	1.77	0.018	9	Excellent**
Emerald	1.58	0.014	7 ½	Good to Poor

*In cleavage direction, toughness is "good"

**Except twinned stones

1. Sources: Gemological Institute of America, [Gem Reference Guide for GIA Colored Stones, Gem Identification and Colored Stone Grading Courses](#) 32-35, 65-82, 87-90 (1995); Cornelius S. Hurlburt, Jr. & Robert C. Kammerling, [Gemology](#) 320-324 (2d Ed. 1991); Kirk-Othmer, [Encyclopedia of Chemical Technology](#) 524-541 (5th Ed. 2004); [Institution Of Electrical Engineers, Properties of Silicon Carbide](#) (Gary L. Harris, Ed., 1995); Robert Webster, [Gems: Their Sources, Descriptions and Identification](#) 889-940 (5th Ed. 1994); W. von Muench, "Silicon Carbide" in [Landolt-Börnstein Numerical Data and Functional Relationships in Science and Technology, New Series, Group III](#), Vol. 17C, pp. 403-416 and 585-592 (M. Schultz and H. Weiss, Eds., 1984); Kurt Nassau, Shane F. McClure, Shane Elen & James E. Shigley, "Synthetic Moissanite: A New Diamond Substitute", [Gems & Gemology](#), Winter 1997, 260-275; Kurt Nassau. "Moissanite: A New Synthetic Gemstone Material", [Journal of Gemmology](#), 425-438 (1999).
2. The Mohs Scale is a relative scale only, and quantitative comparisons of different gemstone materials cannot be made directly using the Mohs Scale. Moissanite jewels, while harder than all other known gemstones, are approximately one-half as hard as diamond.

Products and Product Development

Moissanite jewels

We primarily sell near-colorless moissanite jewels, including our *Classic Moissanite™* jewels and our whiter *Forever Brilliant®* jewels, cut in a variety of shapes including round, square brilliant, princess, cushion, radiant, pear, marquise, heart, and oval, among others, in sizes ranging from approximately 1.3 to 12 millimeters (approximately 0.008 to 5.3 carats). In the future, we may elect to offer, from time to time, additional cuts and sizes of moissanite jewels.

To evaluate the market potential of colored moissanite, we had produced and distributed with moderate success in prior years a limited quantity of green moissanite jewels. Beginning in 2013, we increased our marketing efforts of various colored jewels, including those set in finished jewelry mountings, and identified several markets into which we expanded our sales of green and various colored jewels in 2013 and 2014.

Finished jewelry

We began selling finished jewelry featuring moissanite in 2010. Our basic designs include stud earrings, solitaire and three-stone rings, pendants, and bracelets. We are also selling more fashion-oriented, designer-inspired moissanite jewelry that we offer as an expansion to the basic line of jewelry. The primary ingredients of our moissanite finished jewelry are loose moissanite jewels that we have on hand as part of our finished goods inventory, white or yellow gold settings, and labor to mount the jewels into the settings. We have also created several pieces of jewelry in alternative metals such as sterling silver and palladium.

In addition, we purchase fashion finished jewelry comprised of base metals and non-precious gemstones for sale through *Lulu Avenue®*. This finished jewelry is fashion oriented and subject to styling trends that may change with each catalog season. The majority of this finished jewelry is custom designed for us.

Source of Raw Material

Our moissanite jewels are made from gem-grade SiC crystals. Our sole supplier of SiC crystals is Cree, Inc., or Cree, with which we have certain exclusive supply rights for SiC crystals to be used for gemstone applications. We source the metals used for our finished jewelry, including white and yellow gold, sterling silver, and palladium, from a number of manufacturers located primarily in the U.S. or internationally in China, India, Mexico, or Thailand.

Exclusive Supply Agreement with Cree

In June 1997, we entered into an Amended and Restated Exclusive Supply Agreement with Cree, or the Cree Exclusive Supply Agreement. The Cree Exclusive Supply Agreement had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the Cree Exclusive Supply Agreement, we had committed to purchase from Cree a minimum of 50%, by dollar volume, of our raw material SiC crystal requirements. Effective February 8, 2013, we entered into an amendment to a prior letter agreement with Cree, which provided a framework for our purchases of SiC crystals under the Cree Exclusive Supply Agreement. Pursuant to this amendment, we agreed to purchase at least \$4.00 million of SiC crystals in an initial new order. After the initial new order, we agreed to issue non-cancellable, quarterly orders that must equal or exceed a set minimum order quantity. Our total purchase commitment under the amendment (as subsequently amended) until July 2015, including the initial new order, was dependent upon the grade of the material and ranged between approximately \$7.64 million and approximately \$18.56 million.

On December 12, 2014, we entered into a new exclusive supply agreement with Cree, or the New Supply Agreement, which superseded and replaced (with respect to materials ordered subsequent to the effective date of the New Supply Agreement) the Cree Exclusive Supply Agreement, which was set to expire in 2015. Under the New Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the New Supply Agreement will expire on June 24, 2018, unless extended by the parties. We also have one option to unilaterally extend the term of the agreement for an additional two-year period, subject to certain conditions. Our total purchase commitment under the New Supply Agreement

until June 2018 is dependent upon the size of the SiC material and ranges between approximately \$29.6 million and approximately \$31.5 million.

Intellectual Property

We have U.S. product and method patents for moissanite jewels, expiring in 2015, under which we have broad, exclusive rights to manufacture, use, and sell moissanite jewels in the U.S. We have these same patents in 25 foreign jurisdictions primarily across Asia and Europe, expiring in 2016, and in Mexico, expiring in 2021. In addition, we have certain trademarks and pending trademark applications that support our moissanite branding strategy. Our success and our ability to compete successfully depend in part upon our proprietary technology. In addition to our patents, we rely on trade secret laws and employee, consultant, and customer confidentiality agreements to protect certain aspects of our technology. We currently are not subject to any claims that our products or processes infringe on the proprietary rights of third parties. At the present time, we are also dependent on Cree's technology for the production of SiC crystals. Cree is exclusively licensed to use a patent concerning a process for growing large single crystals of SiC, has certain patents of its own relating to growth of large single crystals of SiC, and has a patent for a process for growing near-colorless SiC crystals.

Manufacturing and Quality Assurance

Moissanite jewels

The production of *Charles & Colvard Created Moissanite*[®] jewels is an elaborate process developed over a number of years of collaborative research and development, acquired and learned knowledge from scientists, and considerable investment expense.

Following are the key manufacturing processes of our moissanite jewels:

- growing gem-grade raw SiC crystals;
- manufacturing rough preforms;
- polishing jewels; and
- inspecting, sorting, and grading.

Growing gem-grade raw SiC crystals - SiC crystal growth suitable for gem-grade usage at commercial quantities is proprietary both in design and in operational methodology. Cree has grown the majority of our SiC crystals in accordance with the terms of the Cree Exclusive Supply Agreement. We routinely evaluate the yield and quality of saleable moissanite jewels from SiC crystals. The yield of saleable jewels from each crystal is one of the most significant factors affecting the volume and cost of moissanite jewels available for sale. Yield is dependent on the quality of the crystals, and variations in crystal quality can adversely affect our gross margin percentage.

Manufacturing rough preforms - We have made considerable investment in the design, development, and customization of a proprietary manufacturing process that includes equipment, software, and procedures to maximize raw material yield. The result is production of intermediary shapes, called "preforms," that vary depending upon the size and shape of the finished jewel. We continue to invest research and development resources to improve raw material yield, including studying alternate preform shapes and cutting technologies, due to the dramatic effect such an improvement could have on our gross margin percentage.

Polishing jewels - Each preform is hand faceted and polished by our independent third party gem-cutters based on master designs with multiple quality control measures built into the process. Gem-cutter training is a regimented program involving several months of progressive hands-on bench training.

Inspecting, sorting, and grading - Similar to other gemstones, each faceted moissanite jewel is individually graded against established master standards using our specially trained personnel. Additionally, as part of our overall quality assurance program, a representative sample from each batch of jewels is submitted to an image analyzer to ensure critical angles and other attributes designed to maximize moissanite's optical properties are consistently maintained. This phase of manufacturing is relatively labor-intensive and requires skills not readily available in the general work force. In the future, we may elect to outsource certain portions of this stage of the manufacturing process to independent third parties that we will require to adhere to our rigorous quality control and monitoring standards.

Finished jewelry

Our line of finished jewelry featuring moissanite is developed by a team of industry experts integrating our moissanite jewels into many forms of jewelry, generally made of 14 karat gold, but also certain alternative metals such as sterling silver and palladium, either designed or purchased by us utilizing a core group of suppliers, manufacturers, and finishers.

Our line of fashion finished jewelry, comprised of base metals and non-precious gemstones for sale through *Lulu Avenue*[®], is either designed exclusively for us and manufactured to our specifications or purchased from a core group of suppliers and manufacturers.

All finished jewelry components procured are sourced from our approved suppliers, and each finished jewelry item is jobbed and/or tracked by stock keeping unit, or SKU, utilizing our enterprise resource planning system. The components of moissanite finished jewelry comprised in each job are then manufactured into finished jewelry by assemblers either in the U.S. or internationally in China, India, Mexico, or Thailand.

All finished jewelry produced by us undergoes a multi-point inspection process. A representative sampling of manufactured finished jewelry items undergoes stone and metals testing to ensure that the items for sale are of the quality that we strive to maintain. If required by government ordinance or requested by a customer, we facilitate the inspection of our finished jewelry by internationally recognized testing facilities to comply with legal requirements and to ensure consumer confidence.

Marketing and Distribution

Marketing

Social Media and Millennials

- *Social Media* - To reinforce and support our sales channels and position Charles & Colvard as the premier source of moissanite, our marketing team is working on several social media initiatives that target current and future moissanite consumers and support Charles & Colvard along with our Classic Moissanite™ and *Forever Brilliant*[®] brands. Our campaigns are focused on driving a consistent message: emphasizing that we are based in the USA, the ethical-origins of our gems, the everlasting beauty of our gems, and overall value. We are using various forms of digital and social media outreach to accomplish greater awareness of the value proposition we offer.
- *Millennials* - In order to plant the foundation to reach the millennial generation we have trademarked “Moissy™” – the nickname bestowed by our younger generation of consumers, primarily on wedding blogs. We will be using this as the basis of our social platform with a consumer content site called Moissy.com that we expect to launch in the summer of 2015. We believe Moissy.com will create a community and aggregate everything social from Instagram, twitter, and Facebook with content generated from consumers as well as designers who are passionate about this gemstone.

Wholesale Distribution Segment

- *Cooperative advertising* - Some of our loose moissanite jewel wholesale customers participate in our cooperative advertising program, which reimburses, via a credit towards future purchases, a portion of their marketing costs based on the amount of their purchases from us, subject to the customer adhering to our branding guidelines and other conditions.
- *Marketing to the trade* - In 2014, we continued to target the trade with print advertisements featuring our *Forever Brilliant*[®] moissanite jewel and finished jewelry featuring the *Forever Brilliant*[®] jewel in leading trade publications, tagging key distributors to support sales growth. In addition, we maintain relationships with major jewelry industry organizations and jewelry trade publications as an opportunity to communicate with our peers on a consistent basis through media coverage, trade shows, action committees, and charitable events, among others.

- *Trade shows* - Our attendance at leading jewelry trade shows as a sponsor, an exhibitor, or a participant assisting our loose moissanite jewel and finished jewelry wholesale customers has helped us extend our outreach to customers. In 2014, we attended major domestic and international jewelry industry trade shows, including JCK in Las Vegas and the Hong Kong Gem and Jewellery Fair. Given our focus on domestic growth we are planning attendance at major domestic shows in 2015.

Direct-to-Consumer E-commerce Segment

- *Consumer advertising* - We are supporting our initiative to increase consumer awareness of moissanite and our finished jewelry primarily with various forms of electronic communication, including through targeted email.
- *Consumer education* - Because education of the consumer is so important to sell-through of moissanite products, we redesigned and deployed our corporate website www.charlesandcolvard.com during 2014 to include extensive educational information about moissanite, in addition to general background information about our company. Our direct-to-consumer e-commerce site, *Moissanite.com*, features much of the same educational content that allows a consumer to learn more about moissanite prior to purchase. We expect to launch additional improvements and enhancements to *Moissanite.com* in 2015.

Direct-to-Consumer Home Parties Segment

- *Consumer advertising* - We are supporting our initiative to increase consumer awareness of moissanite and our finished jewelry primarily with paid search advertising and various forms of electronic communication, including social media campaigns.
- *Consumer education* - Because education of the consumer is so important to sell-through of moissanite products, we train and certify our independent sales representatives, which we refer to as Style Advisors, through classes offered by our *Lulu Avenue*[®] direct-to-consumer home party business on the attributes of moissanite.

Distribution

Wholesale Distribution Segment

We generally have contracts and agreements with our domestic and international distributor, manufacturer, and retailer wholesale customers with some variations in terms and duration.

- *Domestic* - Finished jewelry featuring moissanite is sold through our wholesale distribution segment to consumers through a broad range of channels, including single- and multiple-location independent jewelry stores, jewelry store chains, online retailers, television shopping networks, department stores, and catalogs. Historically, we have primarily sold our loose moissanite jewels to wholesale distributors and finished jewelry manufacturers, which in turn set them in mountings and sold them to retailers, sold them through their own e-commerce sites, or resold the loose jewels at a markup. While we plan to continue this aspect of our business, in 2010 we began mounting our loose jewels into our own jewelry, which we currently sell at wholesale to home shopping networks, various e-commerce websites, and select retailers. In addition, we have allowed loose moissanite jewel and finished jewelry inventory to be placed in stores on a consignment basis. We continue to evaluate our channel strategy for domestic wholesale distribution, which may result in a change to our historical distribution methods and partners.
- *International* - Our international wholesale distribution is currently comprised primarily of loose moissanite jewels that are sold to international distributors for resale to jewelry manufacturers and retailers in their local markets. We currently have over 20 international wholesale distributors for loose moissanite jewels covering portions of Western Europe, Australia, India, Southeast Asia, and the Middle East. We have continued to invest in certain international markets that we believe have the most potential with respect to acceptance and sales of the moissanite jewel, including Australia, China, India, Italy, and the United Kingdom. Export sales aggregated approximately \$3.54 million, or 14% of total consolidated net sales, and \$7.80 million, or 27% of total consolidated net sales, in 2014 and 2013, respectively. It should be noted that a portion of our international sales consists of jewels sold internationally that may be re-imported

to U.S. retailers. While we continue to believe that international markets are an important part of our business, we plan to prioritize increasing our domestic customer base over developing international markets in 2015.

Direct-to-Consumer E-commerce Distribution Segment

We sell our loose moissanite jewels and finished jewelry featuring moissanite at retail through our direct-to-consumer *Moissanite.com* e-commerce website at www.moissanite.com. We maintain on-hand stock for such basic designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets and fulfill orders from our main facility. Other finished jewelry styles offered for sale on the website are made-to-order by several of our key distributors who also assist in providing fulfillment of these products directly to the end consumer.

Currently, all of our direct-to-consumer e-commerce segment distribution is domestic. Sales made to international shipping addresses through our *Moissanite.com* e-commerce website are shipped to a domestic third-party intermediary that assumes all risks and liabilities for the international transaction.

Direct-to-Consumer Home Parties Distribution Segment

Our finished fashion and moissanite jewelry offered by *Lulu Avenue*[®] is sold to consumers online at www.luluavenue.com; and in convenient, comfortable venues by our Style Advisors, using sample pieces contained in a sales kit purchased by the Style Advisor as part of the enrollment process. The Style Advisors supplement the sample pieces with additional styles displayed in seasonal catalogs and online at www.luluavenue.com. Orders are entered by the Style Advisor into a back office system, and the products are fulfilled by a third-party logistics company that ships the products to the Style Advisor or end consumer.

Currently, all of our direct-to-consumer home party segment distribution is domestic.

Seasonality

Sales in the retail jewelry industry are typically seasonal due to increased consumer purchases during the Christmas and holiday season. Because historically we have primarily sold our loose moissanite jewels and finished jewelry featuring moissanite at wholesale to distributors, manufacturers, and retailers, our sales to support the holiday season largely have taken place during the third and beginning of the fourth calendar quarters, depending on the sales channel and the level of advance planning and production our customers undertook; however, the effect of seasonality on our business is also impacted by the timing of orders we receive to support new or expanded distribution and the level of current inventory position held by our customers. In the years ended December 31, 2014 and 2013, we experienced a higher degree of seasonality in the fourth quarter than we have previously experienced in prior years primarily as a result of Christmas and holiday season wholesale finished jewelry sales to television shopping networks. In the fourth quarter of 2013 and 2014, we experienced a higher level of sales to end consumers through our direct-to-consumer e-commerce website, *Moissanite.com*. In future periods as sales of our finished jewelry increase to retailers and directly to consumers, both in dollars and as a percent of total sales, we anticipate a seasonality trend more typical with the retail jewelry industry, and these factors may significantly affect our results of operations in a given quarter.

Working Capital Practices

Our primary source of working capital is cash on hand and cash generated by operations. Because we have a quarterly minimum purchase commitment under the New Supply Agreement, we may be required to purchase SiC materials in excess of our immediate needs from time to time, which may result in inventories that are higher than we might otherwise maintain. Our current inventory levels are sufficient to enable us to respond promptly to most customer orders.

Our standard wholesale customer payment terms on trade receivables are generally between 30 and 90 days, though we may offer extended terms with specific customers and on significant orders from time to time. We extend credit to our 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 us, the customer's reputation in the trade, and/or an evaluation of the customer's opportunity to introduce our moissanite jewels or finished jewelry featuring moissanite to new or expanded markets.

Our return policy allows for the return of jewels and finished jewelry for credit generally within 30 days of shipment and must be returned for a valid reason, such as quality problems or an error in shipment. From time to time, some wholesale customers may have a contractual right to return a certain percentage of sales for any reason for specified periods of time. We have established an allowance for returns based on our historical return rate, which takes into account any contractual return privileges granted to our customers. Periodically, we ship loose jewel and jewelry finished goods 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.

Competition

Our competitive success is reliant upon, in part, the following:

- our continued success in developing and promoting brands for our moissanite jewel and finished jewelry featuring moissanite, resulting in increased interest and demand for moissanite jewelry at the consumer level;
- the continued willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote *Charles & Colvard Created Moissanite*[®], including both our *Classic Moissanite*[™] jewels and *Forever Brilliant*[®] jewels, to the retail jewelry trade;
- the continued willingness of distributors, retailers, and others in the channel of distribution to purchase loose *Charles & Colvard Created Moissanite*[®], including both our *Classic Moissanite*[™] jewels and *Forever Brilliant*[®] jewels, and the continued willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;
- our continued ability and the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our moissanite jewels and finished jewelry;
- our continued ability and the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in finished jewelry with high-quality workmanship;
- our continued ability and the ability of retail jewelers to effectively market and sell finished jewelry featuring moissanite, including finished jewelry featuring both our *Classic Moissanite*[™] jewels and *Forever Brilliant*[®] jewels, to consumers; and
- our ability to operationally execute our direct-to-consumer e-commerce and home party businesses.

Moissanite jewels

Gemstone materials can be grouped into three types:

- natural gemstone, which is found in nature;
- synthetic gemstone, which has the same chemical composition and essentially the same physical and optical characteristics of natural gemstone but is created in a lab; and
- simulated or substitute material, which is similar in appearance to natural gemstone but does not have the same chemical composition, physical properties, or optical characteristics.

Our moissanite jewel competes with fine gemstones such as ruby, sapphire, emerald, and tanzanite as well as with natural, synthetic, and treated diamonds. We may also face competition from synthetic diamonds, synthetic diamond films, and other sources of synthetic moissanite not presently available in qualities, sizes, and volumes suitable for use as gemstones. Some suppliers of diamonds and other fine gemstones, as well as the suppliers of synthetic and simulated gemstones, have substantially greater financial, technical, manufacturing, and marketing resources and greater access to distribution channels than we do.

We market our unique jewel as an affordable, luxurious alternative to diamond at price points that make our jewel more attainable by many consumers. The diamond industry enjoys higher consumer desirability and acceptance, which has been iconized by the “Diamonds are Forever” marketing campaign. Historical efforts to differentiate moissanite from diamond as a unique jewel by virtue of its distinctive composition and its superior optical characteristics remain a challenge, as moissanite resembles diamond in the eyes of consumers. Therefore, we shifted our marketing strategy of moissanite to be a high-quality alternative to diamond beginning in the fourth quarter of 2009.

The worldwide market for large, uncut, high-quality natural diamonds is significantly consolidated and controlled by

DeBeers (headquartered in South Africa), Alrosa (Russia), Rio Tinto (Australia), and BHP (Canada). These companies have a major impact on the worldwide supply and pricing of natural diamonds at both the wholesale and retail levels. Diamond producers may undertake additional marketing or other activities designed to protect the diamond jewelry market against sales erosion from consumer acceptance of moissanite jewels.

We may also face competition from treated and synthetic diamonds. Treated diamonds, which are natural diamonds with imperfections or flaws that have been altered in some manner to enhance their appearance, have been available in the jewelry industry for the past several decades and are generally less expensive than diamonds of similar size, cut, and color that have not been altered. Synthetic diamonds are also available in the marketplace and are produced for jewelry applications available to consumers; however, most synthetic diamonds that are sold today are in the yellow color range. Although we believe that colorless gemstone-quality synthetic and treated diamonds presently cannot be produced at prices competitive with those currently offered for our near-colorless moissanite jewels, there can be no assurances that such competitive prices cannot be achieved in the future by the producers of either or both synthetic and treated diamonds. The primary producers of synthetic diamonds used for industrial applications are DeBeers, Sumitomo, and GE. There are also a number of Russian producers of synthetic diamonds for industrial uses. In addition, companies such as Gemesis Corporation, Chatham, and Apollo Diamonds are synthesizing diamonds in limited quantities, limited carat sizes, and in limited ranges of color. Synthetic diamond films can be grown at commercially viable prices in thicknesses that can be applied to various surfaces such as other synthetic materials.

Although we believe that our moissanite jewel has a proprietary position, we could face competition from other companies that develop competing SiC technologies. Some of these technologies could be developed by producers of SiC used for other industrial applications. Manufacturers of industrial SiC products include The Carborundum Corporation (currently for abrasive uses); and Cree, Siemens AG, Norstel, Bridgestone, ABB, Dow Chemical, SiC Crystal AG, and Northrop Grumman Corporation (currently for semiconductor uses). We believe that Cree is currently the only supplier of SiC crystals in colors, sizes, and volumes that are suitable for gemstone applications. It is possible, however, that these or other producers of SiC could develop SiC crystals suitable for gemstone applications and produce moissanite jewels until we could obtain judicial enforcement of our patent rights. It is also possible that such competition could emerge in geographic territories where we might not have adequate patent protection.

We may also, to a lesser degree, face competition from existing diamond simulants and other synthetic gemstones, including cubic zirconia. Producers and sellers of these products may see the markets for these products being eroded by the market penetration of our moissanite jewels. We believe that the substantially lower price of these products is the primary basis upon which they will compete with our moissanite jewels; however, they are not considered fine jewelry products.

Finished jewelry

The global jewelry market is approximately \$145 billion and competition is fierce. Such well-known jewelry designers and manufacturers as David Yurman, Tacori, Harry Winston, Tiffany & Co., and Pandora, among others, have a variety of jewelry collections featuring diamonds and other precious and semi-precious gemstones, strong brand recognition, and a loyal consumer following. These companies also have greater financial resources than we do to develop and market their products.

We intend to expand our market share and compete with these well-known brands primarily on the basis of price, as moissanite is the highest quality, affordable alternative available to more expensive gemstones such as diamond. We believe that focusing on the clear advantages in its retail price points, especially in the one-carat and larger sizes, will provide a key point of differentiation and value proposition to the end consumer who may not have had the opportunity previously to purchase fine jewelry due to limitations in discretionary spending income.

In addition, we believe that the *Charles & Colvard Created Moissanite*[®] brand, in addition to other brands for both the moissanite jewel, including *Forever Brilliant*[®] for our whiter jewels, and fashion and moissanite finished jewelry that we are developing pursuant to our marketing programs, may create a long-term competitive advantage for our products as we build brand recognition. We endeavor to partner with recognized designers and jewelry companies, in addition to our own proprietary brands of finished jewelry. While our finished jewelry business is still developing, our goal is to build multiple strong brands sought after by the end consumer as our intellectual property rights expire in the future. We propose to focus our marketing efforts on emphasizing our attractive designs, coupled with

moissanite's exceptional brilliance, fire, durability, and rarity to establish moissanite as a primary consumer choice in fine jewelry.

Our design, manufacture, and marketing of finished jewelry featuring moissanite under exclusive brands for sale at wholesale to distributors and retailers and at retail to end consumers through our *Moissanite.com* e-commerce and *Lulu Avenue*[®] home party sales channels may result in some of our current wholesale customers perceiving us as a competitor, despite our efforts to use primarily non-conflicting sales channels. As we continue to develop our finished jewelry business, we intend to increase distribution through new and existing channels similarly to how many other companies have executed cross-channel marketing and distribution strategies. Due to the size of the finished jewelry market, we believe that such sales channels can co-exist, with the overall end result being increased consumer and brand awareness of moissanite products and a corresponding increased demand for not only our products, but those of our distributor and manufacturer customers as well.

Competition in the direct selling industry is intense. Such well-known jewelry direct selling companies as Stella & Dot, Silpada, Park Lane, and Cookie Lee, among others, have a large number of independent sales representatives selling their products, strong brand recognition, and a loyal consumer following. These companies also have greater financial resources than we do to develop and market their products and recruit independent sales representatives into their businesses. Start-up companies in the direct selling industry often follow an "incubation" period of several years in which product offerings and marketing messaging are developed and refined, systems are implemented, and independent sales representatives are enrolled into the business. We believe we made strides in 2014 towards refining our product offerings and marketing messages and growing our independent sales force. Our independent sales force growth accelerated at the end of 2014 due in part to a competitor closing its business and some of its independent sales representatives choosing to join *Lulu Avenue*[®]. We expect our *Lulu Avenue*[®] home party business to compete with other well-established jewelry direct selling companies based on our exclusive fashion and moissanite jewelry designs. We also believe that *Lulu Avenue*[®] will afford a higher earning opportunity and appeal to independent sales representatives due to the perceived value and higher price points of moissanite jewelry, available through no other jewelry direct selling company.

Government Regulation

We are subject to governmental regulations in the manufacture and sale of moissanite jewels and finished jewelry. In particular, the Federal Trade Commission, or FTC, has issued regulations and guidelines governing the marketing of synthetic gemstones and other gemstones similar to diamond that require such gemstones to be clearly identified in any promotional or marketing materials. In addition, the precious metal in our finished jewelry may be subject to requirements, which vary by country and by state, such as hallmarking and alloy content. While we have a policy to ensure compliance with applicable regulations, if our actions are found to be in violation of FTC or other governmental regulations, we may be required to suspend marketing of our products and could incur significant expenses in developing new marketing strategies and materials that would not violate FTC regulations.

Research and Development

We invested approximately \$18,000 and \$25,000 in research and development during the years ended December 31, 2014 and 2013, respectively, primarily for the study of product enhancement and manufacturing process efficiencies.

Employees

As of March 9, 2015, we had a total of 71 employees, 70 of which were full-time and 1 was part-time. None of our employees are represented by a labor union. We believe that our employee relations are good.

Directors and Executive Officers of Charles & Colvard, Ltd.

The members of our current Board of Directors are the following:

Neal Goldman

Executive Chairman of the Board; President of Goldman Capital Management, Inc., an investment advisory firm

David B. Barr

Chairman of PMTD Restaurants LLC, a franchisee of KFC and Taco Bell; Member of Boards of Directors of Del Frisco's Restaurant Group, LLC; Mrs. Fields Original Cookies, Inc.; RM HoldCo, LLC; Bistro Restaurant Group; Your Pie Franchising LLC; and BrightStar Group Holdings, Inc.

H. Marvin Beasley

Retired former Chief Executive Officer of Helzberg Diamonds, a retail jewelry store chain

Anne M. Butler

Chief Executive Officer of Butler Advisors, a consulting firm specializing in strategic and operational advising to private equity, venture capital, and institutional investors on direct selling acquisitions and management

George R. Cattermole

Retired former Chairman of the Board, President and Chief Executive Officer of Outlast Technologies Inc, a technology company that provides "phase change materials" to the fiber, textile, bedding, and apparel markets worldwide

Randall N. McCullough

President and Chief Executive Officer of Charles & Colvard, Ltd.

Ollin B. Sykes

President of Sykes & Company, P.A., a regional accounting firm specializing in accounting, tax, and financial advisory services

Our current executive officers are the following:

Randall N. McCullough

President and Chief Executive Officer

Kyle Macemore

Senior Vice President, Chief Financial Officer and Treasurer

Steven M. Larkin

Chief Operating Officer

Available Information

Our corporate information is accessible through our Internet website at www.charlesandcolvard.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available, free of charge, access on our website to all reports we file with, or furnish to, the SEC, including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. A copy of this Annual Report on Form 10-K and our other reports is available without charge upon written request to Investor Relations, Charles & Colvard, Ltd., 170 Southport Drive, Morrisville, North Carolina 27560.

Item 1A. Risk Factors

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. If any of these risks actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

Our future financial performance depends upon increased consumer acceptance, growth of sales of our products, and operational execution of our strategic initiatives. We believe that most consumers are not generally aware of the existence and attributes of moissanite jewels and that the consumer market for moissanite jewels and finished jewelry featuring moissanite remains in the early stages of development. Total moissanite jewelry retail sales have historically been less than 1% of the total jewelry market. The degree of future market acceptance and demand is subject to a significant amount of uncertainty. Our future financial performance will depend, in part, upon greater consumer acceptance of moissanite jewels, including both our *Classic Moissanite™* jewels and our whiter *Forever Brilliant®* jewels, as an affordable, luxurious alternative to other gemstones, such as diamond; and our ability to develop brands and execute strategic initiatives, in particular, our direct-to-consumer e-commerce and home party businesses, to grow our sales and operating income. As we execute our strategy to build and reinvest in our businesses, significant expenses and investment of cash will be required ahead of the revenue streams we expect in the future, and this may adversely affect our operating income. If we are unable to execute and achieve desired revenue levels, we may adjust our strategic initiatives in response to the results of our investments.

In addition, consumer acceptance may be affected by retail jewelers' and jewelry manufacturers' acceptance of moissanite jewels and finished jewelry featuring moissanite. The quality, design, and workmanship of the jewelry settings, whether manufactured by us or other manufacturers, could affect both consumers' perception and acceptance of our jewels and costs incurred by returns and markdowns.

Thus, our future financial performance may be affected by:

- our continued success in developing and promoting brands for our moissanite jewel and finished jewelry featuring moissanite, resulting in increased interest and demand for moissanite jewelry at the consumer level;
- the continued willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote *Charles & Colvard Created Moissanite®*, including both our *Classic Moissanite™* jewels and *Forever Brilliant®* jewels, to the retail jewelry trade;
- the continued willingness of distributors, retailers, and others in the channel of distribution to purchase loose *Charles & Colvard Created Moissanite®*, including both our *Classic Moissanite™* jewels and *Forever Brilliant®* jewels, and the continued willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;
- our continued ability and the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our moissanite jewels and finished jewelry;
- our continued ability and the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in finished jewelry with high-quality workmanship;
- our continued ability and the ability of retail jewelers to effectively market and sell finished jewelry featuring moissanite, including finished jewelry featuring both our *Classic Moissanite™* jewels and *Forever Brilliant®* jewels, to consumers; and
- our ability to operationally execute our direct-to-consumer e-commerce and home party businesses.

We are currently substantially dependent on a limited number of distributors, jewelry manufacturers, and retailers for the sale of our products. The majority of the moissanite jewels and finished jewelry featuring moissanite that we sell are distributed through a limited number of distributors, manufacturers, and retailers and, therefore, we are substantially dependent upon these companies for distribution of our products. During 2014, our three largest customers, two of which are loose jewel and finished jewelry distributors and one of which is a television shopping network loose jewel and finished jewelry retailer, collectively accounted for 46% of net sales. As we continue to build our finished jewelry business, we anticipate in the near term that the majority of the moissanite jewels and finished jewelry featuring moissanite that we sell will continue to be to a limited number of manufacturers, distributors, and retailers.

The execution of our business plans could significantly impact our liquidity. The execution of our business plans to expand our direct-to-consumer distribution channels and to create required inventory of our new *Forever Brilliant*[®] jewels requires significant investments, which has reduced our cash position. Should we fail to execute on our business plans, we could see delays in the return of cash from our investments, resulting in a liquidity shortfall. Under the \$10,000,000 asset-based revolving credit facility, or the Credit Facility, that we obtained from Wells Fargo, National Association, or Wells Fargo, on June 25, 2014, failure to conduct our business as conducted on the date we obtained the Credit Facility, failure to make required payments to third parties, or failure to comply with the other covenants and defaults contained in the Credit Facility, including a covenant to maintain at least \$1,000,000 in excess availability (as defined under the Credit Facility), could restrict our ability to draw on the Credit Facility. If we are not able to take advances against the Credit Facility, our cash and cash equivalents and other working capital may be insufficient to meet our working capital and capital expenditure needs.

Our business and our results of operations could be materially adversely affected as a result of our inability to fulfill orders on a timely basis. As sales of our loose moissanite jewels increase, including our whiter *Forever Brilliant*[®] jewels, certain shapes and sizes may be at risk for depletion. In addition, finished jewelry has a large variety of styles of which we maintain on-hand stock for such basic designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets; and make-to-order under strict deadlines for certain wholesale and direct-to-consumer e-commerce customers. We must adequately forecast demand and operate within the lead times of third parties that facet and/or enhance the jewels and manufacture the finished jewelry setting to ensure adequate on-hand quantities and/or the shipment of customer orders in a timely manner. The inability to fulfill orders on a timely basis and within promised customer deadlines could result in a cancellation of the orders and loss of customer goodwill that could materially and adversely affect our business, results of operations, and financial condition.

The financial difficulties or insolvency of one or more of our major customers or their lack of willingness and ability to market our products could adversely affect results. We are subject to a concentration of credit risk amongst our major customers (some of whom are distributors), and a default by any of these customers on their debts to us could have a material adverse effect on our financial position. Future sales and our ability to collect accounts receivable depend, in part, on the financial strength of our customers and our distributors' willingness and ability to successfully market our products. We estimate an allowance for accounts for which collectability is at risk and this allowance adversely impacts profitability. In the event customers experience greater than anticipated financial difficulties, insolvency, or difficulty marketing products, we expect profitability to be adversely impacted by our failure to collect accounts receivable in excess of the estimated allowance. In these circumstances, we may demand the return of product sold to such customers, resulting in an increase in inventory and a reduction in accounts receivable. Given the current economic environment, constrained access to capital and general market contractions may heighten our exposure to customer default and lower than expected distributor sales.

We expect to remain dependent upon Cree for the sole supply of our SiC crystals for the foreseeable future. If we are unable to obtain sufficient, high-quality SiC crystals from Cree and we have a significant increase in demand for our moissanite jewel, then we may not be able to meet that demand. Cree has certain proprietary rights relating to its process for growing large single crystals of SiC and its process for growing near-colorless SiC crystals. Under the New Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the New Supply Agreement will expire on June 24, 2018, unless extended by the parties. We also have one option to unilaterally extend the term of the agreement for an additional two-year period, subject to certain conditions. Our total purchase commitment under the New Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately \$29.6 million and approximately \$31.5 million. However, there can be no assurance that Cree will be able to continue to produce and supply us with SiC crystals of sufficient quality, sizes, and volumes that we desire or that we will successfully negotiate future purchase commitments at acceptable prices that enable us to manage our inventories and raw material costs effectively.

Our current wholesale customers may potentially perceive us as a competitor in the finished jewelry business. As described above, we are currently substantially dependent on a limited number of customers, including distributors and jewelry manufacturers, for the sale of our products. Our design, manufacture, and marketing of finished jewelry featuring moissanite under exclusive brands for sale to distributors and retailers may result in some of these current customers perceiving us as a competitor, despite our efforts to use primarily non-conflicting sales channels. In response, these customers may choose to reduce their orders for our products. This reduction in orders could occur

faster than our sales growth in this new business, which could materially and adversely affect our business, results of operations, and financial condition.

We face intense competition in the worldwide jewelry industry. The jewelry industry is highly competitive and we compete with numerous other jewelry products. In addition, we face competition from treated diamonds, synthetic diamonds, and companies developing other synthetic jewelry technologies. A substantial number of companies supply products to the jewelry industry, many of which we believe have greater financial resources than we do. Competitors could develop new or improved technologies that may render the price point for moissanite noncompetitive, which would have an adverse effect on our business, results of operations, and financial condition.

In addition, we rely on our patent rights and other intellectual property rights to maintain our competitive position. Our current U.S. product and method patents for moissanite jewels will expire in 2015 and most of our patents in foreign jurisdictions will expire in 2016. The expiration of our patents could result in increased competition. If we are unable to successfully build strong brands for our moissanite jewel and finished jewelry featuring moissanite, we may not have commercially meaningful protection for our products or a commercial advantage against our competitors or their competitive products or processes, which may have a material adverse effect on our business, results of operations, and financial condition.

Our business and our results of operations could be materially adversely affected as a result of general economic and market conditions, including the recent economic environment. Global financial markets have recently experienced extreme disruptions, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increased unemployment rates, and uncertainty about economic stability. While we have seen occasional signs of stabilization in the financial markets during 2013 and 2014, a shift towards continued recessionary conditions could adversely impact our sales volumes and overall profitability. We are unable to predict the likely duration and severity of the effects of these disruptions in the financial markets and the adverse global economic conditions, and if uncertainty continues or economic conditions deteriorate, our business and results of operations could be materially and adversely affected. The consequences of such adverse effects could include interruptions or delays in our suppliers' performance of our contracts, reductions and delays in customer purchases, delays in or the inability of customers to obtain financing to purchase our products, and bankruptcy of customers and/or suppliers.

Luxury products, such as fine jewelry, are discretionary purchases for consumers. The recent reduction in consumer discretionary spending, largely attributed to the conditions described above, affected our industry more significantly than many other industries. Consumer discretionary spending is strongly affected by economic factors outside our control, including the condition of financial markets, consumer credit availability, prevailing interest rates, energy costs, employment levels, salary levels, and tax rates. While discretionary consumer spending trends have improved, a reduction in discretionary consumer spending could have a material adverse effect on our business, results of operations, and financial condition.

We are subject to certain risks due to our international distribution channels and vendors. We currently have over 20 international distributors for moissanite jewels covering portions of Western Europe, Australia, India, Southeast Asia, and the Middle East. In addition, we use certain companies based outside the U.S. to facet our moissanite jewels and to manufacture finished jewelry. Due to our reliance on development of foreign markets and use of foreign vendors, we are subject to the risks of conducting business outside of the U.S. These risks include the following:

- the adverse effects on U.S.-based companies operating in foreign markets that might result from war; terrorism; changes in diplomatic, trade, or business relationships; or other political, social, religious, or economic instability;
- the continuing adverse economic effects of the recent global financial crisis;
- unexpected changes in, or impositions of, legislative or regulatory requirements;
- delays resulting from difficulty in obtaining export licenses;
- tariffs and other trade barriers and restrictions;
- the burdens of complying with a variety of foreign laws and other factors beyond our control;
- the potential difficulty of enforcing agreements with foreign customers and suppliers; and
- the complications related to collecting receivables through a foreign country's legal system.

Additionally, while the majority of our foreign transactions are denominated in U.S. dollars, foreign currency

fluctuations could impact demand for our products or the ability of our foreign suppliers to continue to perform. Further, some of our foreign distributors operate relatively small businesses and may not have the financial stability to assure their continuing presence in their markets. There can be no assurance that the foregoing factors will not adversely affect our operations in the future or require us to modify our anticipated business practices.

Sales of moissanite jewelry could be dependent upon the pricing of precious metals, which is beyond our control. Any increases in the market price of precious metals (primarily gold) could affect the pricing and sales of jewelry incorporating moissanite jewels, including jewelry manufactured by us. The majority of price increases in precious metals are passed on to the end consumer in the form of higher prices for finished jewelry. These higher prices could have a negative impact on the sell-through of moissanite jewelry at the retail level. From the beginning of 2006 through 2014, the price of gold has increased significantly (approximately 123%), resulting in higher retail price points for gold jewelry. This has had a negative impact on both sales of moissanite jewelry and the jewelry industry as a whole.

Seasonality of our business may adversely affect our net sales and operating income. Sales in the retail jewelry industry are typically seasonal due to increased consumer purchases during the Christmas and holiday season. Because historically we have primarily sold our loose jewels and finished jewelry featuring moissanite at wholesale to distributors, manufacturers, and retailers, our sales to support the holiday season largely have taken place during the third and beginning of the fourth calendar quarters, depending on the sales channel and the level of advance planning and production our customers undertook. As sales of our finished jewelry featuring moissanite to retailers and directly to consumers increase, both in dollars and as a percentage of total sales, our fourth quarter results may depend upon the general level of retail sales during the Christmas and holiday season as well as general economic conditions and other factors beyond our control. In anticipation of increased sales activities during the fourth quarter, we may incur significant additional expenses, including higher inventory of finished jewelry in the second half of the year. In 2014 and 2013, we experienced a higher degree of seasonality in the fourth quarter than we have previously experienced primarily as a result of Christmas and holiday season finished jewelry sales to television shopping networks. In the fourth quarter of 2013 and 2014, we also experienced a higher level of sales to end consumers through our direct-to-consumer e-commerce website, *Moissanite.com*. Our quarterly results of operations may continue to fluctuate as a result of a number of factors, including seasonal cycles, the timing of new product introductions, the timing of orders by our customers, and the mix of product sales demand, and these factors may significantly affect our results of operations in a given quarter.

We may not be able to adequately protect our intellectual property, which could harm the value of our products and brands and adversely affect our business. We rely primarily on patent, copyright, trademark, and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. We have U.S. product and method patents for moissanite jewels, expiring in 2015, under which we believe that we have broad, exclusive rights to manufacture, use, and sell moissanite jewels in the U.S. We have these same patents in a number of foreign jurisdictions, most of which expire in 2016. We believe that these patents create substantial technological barriers to our potential competitors. At the present time, we are also dependent on Cree's technology for the production of SiC crystals. There can be no assurance that any patents issued to or licensed by or to us or Cree will provide any significant commercial protection, that we or Cree will have sufficient resources to protect our respective patents, that any additional patents will be issued in the future, or that any existing or future patents will be upheld by a court should we or Cree seek to enforce our respective rights against an infringer. At this point, we cannot reasonably estimate the impact these patent expirations will have on our future results of operations.

Our former South Korean patent is no longer valid as a result of a ruling by the South Korean Patent Court, and there can be no assurance that we will not incur similar outcomes in other jurisdictions in the future. For example, on August 14, 2012, we learned that BetterThanDiamond.com requested that the Canadian Intellectual Property Office, or CIPO, conduct a re-examination of our Canadian Patent No. 2,230,262, or the '262 Patent, for manufacturing SiC gemstones based on claims of prior art. On November 3, 2012, the CIPO granted the re-examination request based on its finding that the information provided in the request raises "a substantial new question of patentability." The U.S. Patent and Trademark Office, or USPTO, upheld in October 2012 all claims of our U.S. Patent No. 5,723,391 in a similar challenge by BetterThanDiamond.com, but there is no certainty of the same outcome with respect to the challenge of the '262 Patent. If the CIPO were to determine that some or all of the claims in the '262 Patent are invalid, our business, financial condition, and results of operations could be negatively impacted. In addition, the re-examination of the '262 Patent could result in substantial legal expenses and could divert our management's time and attention away from our business operations. We believe that all of the claims of

the '262 Patent are valid and enforceable, and we intend to vigorously defend the patents that protect our moissanite jewels and technology.

The existence of valid patents does not prevent other companies from independently developing competing technologies. Existing producers of SiC crystals or others may refine existing processes for growing SiC crystals or develop new technologies for growing large single crystals of SiC or colorless SiC crystals in a manner that does not infringe patents owned or licensed by us or Cree. Accordingly, existing and potential competitors may be able to develop products that are competitive with or superior to our products, and such competition could have a material adverse effect on our business, results of operations, and financial condition.

In addition, we have certain trademarks and pending trademark applications that support our moissanite branding strategy, and we use certain brand names for which we do not currently have proprietary rights. The success of our growth strategy depends on our continued ability to use our existing brand names in order to increase consumer awareness and further develop strong brands around our moissanite jewel and finished jewelry collections. We cannot assure that any future trademark or other registrations will be issued for pending or future applications or that we will be able to obtain licenses or other contractual rights to use brand names that may infringe the proprietary rights of third parties. We also cannot assure that any registered or unregistered trademarks or other intellectual property or contractual rights will be enforceable or provide adequate protection of our proprietary rights. Our inability to secure proprietary protection with respect to our brands could have a material adverse effect on our business, results of operations, and financial condition.

We also cannot be certain that our products and brand names do not or will not infringe valid patents, trademarks, and other intellectual property rights held by third parties. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. Litigation to determine the validity of any third party's claims could result in significant expense and divert the efforts of our technical and management personnel, whether or not such litigation is determined in our favor. In the event of an adverse result of any such litigation, we could be required to expend significant resources to develop non-infringing technology or to obtain licenses for, and pay royalties on the use of, the technology subject to the litigation. We have no assurance that we would be successful in such development or that any such license would be available on commercially reasonable terms.

A failure of our information technology (IT) infrastructure or a failure to protect confidential information of our customers and our network against security breaches could adversely impact our business and operations. We rely upon the capacity, reliability, and security of our information technology infrastructure and our ability to expand and continually update this infrastructure in response to the changing needs of our business. For example, we are continuing to implement new IT systems and payment gateways that support our wholesale, *Moissanite.com* e-commerce, and *Lulu Avenue*[®] home party businesses. As we implement and integrate the new systems, they may not perform as expected. We also face the challenge of supporting our older systems and implementing necessary upgrades. If we experience a problem with the functioning of an important IT system or a security breach of our IT systems, the resulting disruptions could have an adverse effect on our business.

In addition, we and certain of our third-party vendors receive and store personal information associated with our sales operations and other aspects of our business. In connection with our e-commerce and home party businesses, we rely on encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Despite our implementation of security measures, our IT systems and e-commerce and home party businesses are vulnerable to damages from computer viruses, natural disasters, unauthorized access, cyber attack, and other similar disruptions. An increasing number of websites and Internet companies have reported breaches of their security. Any such compromise of our security could damage our reputation, business, and brand and expose us to a risk of loss or litigation and possible liability, which could substantially harm our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations, damage our computers or those of our customers, or otherwise damage our reputation and business. These issues are likely to become more difficult as we expand the number of countries in which our e-commerce and home party websites operate. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.

If we fail to evaluate, implement, and integrate strategic acquisition or disposition opportunities successfully, our business may suffer. From time to time we evaluate strategic opportunities available to us for product, technology,

or business acquisitions or dispositions. If we choose to make acquisitions or dispositions, we face certain risks, such as failure of an acquired business to meet our performance expectations, diversion of management attention, retention of existing customers of our current and acquired business, and difficulty in integrating or separating a business's operations, personnel, and financial and operating systems. We may not be able to successfully address these risks or any other problems that arise from future acquisitions or dispositions. Any failure to successfully evaluate strategic opportunities and address risks or other problems that arise related to any acquisition or disposition could adversely affect our business, results of operations, and financial condition.

Governmental regulation and oversight might adversely impact our operations. We are subject to governmental regulations in the manufacture and sale of moissanite jewels and finished jewelry. In particular, the FTC has issued regulations and guidelines governing the marketing of synthetic gemstones and other gemstones similar to diamond that require such gemstones to be clearly identified in any promotional or marketing materials. In addition, the precious metal in our finished jewelry may be subject to requirements, which vary by country and by state, such as hallmarking and alloy content. We may be under close scrutiny both by governmental agencies and by competitors in the gemstone industry, any of which may challenge our promotion and marketing of our moissanite jewel and finished jewelry products. While we have a policy to ensure compliance with applicable regulations, if our production or marketing of moissanite jewels and/or finished jewelry is challenged by governmental agencies or competitors, or if regulations are issued that restrict our ability to market our products, our business, results of operations, and financial condition could be materially adversely affected.

Some anti-takeover provisions of our charter documents may delay or prevent a takeover of our company. A number of provisions of our articles of incorporation and bylaws impact matters of corporate governance and the rights of shareholders. Certain of these provisions have an anti-takeover effect and may delay or prevent takeover attempts not first approved by our Board of Directors (including takeovers that certain shareholders may deem to be in their best interests). These provisions also could delay or frustrate the removal of incumbent directors or the assumption of control by shareholders. We believe that these provisions are appropriate to protect our interests and the interests of all of our shareholders.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

We currently lease approximately 36,350 square feet of office, storage, and light manufacturing space in the Research Triangle Park area of North Carolina from an unaffiliated third party that is used by all three of our operating and reportable segments.

The majority of all U.S. personnel, including our executive offices, sales offices, administrative personnel, and production facilities are housed in the current space.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which we are a party or to which any of our property is subject.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

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

Market for Registrant's Common Equity

Our common stock is traded on the NASDAQ Global Select Market under the symbol “CTHR.” The following table presents, for the periods indicated, the high and low sales prices of our common stock, as reported by the NASDAQ Global Select Market. As of March 9, 2015 there were 261 shareholders of record of our common stock.

	<u>High</u>	<u>Low</u>
Year Ended December 31, 2013:		
First Quarter	\$4.13	\$3.38
Second Quarter	\$4.58	\$3.68
Third Quarter	\$8.34	\$4.00
Fourth Quarter	\$7.12	\$4.68
Year Ended December 31, 2014:		
First Quarter	\$5.06	\$2.84
Second Quarter	\$2.98	\$1.87
Third Quarter	\$2.50	\$1.70
Fourth Quarter	\$3.00	\$1.16

We did not pay any dividends on our common stock during 2014 or 2013. We will regularly review and consider the best policies and practices for our company, including the dividend policy. The payment of future dividends will be dependent on the facts and circumstances at the time of that review

Item 6. Selected Financial Data

Not applicable.

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

The following discussion is intended to provide a better understanding of our consolidated financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. This information should be read in conjunction with Item 1A, “Risk Factors” and our consolidated financial statements and the notes thereto included in Item 8, “Financial Statements and Supplementary Data” of this Annual Report on Form 10-K. Historical results and percentage relationships among any amounts in the consolidated financial statements are not necessarily indicative of trends in operating results for future periods.

Overview

We manufacture, market, and distribute *Charles & Colvard Created Moissanite*[®] jewels (which we refer to as moissanite or moissanite jewels), finished jewelry featuring moissanite, and fashion finished jewelry for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide, or 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 our advantage of being the original and leading worldwide source of created moissanite jewels, our strategy is to establish Charles & Colvard with reputable, high-quality, and sophisticated brands and to position moissanite as an affordable, luxurious alternative to other gems, such as diamond. We believe this is possible due to moissanite’s exceptional brilliance, fire, durability, and rarity like no other jewel available on the market.

We manage our business primarily by our three distribution channels that we use to sell our product lines, loose jewels and finished jewelry. Accordingly, we determined our three operating and reportable segments to be wholesale distribution transacted through our parent entity, direct-to-consumer e-commerce distribution transacted through our wholly owned operating subsidiary, Moissanite.com, LLC, or Moissanite.com, and direct-to-consumer home party distribution transacted through our wholly owned operating subsidiary, Charles & Colvard Direct, LLC, or Charles & Colvard Direct. We sell our loose moissanite jewels at wholesale to some of the largest distributors and manufacturers in the world, which mount them into fine jewelry to be sold at retail outlets and via the Internet. We also sell loose moissanite jewels and finished jewelry featuring moissanite at wholesale to retailers to be sold to end consumers and, in the third quarter of 2011, we established a direct-to-consumer e-commerce sales channel through Moissanite.com that sells both loose moissanite jewels and finished jewelry featuring moissanite. Additionally, in April 2012 we launched a pilot test of a direct-to-consumer home party sales channel through Charles & Colvard Direct that sells fashion and moissanite finished jewelry. We believe the expansion of our sales channels to the

jewelry trade and the end consumer with branded finished moissanite jewelry creates a more compelling consumer value proposition to drive increased demand.

We are continuing to focus on our core business of manufacturing and distributing the loose moissanite jewel and finished jewelry featuring moissanite through wholesale sales channels, because this is currently the primary way we reach consumers. We believe there is opportunity to grow our wholesale business and to capture a larger share of the jewelry market as we execute our strategy to increase consumer awareness of moissanite.

The wholesale finished jewelry business that we launched in 2010 has expanded through select retailers and television shopping networks. We believe there is significant opportunity to further expand our wholesale finished jewelry business through e-commerce, television shopping, and other retailers. We also believe our finished jewelry business, including finished jewelry sold through our direct-to-consumer e-commerce and home party sales channels, allows us to have more control over the end product and enhance our relationships with consumers, as well as provide incremental sales and gross profit dollars due to the higher price points of finished jewelry containing moissanite relative to loose jewels. To that end, we focused on the following critical aspects of our strategic plan during 2014:

- *Developing brand strategies* - Our goal is to build multiple strong brands around the moissanite jewel and finished jewelry collections in attractive and desirable jewelry designs, especially those featuring larger center stones that leverage moissanite's point of differentiation and value proposition. We believe branding will allow us to increase consumer awareness, which we expect to help drive sales and develop consumer brand recognition and loyalty.

In June 2012, we launched a moissanite jewel with optical properties that are significantly whiter than our standard VG, or *Classic Moissanite™* grade jewels. We are marketing these whiter jewels under the *Forever Brilliant®* trademark as a premier brand to differentiate from other grades of our moissanite as well as moissanite sold by potential competitors in the future.

In September 2014, we launched The Survivor Collection™, a unique jewelry line designed to celebrate breast cancer survivors. The line features three-stone rings and pendants, two *Forever Brilliant®* and one pink moissanite gem to symbolize life before, during and after cancer. At the launch, we partnered with The Breast Cancer Research Foundation, as well as the Women Survivors Alliance to promote breast cancer awareness, celebrate breast cancer survivors and effectively work to find a cure. The Survivor Collection™ has launched in over 150 retail locations in the United States and Canada, and our direct-to-consumer home party business *Lulu Avenue®*. The collection has a website that shares information including "where to buy" and a vibrant social presence on Facebook, Twitter, and Pinterest.

We expect demand for our *Forever Brilliant®* loose jewel and finished jewelry featuring the *Forever Brilliant®* jewel to grow, both in our wholesale channel and on our *Moissanite.com* e-commerce website, and that *Forever Brilliant®* will become an increasingly important brand for Charles & Colvard, Ltd. as we execute future branding initiatives. We are also exploring additional product lines and branding strategies that will differentiate our products in the market.

In 2013, we engaged two New York-based public relations, marketing, and events agencies to generate optimal exposure with consumer media for both our *Lulu Avenue®* and *Forever Brilliant®* brands, with the goal to increase consumer awareness of our brands specifically and moissanite generally. After our engagements, several media events occurred where magazine editors, fashion columnists, and bloggers were invited to experience first-hand our *Lulu Avenue®* fashion and moissanite finished jewelry and our *Forever Brilliant®* loose jewels. We utilized both agencies to increase exposure for our brands in the first nine months of 2014 through improved product placement in leading fashion periodicals and blogging sites, and through broadcast and print editorial outreach. We continued to utilize one agency during the last three months of 2014.

We believe our efforts to position *Forever Brilliant®* as the whitest and brightest moissanite jewel available anywhere in the world and the introduction of designer finished jewelry brands will help us to build brand recognition and increase consumer awareness of our products. We also expect that this strategy of building brand recognition will help to support revenue streams as our intellectual property rights expire beginning

in 2015. To better position us for greater market share growth, we identified the need for a VP of Marketing to focus our branding efforts on our target consumers, and we filled the role in April 2014.

- *Expanding our direct-to-consumer e-commerce business* - Our direct-to-consumer e-commerce website, *Moissanite.com*, features an intuitive site design with robust functionality to enhance the customer experience and convert traffic into sales. We continue to expand the website's jewelry collections and its loose moissanite jewel assortment by featuring a variety of colors and shapes, and we are investing resources in targeted advertising and marketing campaigns. In 2013 and 2014, we continued fine-tuning such marketing efforts to maximize return on investment, increasing product assortment, and building new site functionality designed to increase sales conversion rates. We believe our direct-to-consumer e-commerce sales channel will not only add to our top-line revenues in a significant manner, but will also play a key role in our campaign to increase overall consumer awareness of moissanite. We also envision e-commerce as a part of a broader effort to establish online connections with consumers that build our brands and our business with retail partners.
- *Developing our direct-to-consumer home party business* - In October 2012, our direct-to-consumer home party business, *Lulu Avenue*[®], began to integrate the custom designs of a well-known jewelry designer into the current jewelry line. The first phase of the integration was completed in March 2013. In April 2013, we hired a President of *Lulu Avenue*[®] whose focus is on the scale-up of the sales force, and during 2014, we continued to invest in finance and sales and customer service personnel to support our back office technology and supply chain efforts of *Lulu Avenue*[®]. Our direct-to-consumer home party sales channel has provided sales growth in 2014 and we believe it will play a role in our campaign to increase overall consumer awareness of moissanite.

As we execute our strategy to build and reinvest in our businesses, significant expenses and investment of cash will be required ahead of the revenue streams we expect in the future, and this resulted in some unprofitable reporting periods in 2014. Despite this, we have maintained as one of our primary goals to generate positive cash flow to protect our cash position. We were not successful in achieving this goal during 2013 primarily as a result of our significant inventory build of *Forever Brilliant*[®] loose jewels to meet anticipated demand, establish an in-stock position for future orders, and collect on our trade receivables generated from these sales. However, during 2014 we were able to reduce our inventories and aggressively collect on our trade accounts receivable balance from year end and on sales in 2014. We will continue to monitor our cash burn rate and collection efforts as we grow the business.

Our total consolidated net sales for the year ended December 31, 2014 of \$25.64 million were 10% lower than total consolidated net sales during the year ended December 31, 2013. Wholesale distribution segment net sales for the year ended December 31, 2014 of \$20.78 million were 19% lower than wholesale distribution segment net sales during the year ended December 31, 2013. Direct-to-consumer e-commerce distribution segment net sales for the year ended December 31, 2014 of \$3.41 million were 37% greater than direct-to-consumer e-commerce distribution segment net sales during the year ended December 31, 2013. Direct-to-consumer home party distribution segment net sales during the year ended December 31, 2014 of \$1.45 million were 252% greater than direct-to-consumer home party distribution segment net sales during the year ended December 31, 2013.

Loose jewel sales comprised 50% of our total consolidated net sales for the year ended December 31, 2014 and decreased 30% to \$12.93 million, compared with \$18.48 million in the previous year. Finished jewelry sales comprised 50% of our total consolidated net sales and increased 27% to \$12.71 million, compared with \$10.00 million in the previous year. We expect these increases in sales by product mix to continue as we execute our strategy of developing new wholesale and direct-to-consumer sales channels and expanding our finished jewelry business.

Operating expenses increased by \$1.20 million, or 8%, to \$16.67 million for the year ended December 31, 2014, compared with \$15.47 million in the previous year. Of this increase, general and administrative expenses increased \$1.31 million, or 24%, to \$6.79 million primarily as a result of bad debt expenses, as well as personnel and consulting increases. Sales and marketing expenses decreased \$14,000, or 0%, to \$9.85 million, primarily as a result of lower consulting expenses incurred to launch the e-commerce and home party direct sales businesses and cooperative advertising expense, offset in part by increased expenses for personnel additions. As we grow our business, we intend to continue to closely manage our operating expenses by seeking the most cost effective and efficient solutions to our operating requirements. We recorded a net loss of \$13.10 million, or \$0.65 per diluted share, for the year ended December 31, 2014, primarily due to a lower gross profit margin, higher general and

administrative expenses, and a \$4.05 million tax expense resulting from a valuation allowance on certain deferred tax assets based on our cumulative negative taxable income over the last three years and the uncertainty of sufficient future taxable income to utilize our deferred tax assets. Our lower gross profit resulted from a greater sales mix of finished jewelry that typically yields a lower gross margin than loose jewels due to the lower markup on precious metals and labor used in the manufacture of jewelry, and an effort to move existing finished gemstones that will not be a focus of our future initiatives.

The execution of our strategy to grow our company, with the ultimate goal of increasing consumer awareness and clearly communicating the value proposition of moissanite, is challenging and not without risk. As such, there can be no assurance that future results for each reporting period will exceed past results in sales, operating cash flow, and/or net income due to the challenging business environment in which we operate and our investment in various initiatives to support our growth strategies. However, as we execute our growth strategy and messaging initiatives, we remain committed to our current priorities of generating positive cash flow and strengthening our financial position while both monetizing our existing inventory and manufacturing our *Forever Brilliant*[®] loose jewel and finished jewelry to meet sales demand. We believe the results of these efforts will propel our revenue growth and profitability and further enhance shareholder value in coming years, but we fully recognize the business and economic challenges that we face.

2014 Summary

The following is a summary of key financial results and certain non-financial results achieved for the year ended December 31, 2014:

- Our total consolidated net sales decreased by \$2.85 million, or 10%, to \$25.64 million in 2014 from \$28.49 million in 2013. The decrease in 2014 sales was primarily due to lower international sales as a result of difficult economic conditions in some of our international markets and the continuing evaluation of the China market. This decrease in international sales was partially offset by an increase in our domestic sales due primarily to the ongoing execution of our growth strategies including our investments in our *Forever Brilliant*[®] moissanite jewel, the growth of our wholesale customers' moissanite finished jewelry lines with styles that include both *Forever Brilliant*[®] and our other grades of loose jewels, and to a 37% and 252% increase in sales through our direct-to-consumer businesses, *Moissanite.com* and *Lulu Avenue*[®], respectively, which collectively increased their net sales to \$4.86 million.
- Operating expenses increased by \$1.20 million, or 8%, to \$16.67 million in 2014 from \$15.47 million in 2013 primarily as a result of personnel additions, bad debt expense, and advertising, marketing, and branding initiatives incurred to position our company for future growth, especially with respect to the two wholly owned operating subsidiaries formed in 2011 for our e-commerce and home party direct sales businesses. As we grow our business, we intend to continue to closely manage our operating expenses by seeking the most cost effective and efficient solutions to our operating requirements.
- Net loss increased by \$11.81 million, to a loss of \$13.10 million in 2014 from a net loss of \$1.29 million in 2013. Net loss per share was \$0.65 in 2014 compared to a net loss per diluted share of \$0.06 in 2013. Net loss for the year ended December 31, 2014 included a \$4.05 million net income tax expense which contributed a loss of \$0.20 per diluted share, comprised of an increase of a valuation allowance on certain deferred tax assets based on our expectation of their future utilization. As discussed above, domestic sales increases in 2014 were offset by higher operating expenses as we continued the investment in our strategic initiatives.
- We generated positive cash flows from operations of \$2.03 million in 2014 compared to negative cash flows of \$9.31 million in 2013. The primary drivers of positive cash flow were \$7.60 million of net non-cash charges, a decrease in trade accounts receivable of \$4.28 million, a decrease in inventory of \$3.18 million, an increase in other accrued liabilities primarily related to our long-term lease obligations of \$346,000, and a decrease in prepaid expenses and other assets of \$116,000. These factors more than offset a net loss of \$13.10 million and a decrease in trade accounts payable of \$384,000.
- Cash and cash equivalents at December 31, 2014 were \$4.01 million compared to \$2.57 million at December 31, 2013. The primary reason for this increase is the \$2.59 million of cash flow provided by operations.

- Total inventory, including long-term and consignment inventory, was \$38.94 million as of December 31, 2014, down from approximately \$42.41 million at December 31, 2013. This decrease is primarily a result of purchases in 2013 of jewelry castings, findings, and other jewelry components; purchases of fashion finished jewelry in support of our *Lulu Avenue*® home party direct sales business; and production of *Forever Brilliant*® jewels that were sold in 2014. We believe we have an opportunity to build our cash position as we sell down our on-hand loose moissanite jewel and finished jewelry inventory.
- We continue to carry no long-term debt and believe we can fund our growth strategies for the foreseeable future from operating cash flows.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which we prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. “Critical accounting policies and estimates” are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. The most significant estimates impacting our consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions, cooperative advertising, and revenue recognition on transactions with extended payment terms. We also have other policies that we consider key accounting policies, but these policies typically do not require us to make estimates or judgments that are difficult or subjective.

Inventories - Inventories are stated at the lower of cost or market on an average cost basis. Our finished goods inventory consists primarily of near-colorless moissanite jewels that meet rigorous grading criteria and are of cuts and sizes most commonly used in the jewelry industry. As of December 31, 2014, we carried only a limited amount of moissanite jewels in finished jewelry settings, and the carrying value of these jewels is included in the finished jewelry valuation described below. Our loose moissanite jewel inventories do not degrade in quality over time and are not subject to fashion trends. We have very small market penetration in the worldwide jewelry market and have 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, we have concluded that no excess or obsolete loose jewel inventory reserve requirements existed as of December 31, 2014.

Jewelry inventories consist primarily of finished goods, a portion of which we acquired as part of a January 2009 settlement agreement with a former manufacturer customer to reduce the outstanding receivable to us. 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 we 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. To determine the amount of the jewelry reserve, we needed to estimate the amount of gold in each piece of jewelry, the price per ounce we would receive for the gold, and the amount of jewels that could be returned to finished goods inventory. The scrap reserve of \$101,000 and \$106,000 at December 31, 2014 and 2013, respectively, 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. In 2010, we entered the finished jewelry business and began manufacturing finished jewelry featuring moissanite pursuant to an operational plan to market and sell the inventory. As a result, the moissanite finished jewelry we currently produce is not subject to this reserve.

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 our 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, we manufacture small individual quantities of designer-inspired moissanite fashion jewelry as part of our sample line that are used in the selling process to our wholesale customers.

In 2011, we 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 our wholly owned operating subsidiary, Charles & Colvard Direct. 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. We review the finished jewelry inventory on an ongoing basis for any lower of cost or market and obsolescence issues. We identified certain fashion finished jewelry inventory that could not be sold due to damage or branding issues and established an obsolescence reserve of \$250,000 as of December 31, 2014 and \$128,000 as of December 31, 2013, for the carrying costs in excess of any estimated scrap values. As of December 31, 2014, we identified certain finished jewelry featuring moissanite that was obsolete and established an obsolescence reserve of \$31,000 for the carrying costs in excess of any estimated scrap values. No obsolescence reserve requirement relating to our finished jewelry featuring moissanite existed as of December 31, 2013.

We also maintain loose jewel and finished jewelry inventory reserves for shrinkage, recuts, and repairs. Shrinkage refers to loose jewels and finished jewelry on review with customers and vendors that may not be returned to us. The recuts reserve is for the projected material loss resulting from the re-cutting of damaged jewels into smaller loose jewels to remove the damage. The repairs reserve is for finished jewelry in need of repair before it can be returned to finished goods inventory and be available for sale.

Any inventory on hand at the measurement date in excess of our current requirements based on historical and anticipated levels of sales is classified as long-term on our consolidated balance sheets. Our classification of long-term inventory requires us to estimate the portion of 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.

Accounts Receivable Reserves - Estimates are used to determine the amount of two reserves against trade accounts receivable. The first reserve is an allowance for sales returns. At the time revenue is recognized, we estimate future returns using a historical return rate that is reviewed quarterly with consideration of any contractual return privileges granted to customers, and we reduce sales and trade accounts receivable by this estimated amount. The allowance for sales returns was \$910,000 and \$1.9 million at December 31, 2014 and 2013, respectively.

The second reserve is an allowance for doubtful accounts for estimated losses resulting from the failure of our customers to make required payments. This allowance reduces trade accounts receivable to an amount expected to be collected. Based on historical percentages of uncollectible accounts by aging category, changes in payment history, and facts and circumstances regarding specific accounts that become known to management when evaluating the adequacy of the allowance for doubtful accounts, we determine a percentage based on the age of the receivable that we deem uncollectible. The allowance is then calculated by applying the appropriate percentage to each of our accounts receivable aging categories, with consideration given to individual customer account activity subsequent to the current period, including cash receipts, in determining the appropriate allowance for doubtful accounts in the current period. Any increases or decreases to this allowance are charged or credited, respectively, as a bad debt expense to general and administrative expenses. We generally use an internal collection effort, which may include our sales personnel as we deem appropriate. After all internal collection efforts have been exhausted, we generally write off the account receivable.

Any accounts with significant balances are reviewed separately to determine an appropriate allowance based on the facts and circumstances of the specific account. During our reviews for 2014 and 2013, we analyzed several of our slower-paying customers and determined that no additional reserves were necessary. Based on these criteria, we determined that allowances for doubtful accounts receivable of \$1.07 million and \$522,000 at December 31, 2014 and 2013, respectively, were required.

Deferred Tax Assets - As of each reporting date, management considers new evidence, both positive and negative, that could impact its view with regard to future realization of deferred tax assets. Management determined that sufficient positive evidence existed as of December 31, 2013 to conclude that it is more likely than not that certain deferred tax assets of \$4.04 million were realizable. A valuation allowance remained at December 31, 2013 against certain deferred tax assets relating to state net operating loss carryforwards from our 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 remained at December 31,

2013 against certain deferred tax assets relating to investment loss carryforwards because management did not anticipate we would generate sufficient investment income to utilize the carryforwards. Management also previously considered various strategic alternatives, resulting in management determining that a valuation allowance was not necessary at that time. During the year ended December 31, 2014, management determined that such strategic alternatives were no longer in our best interest. Accordingly, management concluded that the positive evidence was no longer sufficient to offset available negative evidence, primarily as a result of the pre-tax operating losses incurred during the year ended December 31, 2014. As a result, management concluded that it was uncertain that we would have sufficient future taxable income to utilize our deferred tax assets, and therefore, we established a valuation allowance against our deferred tax assets, resulting in a tax expense of \$4.05 million for the year ended December 31, 2014.

Our deferred tax assets in Hong Kong were fully reserved with a valuation allowance of \$996,000 as of December 31, 2014 and 2013 and had been fully reserved in all prior periods due to the uncertainty of future taxable income in this jurisdiction to utilize the deferred tax assets. Our Hong Kong subsidiary ceased operations during 2008 and became a dormant entity during 2009. If we use any portion of our deferred tax assets in future periods, the valuation allowance would need to be reversed and may impact our future operating results.

Uncertain Tax Positions - Effective January 1, 2007, we adopted U.S. GAAP guidance regarding the de-recognition, classification, accounting in interim periods, and disclosure requirements for uncertain tax positions. Determining which tax positions qualify as uncertain positions and the subsequent accounting for these positions requires significant estimates and assumptions. Our net accrued income tax liability under the provisions of this guidance was \$408,000 and \$395,000 at December 31, 2014 and 2013, respectively. This liability is only resolved when we obtain an official ruling from the tax authority on the positions or when the statute of limitations expires. Our liability increased by \$13,000 for accrued interest on these positions.

Cooperative Advertising - We offer a cooperative advertising program to many of our wholesale customers that reimburses, via a credit towards future purchases, a portion of their marketing costs based on their net purchases from us. At the end of any given period, we estimate the amount of cooperative advertising expense that has not yet been submitted for credit by our customers. These amounts were \$220,000 and \$188,000 at December 31, 2014 and 2013, respectively. We estimate this amount based on our historical experience with each customer and the related contractual arrangements to provide certain levels of cooperative advertising for our customers. Any differences in actual amounts to our estimates will result in a charge or credit to sales and marketing expenses.

Revenue Recognition - Revenue is recognized when title transfers at the time of shipment from our or a third-party fulfillment company's facility, excluding consignment shipments as discussed below; evidence of an arrangement exists; pricing is fixed or determinable; and collectability is reasonably assured. Our standard wholesale customer payment terms are generally between 30 and 90 days, though we may offer extended terms with specific customers and on significant orders from time to time. Some wholesale customers and all direct-to-consumer customers are required to prepay prior to shipment. At the time revenue is recognized, an allowance for estimated returns is established. Any change in the allowance for returns is charged against net sales. Our return policy allows for the return of loose jewels and finished jewelry for credit generally within 30 days of shipment and must be returned for a valid reason, such as quality problems or an error in shipment. From time to time, some wholesale customers may have a contractual right to return a certain percentage of goods for any reason for specified periods of time. In these instances, we only recognize revenue when the contractual right of return is exhausted. Periodically, we ship 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 that typically ranges from six months to one year. Our wholesale customers are generally required to make payments on consignment shipments within 60 days upon the customer informing us that it will keep the inventory. Accordingly, we do not recognize revenue on these consignment transactions until the earlier of (1) the customer informing us that it will keep the inventory or (2) the expiration of the right of return period.

Recent Accounting Pronouncements - See Note 2 to our consolidated financial statements in Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K for a description of recent accounting pronouncements, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

Results of Operations

The following table sets forth certain consolidated statements of operations data for the years ended December 31, 2014 and 2013.

	Year Ended December 31,	
	2014	2013
Net sales	\$ 25,640,649	\$ 28,487,187
Costs and expenses:		
Cost of goods sold	18,013,335	14,600,177
Sales and marketing	9,853,671	9,867,425
General and administrative	6,789,274	5,476,939
Research and development	18,070	24,903
Loss on abandonment of assets	10,523	98,027
Total costs and expenses	<u>34,684,873</u>	<u>30,067,471</u>
Loss from operations	(9,044,224)	(1,580,284)
Other income (expense):		
Interest income	65	22,007
Interest expense	(901)	(2,106)
Total other (expense) income	<u>(836)</u>	<u>19,901</u>
Loss before income taxes	(9,045,060)	(1,560,383)
Income tax net (expense) benefit	(4,051,963)	269,285
Net loss	<u>\$ (13,097,023)</u>	<u>\$ (1,291,098)</u>

Consolidated Net Sales

Consolidated net sales for the years ended December 31, 2014 and 2013 comprise the following:

	Year Ended December 31,		Change	
	2014	2013	Dollars	Percent
Loose jewels	\$ 12,926,370	\$ 18,483,995	\$ (5,557,625)	-30%
Finished jewelry	12,714,279	10,003,192	2,711,087	27%
Total consolidated net sales	<u>\$ 25,640,649</u>	<u>\$ 28,487,187</u>	<u>\$ (2,846,538)</u>	-10%

Consolidated net sales were \$25.64 million for the year ended December 31, 2014 compared to \$28.49 million for the year ended December 31, 2013, a decrease of \$2.85 million, or 10%. The decrease in 2014 sales was primarily due to lower international sales as a result of difficult economic conditions in some of our international markets and the continuing evaluation of the China market. This decrease in international sales was partially offset by an increase in our domestic sales due primarily to the ongoing execution of our growth strategies including our investments in our *Forever Brilliant*[®] moissanite jewel, the growth of our wholesale customers' moissanite finished jewelry lines with styles that include both *Forever Brilliant*[®] and our other grades of loose jewels, and to a 37% and 252% increase in sales through our direct-to-consumer businesses, *Moissanite.com* and *Lulu Avenue*[®], respectively, which collectively increased their net sales to \$4.86 million. We anticipate orders and related sales of both loose moissanite jewels and finished jewelry in our wholesale distribution segment and our two direct-to-consumer distribution segments will improve as we continue to execute our growth strategies.

Sales of loose jewels represented 50% and 65% of total consolidated net sales for the years ended December 31, 2014 and 2013, respectively. For the year ended December 31, 2014, loose jewel sales were \$12.93 million compared to \$18.48 million for the year ended December 31, 2013, a decrease of \$5.56 million, or 30%. This decrease was primarily due to the decline in sales to our international customers within our wholesale business, generally due to economic and market conditions facing these larger international customers. We believe the economic and market conditions will improve in our international markets. In addition, as we have attempted to expand the China and Hong Kong markets, we sold loose jewels to several wholesale distributors in 2013. During 2014, we have been evaluating each of these distributors, and others, to determine the best long-term partner within these markets, as well as enforcing the collection from one customer with which we are in dispute. As a result, our sales in 2014 have decreased compared to the same period in 2013.

Sales of finished jewelry represented 50% and 35% of total consolidated net sales for the years ended December 31, 2014 and 2013, respectively. For the year ended December 31, 2014, finished jewelry sales were \$12.71 million compared to \$10.00 million for the year ended December 31, 2013, an increase of \$2.71 million, or 27%. This increase was attributable to our ongoing expansion into the finished jewelry business through televised home shopping networks in our wholesale distribution segment and the growth of our e-commerce and home party businesses in our direct-to-consumer distribution segment. In the years ended December 31, 2014 and 2013, we experienced a higher degree of seasonality in the fourth quarter than we have previously experienced in prior years primarily as a result of Christmas and holiday season wholesale finished jewelry sales to television shopping networks. In the fourth quarter of 2014 and 2013, we also experienced a higher level of sales to end consumers through our direct-to-consumer e-commerce website, *Moissanite.com*. In future periods as sales of our finished jewelry increase to retailers and directly to consumers, both in dollars and as a percent of total sales, we anticipate a seasonality trend more typical with the retail jewelry industry, and these factors may significantly affect our results of operations in a given quarter.

U.S. net sales accounted for approximately 86% and 73% of total consolidated net sales during the years ended December 31, 2014 and 2013, respectively. U.S. net sales increased 7% during 2014 primarily due to the increased sales through our direct-to-consumer businesses, *Moissanite.com* and *Lulu Avenue*[®].

Our largest U.S. customer during the year ended December 31, 2014 accounted for 28% of our total consolidated sales compared to 19% during the year ended December 31, 2013. A second U.S. customer accounted for 10% of our total consolidated sales during the year ended December 31, 2014 but did not account for more than 10% of our total consolidated sales during the year ended December 31, 2013. No additional U.S. customers accounted for more than 10% of total consolidated sales in 2014 or 2013. We expect that we will remain dependent on our ability, and that of our largest customers, to maintain and enhance retail programs. A change in or loss of any of these customer or retailer relationships could have a material adverse effect on our results of operations.

International net sales accounted for approximately 14% and 27% of total consolidated net sales during the years ended December 31, 2014 and 2013, respectively. International net sales decreased 55% during 2014 generally due to economic and market conditions facing our larger international customers. We believe the economic and market conditions will improve in our international markets. In addition, as we have attempted to expand the China and Hong Kong markets, we sold loose jewels to several wholesale distributors in 2013. During 2014, we have been evaluating each of these distributors, and others, to determine the best long-term partner within these markets, as well as enforcing the collection from one customer with which we are in dispute. As a result, our international sales in 2014 have decreased compared to the same period in 2013.

No international customers accounted for more than 10% of total consolidated sales in 2014 or 2013. A portion of our international consolidated sales represents jewels sold internationally that may be re-imported to U.S. retailers. Our top three international distributors by sales volume during the year ended December 31, 2014 were located in Hong Kong, India, and the United Kingdom.

Costs and Expenses

Cost of Goods Sold

Cost of goods sold for the years ended December 31, 2014 and 2013 are as follows:

	Year Ended December 31,		Change	
	2014	2013	Dollars	Percent
Product line cost of goods sold				
Loose jewels	\$ 7,566,829	\$ 7,646,375	\$ (79,546)	-1%
Finished jewelry	8,428,182	5,299,572	3,128,610	59%
Total product line cost of goods sold	15,995,011	12,945,947	3,049,064	24%
Non-product line cost of goods sold	2,018,324	1,654,230	364,094	22%
Total cost of goods sold	\$ 18,013,335	\$ 14,600,177	\$ 3,413,158	23%

Total cost of goods sold was \$18.01 million for the year ended December 31, 2014 compared to \$14.60 million for the year ended December 31, 2013, an increase of \$3.41 million, or 23%. Product line cost of goods sold is defined

as product cost of goods sold in each of our wholesale distribution, direct-to-consumer e-commerce distribution and direct-to-consumer home parties distribution operating segments excluding non-capitalized expenses from our 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 increase in cost of goods sold was primarily due to a \$3.13 million increase in finished jewelry product line cost of goods sold resulting from the 27% increase in finished jewelry sales and the sale of slow moving jewelry at lower product margins to one customer during the year, which included the substitution of higher grade and cost loose jewels in finished jewelry in some cases where there was no available inventory of lower grade loose jewels. Although the cost of goods sold for loose jewels declined by \$80,000, the product gross margin on loose jewel sales to distributors declined compared to the prior year due to higher discounting in an effort to improve retail price points and broaden market adoption. Non-product line cost of goods sold increased by \$364,000. The net increase in non-product line cost of goods sold is comprised of a \$416,000 net increase in non-capitalized manufacturing and production control expenses primarily due to lower overhead capitalization rates to reflect decreased inventory production, and an \$83,000 increase in freight out due to greater volume of package shipments. These increases in non-product line cost of goods sold are offset in part by a \$64,000 decrease in inventory valuation adjustments, including inventory shrinkage, recuts, repairs, and scrap reserves; and a \$71,000 decrease in other inventory adjustments related to costing and quantity corrections.

Sales and Marketing

Sales and marketing expenses for the years ended December 31, 2014 and 2013 are as follows:

	<u>Year Ended December 31,</u>		<u>Change</u>	
	<u>2014</u>	<u>2013</u>	<u>Dollars</u>	<u>Percent</u>
Sales and marketing	\$ 9,853,671	\$ 9,867,425	\$ (13,754)	-0%

Sales and marketing expenses were \$9.85 million for the year ended December 31, 2014 compared to \$9.87 million for the year ended December 31, 2013, a decrease of \$14,000, or 0%.

The decrease in sales and marketing expenses for the year ended December 31, 2014 compared to the same period in 2013 was primarily due to a \$905,000 net decrease in advertising expenses; a \$166,000 net decrease in professional services related to the reduction of temporary personnel, consulting services, and the maintenance of software platforms for our direct-to-consumer e-commerce and home party lines of business; a \$95,000 decrease in recruiting fees; and a \$19,000 decrease in depreciation expense related to the *Moissanite.com* and *Lulu Avenue*[®] e-commerce websites' direct sales platforms. These decreases in sales and marketing expenses were partially offset by increases of \$904,000 in net compensation expenses; a \$169,000 increase in office-related expenses; a \$69,000 increase in meeting expenses, primarily associated with the direct-to-consumer home party business; and a \$29,000 increase in travel-related expenses primarily due to increased costs of airfare.

The decrease in advertising expenses for the year ended December 31, 2014 compared to the same period in 2013 comprises a \$705,000 decrease in cooperative advertising; a decrease in Internet marketing of \$128,000 primarily due to greater efficiencies gained in paid search advertising in support of our *Moissanite.com* e-commerce website; a decrease of \$54,000 in print media expenses to develop and promote brand awareness campaigns; and an \$18,000 decrease in agency and other media spending. The decrease in cooperative advertising expenses resulted primarily from the decrease in sales of loose jewels to our international customers, compared to the same period in the prior year and management's decision to offer sales discounts to select customers in lieu of cooperative advertising assistance.

Compensation expenses for the year ended December 31, 2014 compared to the same period in 2013 increased primarily from an increase in commissions of \$583,000 for sales to specific customers under which commission plans of sales representatives are based and the direct-to-consumer home party business; a \$353,000 increase in salaries and related employee benefits; an \$82,000 increase in stock-based compensation costs; and a \$48,000 increase in severance. These increases in compensation expense were partially offset by a decrease in bonus expense of \$147,000 and a decrease of \$15,000 in employee relocation expenses.

We expect our total sales and marketing expenses will increase as sales increase, primarily in our direct-to consumer

home party business, but the rate of growth should slow and become a lower percentage of sales as expenses more variable in nature, such as advertising and commissions, increase as part of our strategy to build sales; but fixed expenses, such as compensation costs, grow at a slower rate.

General and Administrative

General and administrative expenses for the years ended December 31, 2014 and 2013 are as follows:

	<u>Year Ended December 31,</u>		<u>Change</u>	
	<u>2014</u>	<u>2013</u>	<u>Dollars</u>	<u>Percent</u>
General and administrative	\$ 6,789,274	\$ 5,476,939	\$ 1,312,335	24%

General and administrative expenses were \$6.79 million for the year ended December 31, 2014 compared to \$5.48 million for the year ended December 31, 2013, an increase of \$1.31 million, or 24%.

The increase in general and administrative expenses for the year ended December 31, 2014 compared to the same period in 2013 was primarily due to a \$731,000 increase in bad debt expense associated with our allowance for doubtful accounts reserve policy, and for which we placed a full reserve against one customer account that is in dispute and a 75% reserve against a second customer account that has become past due; a \$405,000 increase in professional services; a \$140,000 increase in depreciation and amortization expense; a \$49,000 increase in board compensation; a \$39,000 increase in business and franchise taxes; an increase of \$35,000 from moving the corporate headquarters to its new leased space; and a \$9,000 increase in office-related expenses. These increases were partially offset by a \$95,000 decrease in compensation expense and a \$1,000 decrease in travel-related expenses associated with investor, customer, and supplier meetings.

Professional services increased for the year ended December 31, 2014 compared to the same period in 2013 primarily due to an increase in legal fees of \$299,000 primarily as a result of negotiating the Credit Facility and the New Supply Agreement; an increase of \$68,000 in consulting and other professional services; and an investor and public relations expenses increase of \$45,000. These increases were offset in part by a \$7,000 decrease in audit and tax services.

Compensation expenses decreased for the year ended December 31, 2014 compared to the same period in 2013 primarily as a result of a decrease in severance expense of \$230,000 associated with the departure of an executive officer in 2013; a decrease in bonus expense of \$64,000; and a decrease in stock-based compensation expense of \$91,000. These decreases in compensation expense were partially offset by an increase in salaries and related employee benefits in the aggregate of \$283,000 and a \$7,000 increase in relocation expense.

Research and Development

Research and development expenses for the years ended December 31, 2014 and 2013 are as follows:

	<u>Year Ended December 31,</u>		<u>Change</u>	
	<u>2014</u>	<u>2013</u>	<u>Dollars</u>	<u>Percent</u>
Research and development	\$ 18,070	\$ 24,903	\$ (6,833)	-27%

Research and development expenses were \$18,000 for the year ended December 31, 2014 compared to \$25,000 for the year ended December 31, 2013, a decrease of \$7,000, or 27%.

The decrease in research and development expenses was primarily due to a \$4,000 decrease in compensation expense allocated to research and development activities and a \$3,000 decrease in professional services.

Loss on Abandonment of Assets

Loss on abandonment of assets for the years ended December 31, 2014 and 2013 is as follows:

	<u>Year Ended December 31,</u>		<u>Change</u>	
	<u>2014</u>	<u>2013</u>	<u>Dollars</u>	<u>Percent</u>
Loss on abandonment of assets	\$ 10,523	\$ 98,027	\$ (87,504)	-89%

Loss on abandonment of assets was \$11,000 for the year ended December 31, 2014 compared to \$98,000 for the year ended December 31, 2013, a decrease of \$87,000, or 89%. During the second quarter of 2013, we transitioned our *Lulu Avenue*[®] direct sales front-end and back-office system to a new platform and abandoned the prior capitalized software modifications with a remaining book value of approximately \$95,000 associated with the previous platform. In addition, during the fourth quarter of 2013, we upgraded our phone systems, resulting in the disposal of our previous phone system and other related assets with a remaining book value of approximately \$3,000. For the year ended December 31, 2014, we abandoned a trademark with remaining carrying costs of \$2,000 after we determined the trademark would no longer be utilized and various manufacturing and computer equipment of \$9,000 once it was determined the assets would no longer be utilized.

Interest Income

Interest income for the years ended December 31, 2014 and 2013 is as follows:

	<u>Year Ended December 31,</u>		<u>Change</u>	
	<u>2014</u>	<u>2013</u>	<u>Dollars</u>	<u>Percent</u>
Interest income	\$ 65	\$ 22,007	\$ (21,942)	-100%

Interest income was \$0 for the year ended December 31, 2014 compared to \$22,000 for the year ended December 31, 2013, a decrease of \$22,000, or 100%.

The decrease in interest income resulted primarily from not investing excess cash in U.S. government agency securities and lower average cash balances in lower yielding money market accounts during the year ended December 31, 2014 as compared to the same periods in 2013.

Provision for Income Taxes

We recognized an income tax net expense of \$4.05 million for the year ended December 31, 2014 compared to an income tax net benefit of \$269,000 for the year ended December 31, 2013.

As of each reporting date, management considers new evidence, both positive and negative, that could impact its view with regard to future realization of deferred tax assets. Management determined that sufficient positive evidence existed as of December 31, 2013 to conclude that it is more likely than not that certain deferred tax assets of \$4.04 million were realizable and recorded approximately \$281,000 of income tax benefit to adjust these deferred tax assets. A valuation allowance remained at December 31, 2013 against certain deferred tax assets relating to state net operating loss carryforwards from our 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 remained at December 31, 2013 against certain deferred tax assets relating to investment loss carryforwards because management did not anticipate we would generate sufficient investment income to utilize the carryforwards. Management also previously considered various strategic alternatives, resulting in management determining that a valuation allowance was not necessary at that time. During the three months ended June 30, 2014, management determined that such strategic alternatives were no longer in our best interest. Accordingly, management concluded that the positive evidence was no longer sufficient to offset available negative evidence, primarily as a result of the pre-tax operating losses incurred during the six months ended June 30, 2014, and forecasted to continue through the remainder of 2014. As a result, management concluded that it was uncertain that we would have sufficient future taxable income to utilize our deferred tax assets, and therefore, we established a valuation allowance against our deferred tax assets, resulting in a tax expense of \$4.05 million for the year ended December 31, 2014. During the year ended December 31, 2014, we also recognized approximately \$12,000 of income tax expense for interest associated with uncertain tax positions.

During the year ended December 31, 2013, we recorded approximately \$12,000 of income tax expense for estimated tax, penalties, and interest for other uncertain tax positions.

Our statutory tax rate is 35% and consists of the federal income tax rate of 34% and a blended state income tax rate of 1%, net of the federal benefit.

Liquidity and Capital Resources

We require cash to fund our operating expenses and working capital requirements, including outlays for capital expenditures. As of December 31, 2014, our principal sources of liquidity were cash and cash equivalents totaling \$4.01 million, trade accounts receivable of \$5.51 million, and short-term inventory of \$13.32 million, as compared to cash and cash equivalents totaling \$2.57 million, trade accounts receivable of \$10.24 million, and short-term inventory of \$13.07 million as of December 31, 2013. As described more fully below, we also have access to the \$10 million Credit Facility.

During the year ended December 31, 2014, our working capital decreased by approximately \$4.29 million to \$19.25 million from \$23.54 million at December 31, 2013. As described more fully below, the decrease in working capital at December 31, 2014 is primarily attributable to a decrease in trade accounts receivable, deferred income taxes, prepaid expenses and other assets, and a net increase in accrued expenses and other liabilities, offset in part by an increase in cash and cash equivalents, a decrease in trade accounts payable, and a greater allocation of inventory to short-term.

During the year ended December 31, 2014, \$2.03 million of cash was provided by operations. The primary drivers of positive cash flow were a decrease in trade accounts receivable of \$4.28 million, a decrease in inventory of \$3.18 million, an increase in accrued liabilities of \$346,000, and a decrease in prepaid expenses of \$116,000. These factors were partially offset by our loss of \$13.10 million that included \$7.60 million of non-cash expenses and a decrease in accounts payable of \$384,000. Accounts receivable decreased primarily as a result of collection efforts during 2014 on higher sales made in the fourth quarter of 2013, offset in part by extended wholesale customer payment terms that we offer from time to time that may not immediately increase liquidity as a result of current-period sales. We believe our competitors and other vendors in the wholesale jewelry industry have also expanded their use of extended payment terms and, in aggregate, we believe that by expanding our use of extended payment terms, we have provided a competitive response in our market and that our net sales have been favorably impacted. We are unable to estimate the impact of this program on our net sales, but if we ceased providing extended payment terms in select instances, we believe we would not be competitive for some wholesale customers in the marketplace and that our net sales and profits would likely decrease. Generally, we have not experienced any significant accounts receivable write-offs related to revenue arrangements with extended payment terms; however, we have increased our reserves for uncollectible accounts primarily due to one customer with extended terms. We do not believe the terms are a factor with this customer's non-payment. Inventories decreased primarily as a result of sales, including the sale of slower moving standard grade loose jewels, offset in part by the purchase of new raw material SiC crystals during the year pursuant to the Cree Exclusive Supply Agreement; purchases of jewelry castings, findings, and other jewelry components; and production of moissanite gemstones. Accrued rent increased primarily as a result of the lease incentives received from our landlord associated with the new corporate headquarters. Prepaid expenses and other assets decreased primarily as a result of fewer payments in advance of goods or services received. Accounts payable decreased primarily as a result of the timing of costs incurred associated with inventory-related purchases.

We manufactured approximately \$8.87 million in loose jewels and \$6.85 million in finished jewelry, which includes the cost of the loose jewels and the purchase of precious metals and labor in connection with jewelry production, during the year ended December 31, 2014. We expect our purchases of precious metals and labor to increase as we increase our finished jewelry business. In addition, from the beginning of 2006 through the end of 2014, the price of gold has increased significantly (approximately 123%), resulting in higher retail price points for gold jewelry. Because the market price of gold and other precious metals is beyond our control, the upward price trends could continue and have a negative impact on our operating cash flow as we manufacture finished jewelry.

Historically, our raw material inventories of SiC crystals had been purchased under exclusive supply agreements with a limited number of suppliers. Because the supply agreements restricted the sale of these crystals exclusively to us, the suppliers negotiated minimum purchase commitments with us that, when combined with our reduced sales during the periods when the purchase commitments were in effect, have resulted in levels of inventories that are higher than we might otherwise maintain. As of December 31, 2014, \$25.62 million of our inventories were classified as long-term assets. Loose jewel sales and finished jewelry that we manufacture will utilize both the finished good loose jewels currently on-hand and, as we deplete certain shapes and sizes, our on-hand raw material SiC crystals of \$4.66 million and new raw material that we are purchasing from Cree.

In connection with the Cree Exclusive Supply Agreement, which was set to expire in July 2015, we had committed to purchase from Cree a minimum of 50%, by dollar volume, of our raw material SiC crystal requirements. In

February 2013, we entered into an amendment to a prior letter agreement with Cree, which provided a framework for our purchases of SiC crystals under the Cree Exclusive Supply Agreement. Pursuant to this amendment, we agreed to purchase at least \$4.00 million of SiC crystals in an initial new order. After the initial new order, we agreed to issue non-cancellable, quarterly orders that must equal or exceed a set minimum order quantity. Our total purchase commitment under the amendment (as subsequently amended) until July 2015, including the initial new order, was dependent upon the grade of the material and ranged between approximately \$7.64 million and approximately \$18.56 million.

On December 12, 2014, we entered into the New Supply Agreement, which superseded and replaced (with respect to materials ordered subsequent to the effective date of the New Supply Agreement) the Cree Exclusive Supply Agreement. Under the New Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the New Supply Agreement will expire on June 24, 2018, unless extended by the parties. We also have one option to unilaterally extend the term of the agreement for an additional two-year period, subject to certain conditions. Our total purchase commitment under the New Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately \$29.6 million and approximately \$31.5 million.

During the year ended December 31, 2014, we purchased approximately \$5.84 million of SiC crystals from Cree. We expect to use existing cash and cash equivalents and other working capital, together with future cash expected to be provided by operating activities and, if necessary, our Credit Facility, to finance our purchase commitment under the New Supply Agreement.

We made no income tax payments during the year ended December 31, 2014. As of December 31, 2014, we had approximately \$882,000 of remaining federal income tax credits, \$533,000 of which expire between 2018 and 2021 and the balance without an expiration, which can be carried forward to offset future income taxes. As of December 31, 2014, we also had a federal tax net operating loss carryforward of approximately \$5.56 million expiring between 2020 and 2033, which can be used to offset against future federal taxable income, a North Carolina tax net operating loss carryforward of approximately \$11.12 million expiring between 2023 and 2028, and various other state tax net operating loss carryforwards expiring between 2016 and 2033, which can be used to offset against future state taxable income.

On August 6, 2013, the Board authorized the extension of our share repurchase program for an additional 12 months. The program, which was originally authorized on November 13, 2009, authorized us to repurchase up to 1,000,000 shares of our common stock until August 12, 2014 in open market or in privately negotiated transactions. We have not repurchased any shares under this program during the year ended December 31, 2014 and we did not extend the plan past its expiration due to covenants within the Credit Facility described below.

On September 20, 2013, we obtained a \$10,000,000 revolving line of credit, or the Line of Credit, from PNC Bank, National Association for general corporate and working capital purposes. The Line of Credit was evidenced by a Committed Line of Credit Note, dated September 20, 2013, or the Note, which was set to mature on June 15, 2015. The interest rate under the Note was the one-month LIBOR rate (adjusted daily) plus 1.50%, calculated on an actual/360 basis. The Line of Credit was also governed by a loan agreement, dated September 20, 2013 and was guaranteed by Charles & Colvard Direct and Moissanite.com, as our wholly owned subsidiaries. The Line of Credit was secured by a lien on substantially all of our assets, including those of our subsidiaries. Effective June 25, 2014, the Line of Credit was terminated concurrent with our entering into a new banking relationship with Wells Fargo Bank, National Association, or Wells Fargo. We had not utilized the Line of Credit.

On June 25, 2014, we and our wholly owned subsidiaries, Charles & Colvard Direct and Moissanite.com, collectively referred to as the Borrowers, obtained the Credit Facility from Wells Fargo, which is a \$10,000,000 asset-backed revolving credit facility. The Credit Facility will be used for general corporate and working capital purposes, including transaction fees and expenses incurred in connection therewith and the issuance of letters of credit up to a \$1,000,000 sublimit. The Credit Facility will mature on June 25, 2017.

The Credit Facility includes a \$5,000,000 sublimit for advances that are supported by a 90% guaranty provided by the U.S. Export-Import Bank. Advances under the Credit Facility are limited to a borrowing base, which is computed by applying specified advance rates to the value of the Borrowers' eligible accounts and inventory, less

reserves. Advances against inventory are further subject to an initial \$3,000,000 maximum. We must maintain a minimum of \$1,000,000 in excess availability at all times. There are no other financial covenants.

Each advance accrues interest at a rate equal to Wells Fargo's 3-month LIBOR rate plus 2.50%, calculated on an actual/360 basis and payable monthly in arrears. Principal outstanding during an event of default accrues interest at a rate of 3% in excess of the above rate. Any advance may be prepaid in whole or in part at any time. In addition, the maximum line amount may be reduced by us in whole or part at any time, subject to a fee equal to 2% of any reduction in the first year after closing, 1% of any reduction in the second year after closing, and 0% thereafter. There are no mandatory prepayments or line reductions.

The Credit Facility is secured by a lien on substantially all assets of the Borrowers, each of which is jointly and severally liable for all obligations thereunder. Wells Fargo's security interest in certain SiC materials is subordinate to Cree's security interest in such materials pursuant to the New Supply Agreement and an Intercreditor Agreement with Wells Fargo.

The Credit Facility is evidenced by a credit and security agreement, dated as of June 25, 2014 and amended as of September 16, 2014 and December 12, 2014, or the Credit Agreement, and customary ancillary documents. The Credit Agreement contains customary covenants, representations and cash dominion provisions, including a financial reporting covenant and limitations on dividends, distributions, debt, contingent obligations, liens, loans, investments, mergers, acquisitions, divestitures, subsidiaries, affiliate transactions, and changes in control.

Events of default under the Credit Facility include, without limitation, (1) any impairment of the Export-Import Bank guaranty, unless the guaranteed advances are repaid within two business days, (2) an event of default under any other indebtedness of the Borrowers in excess of \$200,000, and (3) a material adverse change in the ability of the Borrowers to perform their obligations under the Credit Agreement or in the Borrowers' assets, liabilities, businesses or prospects, or other circumstances that Wells Fargo believes may impair the prospect of repayment. If an event of default occurs, Wells Fargo is entitled to take enforcement action, including acceleration of amounts due under the Credit Agreement and foreclosure upon collateral.

The Credit Agreement contains other customary terms, including indemnity, expense reimbursement, yield protection, and confidentiality provisions. Wells Fargo is permitted to assign the Credit Facility.

As of December 31, 2014, we had not borrowed against the Credit Facility.

We believe that our existing cash and cash equivalents and other working capital, together with future cash expected to be provided by operating activities, will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Our future capital requirements and the adequacy of available funds will depend on many factors, including our rate of sales growth; the expansion of our sales and marketing activities, including the operating capital needs of our wholly owned subsidiaries; the timing and extent of raw materials and labor purchases in connection with loose jewel production to support our moissanite jewel business and precious metals and labor purchases in connection with jewelry production to support our finished jewelry business; the timing of capital expenditures; and risk factors described in more detail in "Risk Factors" in Part I, Item 1A of this Annual Report on Form 10-K. We obtained the Credit Facility to mitigate these risks to our cash and liquidity position. Also, we may make investments in, or acquisitions of, complementary businesses, which could also require us to seek additional equity or debt financing.

Off-Balance Sheet Arrangements

We do not use off-balance sheet arrangements with unconsolidated entities or related parties, nor do we use other forms of off-balance sheet arrangements. Accordingly, our liquidity and capital resources are not subject to off-balance sheet risks from unconsolidated entities. As of December 31, 2014, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K.

We have entered into an operating lease for approximately 36,350 square feet of mixed-use space, which we currently occupy, from an unaffiliated third party for our offices and manufacturing facility in the normal course of business. This type of arrangement is often referred to as a form of off-balance sheet financing.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Charles & Colvard, Ltd.
Morrisville, North Carolina

We have audited the accompanying consolidated balance sheets of Charles & Colvard, Ltd. as of December 31, 2014 and 2013 and the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Charles & Colvard, Ltd. at December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP
Raleigh, North Carolina

March 13, 2015

CHARLES & COLVARD, LTD.
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2014	2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 4,007,341	\$ 2,573,405
Accounts receivable, net	5,510,253	10,244,732
Inventory, net	13,320,639	13,074,428
Prepaid expenses and other assets	602,850	951,635
Deferred income taxes	-	1,197,832
Total current assets	23,441,083	28,042,032
Long-term assets:		
Inventory, net	25,617,990	29,337,674
Property and equipment, net	1,859,355	1,717,692
Intangible assets, net	216,947	325,867
Deferred income taxes	-	2,841,891
Other assets	291,022	58,696
Total long-term assets	27,985,314	34,281,820
TOTAL ASSETS	\$ 51,426,397	\$ 62,323,852
 LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 3,286,086	\$ 3,670,551
Accrued cooperative advertising	220,000	188,000
Accrued expenses and other liabilities	684,577	642,186
Total current liabilities	4,190,663	4,500,737
Long-term liabilities:		
Accrued expenses and other liabilities	809,879	-
Accrued income taxes	407,682	395,442
Total liabilities	5,408,224	4,896,179
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 50,000,000 shares authorized; 20,382,333 and 20,197,301 shares issued and outstanding at December 31, 2014 and 2013, respectively	53,949,001	53,949,001
Additional paid-in capital – stock-based compensation	11,628,503	9,940,980
Accumulated deficit	(19,559,331)	(6,462,308)
Total shareholders' equity	46,018,173	57,427,673
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 51,426,397	\$ 62,323,852

See Notes to Consolidated Financial Statements.

CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,	
	2014	2013
Net sales	\$ 25,640,649	\$ 28,487,187
Costs and expenses:		
Cost of goods sold	18,013,335	14,600,177
Sales and marketing	9,853,671	9,867,425
General and administrative	6,789,274	5,476,939
Research and development	18,070	24,903
Loss on abandonment of assets	10,523	98,027
Total costs and expenses	34,684,873	30,067,471
Loss from operations	(9,044,224)	(1,580,284)
Other income (expense):		
Interest income	65	22,007
Interest expense	(901)	(2,106)
Total other (expense) income	(836)	19,901
Loss before income taxes	(9,045,060)	(1,560,383)
Income tax net (expense) benefit	(4,051,963)	269,285
Net loss	\$ (13,097,023)	\$ (1,291,098)
Net loss per common share:		
Basic	\$ (0.65)	\$ (0.06)
Diluted	\$ (0.65)	\$ (0.06)
Weighted average number of shares used in computing net loss income per common share:		
Basic	20,295,618	19,904,170
Diluted	20,295,618	19,904,170

See Notes to Consolidated Financial Statements.

CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock		Additional Paid-in Capital –	Accumulated Deficit	Total Shareholders' Equity
	Number of Shares	Amount	Stock-Based Compensation		
Balance at December 31, 2012	19,654,050	\$ 53,318,044	\$ 8,459,020	\$ (5,171,210)	\$ 56,605,854
Stock-based compensation	-	-	1,678,107	-	1,678,107
Issuance of restricted stock	345,403	-	-	-	-
Stock option exercises	197,848	630,957	(210,015)	-	420,942
Tax effect of stock based compensation	-	-	13,868	-	13,868
Net loss	-	-	-	(1,291,098)	(1,291,098)
Balance at December 31, 2013	20,197,301	\$ 53,949,001	\$ 9,940,980	\$ (6,462,308)	\$ 57,427,673
Stock-based compensation	-	-	1,687,523	-	1,687,523
Issuance of restricted stock	185,032	-	-	-	-
Net loss	-	-	-	(13,097,023)	(13,097,023)
Balance at December 31, 2014	<u>20,382,333</u>	<u>\$ 53,949,001</u>	<u>\$ 11,628,503</u>	<u>\$ (19,559,331)</u>	<u>\$ 46,018,173</u>

See Notes to Consolidated Financial Statements.

CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (13,097,023)	\$ (1,291,098)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,107,955	862,683
Amortization of bond premium	-	5,068
Stock-based compensation	1,687,523	1,678,107
Provision for uncollectible accounts	734,243	3,690
Provision for sales returns	(276,000)	723,000
Provision for inventory reserves	295,000	264,000
Provision (benefit) for deferred income taxes	4,039,723	(307,133)
Loss on abandonment of assets	10,523	98,027
Changes in assets and liabilities:		
Accounts receivable	4,276,236	(2,833,064)
Interest receivable	-	694
Inventory	3,178,473	(9,880,092)
Prepaid expenses and other assets, net	116,459	(260,726)
Accounts payable	(384,465)	1,557,966
Accrued cooperative advertising	32,000	(12,000)
Accrued income taxes	12,240	11,712
Accrued expenses and other liabilities	302,110	67,664
Net cash provided by (used in) operating activities	2,034,997	(9,311,502)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(545,543)	(800,367)
Proceeds from call of long-term investments	-	500,000
Patent, license rights, and trademark costs	(55,518)	(110,378)
Net cash used in investing activities	(601,061)	(410,745)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	-	420,942
Tax effect of stock based compensation	-	13,868
Net cash provided by financing activities	-	434,810
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS		
	1,433,936	(9,287,437)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	2,573,405	11,860,842
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 4,007,341	\$ 2,573,405
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 901	\$ 2,106
Cash paid during the year for income taxes	\$ -	\$ 5,570
Non-cash investing activities:		
Tenant improvement allowance received under operating lease	\$ 550,160	\$ -

See Notes to Consolidated Financial Statements.

CHARLES & COLVARD, LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 finished 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 original and leading worldwide source 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, 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 consolidated financial statements as of and for the years ended December 31, 2014 and 2013 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.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (“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 consolidated financial statements have been reclassified to conform to the current year presentation. These reclassifications primarily relate to segment reporting of revenues and costs of goods sold, with other product line revenues and costs allocated across both loose jewel and finished jewelry product lines. Previously, all amounts for other product lines were included in the loose jewel revenues and product cost of goods sold.

Cash and Cash Equivalents - All highly liquid investments with an original maturity of three months or less from the date of purchase are considered to be cash equivalents.

Concentration of Credit Risk - Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, and trade accounts receivable. The Company maintains cash and cash equivalents.. At times, cash balances may exceed the Federal Deposit Insurance Corporation (“FDIC”) insurable limits. The Company has never experienced any losses related to these balances. Non-interest-bearing amounts on deposit in excess of FDIC insurable limits at December 31, 2014 approximated \$3.70 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 with specific customers 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. However, we have increased our reserves for uncollectible accounts primarily due to one customer with extended terms.

See Note 12, “Major Customers and Concentration of Credit Risk,” for further discussion of credit risk within trade accounts receivable.

Accounts Receivable Reserves - Estimates are used to determine the amount of two reserves against trade accounts receivable. The first reserve is an allowance for sales returns. At the time revenue is recognized, the Company estimates future returns using a historical return rate that is reviewed quarterly with consideration of any contractual return privileges granted to customers, and it reduces sales and trade accounts receivable by this estimated amount. The allowance for sales returns was \$910,000 and \$1.19 million at December 31, 2014 and 2013, respectively.

The second reserve is an allowance for doubtful accounts for estimated losses resulting from the failure of the Company’s customers to make required payments. This allowance reduces trade accounts receivable to an amount expected to be collected. Based on historical percentages of uncollectible accounts by aging category, changes in payment history, and facts and circumstances regarding specific accounts that become known to management when evaluating the adequacy of the allowance for doubtful accounts, the Company determines a percentage based on the age of the receivable that it deems uncollectible. The allowance is then calculated by applying the appropriate percentage to each of the Company’s accounts receivable aging categories, with consideration given to individual customer account activity subsequent to the current period, including cash receipts, in determining the appropriate allowance for doubtful accounts in the current period. Any increases or decreases to this allowance are charged or credited, respectively, as a bad debt expense to general and administrative expenses. The Company generally uses an internal collection effort, which may include its sales personnel as it deems appropriate. After all internal collection efforts have been exhausted, the Company generally writes off the account receivable.

Any accounts with significant balances are reviewed separately to determine an appropriate allowance based on the facts and circumstances of the specific account. During its review for 2014, the Company analyzed several of its slower-paying customers and determined that one customer required an additional reserve, which constitutes the majority of the reserve as of December 31, 2014. During its review for 2013, the Company determined no additional reserves were necessary. Based on these criteria, management determined that allowances for doubtful accounts receivable of \$1.07 million and \$522,000 at December 31, 2014 and 2013, respectively, were required.

The following is a reconciliation of the allowance for doubtful accounts:

	Year Ended December 31,	
	2014	2013
Balance, beginning of period	\$ 522,000	\$ 549,000
Additions charged to operations	734,243	3,690
Write-offs, net of recoveries	(182,243)	(30,690)
Balance, end of period	<u>\$ 1,074,000</u>	<u>\$ 522,000</u>

Although the Company believes that its reserves are adequate, if the financial condition of its customers deteriorates, resulting in an impairment of their ability to make payments, or if it underestimates the allowances required, additional allowances may be necessary, which would result in increased expense in the period in which such determination is made.

Inventories - 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 December 31, 2014 and 2013, work-in-process inventories issued to active production jobs approximated \$2.05 million and \$4.09 million, respectively.

The Company has historically sold one grade of jewel that is classified as very good ("VG") and consists of near-colorless jewels that meet certain standards. Previously, only VG jewels were valued in inventory. During the first quarter of 2010, the Company began a project of sorting its jewels into multiple grades and identified several customers for the sale of lower grades of loose jewels and finished jewelry containing these jewels. As a result, various costs associated with this loose jewel inventory incurred subsequent to the identification of this market have been capitalized. The Company currently sorts its loose jewels based on grade and costs are capitalized accordingly.

All inventories are carefully reviewed for quality standards before they are entered into finished goods. As conditions warrant, the Company's grading standards change. The Company reviews the inventory on an ongoing basis to ensure its inventory meets current quality standards.

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 December 31, 2014.

The Company manufactures 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. As of December 31, 2014 and 2013, the Company identified certain fashion finished jewelry inventory that could not be sold due to damage or branding issues, and established an obsolescence reserve of \$250,000 and \$128,000, respectively, for the carrying costs in excess of any estimated scrap values. No reserve requirement relating to the Company's finished jewelry featuring moissanite existed as of December 31, 2013. The Company identified \$31,000 of finished jewelry featuring moissanite that required an obsolescence reserve as of December 31, 2014.

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. 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.

The Company also maintains inventory reserves for shrinkage, recuts, and repairs. Shrinkage refers to loose jewels and finished jewelry on review with customers and vendors that may not be returned to the Company. The recuts reserve is for the projected material loss resulting from the re-cutting of damaged jewels into smaller loose jewels to remove the damage. The repairs reserve is for finished jewelry in need of repair before it can be returned to finished goods inventory and be available for sale.

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

Property and Equipment - Property and equipment are stated at cost and are depreciated over their estimated useful lives using the straight-line method as follows:

Machinery and equipment	5 to 12 years
Computer hardware	3 to 5 years
Computer software	3 years
Furniture and fixtures	5 to 10 years
Leasehold improvements	Shorter of the estimated useful life or the lease term

Intangible Assets - The Company capitalizes costs associated with obtaining or defending patents issued or pending for inventions and license rights related to the manufacture of moissanite jewels. Such costs are amortized over the life of the patent, generally 17 years. The Company also capitalizes licenses it obtains for the use of certain advertising images and external costs incurred for trademarks. Such costs are amortized over the period of the license or estimated useful life of the trademark, respectively.

Impairment of Long-Lived Assets - The Company evaluates the recoverability of its long-lived assets by reviewing them for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of the asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment is measured as the amount by which the carrying amount exceeds the fair value and is recognized as an operating expense in the period in which the determination is made. Assets to be disposed are reported at the lower of the carrying amount or fair value less costs to sell. As of December 31, 2014, the Company did not identify any indicators of long-lived asset impairment.

In addition to the recoverability assessment, the Company routinely reviews the remaining estimated useful lives of its long-lived assets. Any reduction in the useful-life assumption will result in increased depreciation and amortization expense in the period when such determination is made, as well as in subsequent periods. During the year ended December 31, 2013, the useful lives of leasehold improvements associated with the Company's then-current lease were adjusted to the length of the lease term through July 2014. The additional depreciation recognized for the years ended December 31, 2014 and 2013 as a result of the shortened lives was approximately \$74,000 and \$58,000, respectively.

Revenue Recognition - Revenue is recognized when title transfers at the time of shipment from the Company's or a third-party fulfillment company's facility, excluding consignment shipments as discussed below; evidence of an arrangement exists; pricing is fixed or determinable; and collectability is reasonably assured. At the time revenue is recognized, an allowance for estimated returns is established. Any change in the allowance for returns is charged against net sales. The Company's return policy allows for the return of loose jewels and finished jewelry for credit generally within 30 days of shipment and must be returned for a valid reason, such as quality problems or an error in shipment. From time to time, some wholesale customers may have a contractual right to return a certain percentage of goods for any reason for specified periods of time. In these instances, the Company only recognizes revenue when the contractual right of return is exhausted. 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 that typically ranges from six months to one year. The Company's wholesale customers are generally required to make payments on consignment shipments within 60 days upon the customer informing the Company that it will keep the inventory. Accordingly, the Company does not recognize revenue on these consignment transactions until the earlier of (1) the customer informing the Company that it will keep the inventory or (2) the expiration of the right of return period.

Cost of Goods Sold - Cost of goods sold is primarily composed of inventory sold during the period; inventory written off during the period due to ongoing quality reviews or through customer returns; salaries and payroll-related

expenses for personnel involved in preparing and shipping product to customers; an allocation of shared expenses such as rent, utilities, communication expenses, and depreciation related to preparing and shipping product to customers; and outbound freight charges.

Advertising Costs - Advertising production costs are expensed as incurred. Media placement costs are expensed the first time the advertising appears.

The Company also offers a cooperative advertising program to certain of its wholesale customers that reimburses, via a credit towards future purchases, a portion of their marketing costs based on the customers' net purchases from the Company and is subject to the customer providing documentation of all advertising performed that includes the Company's products. For the years ended December 31, 2014 and 2013, these amounts were approximately \$321,000 and \$1.03 million, respectively, and are included as a component of sales and marketing expenses.

Advertising expenses, inclusive of the cooperative advertising program, for the years ended December 31, 2014 and 2013 were approximately \$1.84 million and \$2.74 million, respectively.

Sales and Marketing - Sales and marketing costs are expensed as incurred. These costs include all expenses of promoting and selling the Company's products and include such items as the salaries, payroll-related expenses, and travel of sales and marketing personnel; advertising; trade shows; market research; sales commissions; and an allocation of overhead expenses attributable to these activities. Except for an allocation to general and administrative expenses, these costs also include the operating expenses of the Company's two wholly owned operating subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC.

General and Administrative - General and administrative costs are expensed as incurred. These costs include the salaries and payroll-related expenses of executive, finance, information technology, and administrative personnel; legal, investor relations, and professional fees; general office and administrative expenses; Board of Directors fees; rent; bad debts; and insurance.

Research and Development - Research and development costs are expensed as incurred. These costs primarily comprise salary allocations and consultant fees associated with the study of product enhancement and manufacturing process efficiencies.

Stock-Based Compensation - The Company recognizes compensation expense for stock-based awards based on estimated fair values on the date of grant. The Company uses the Black-Scholes-Merton option pricing model to determine the fair value of stock options. The fair value of other stock-based compensation awards is determined by the market price of the Company's common stock on the date of grant. The expense associated with stock-based compensation is recognized on a straight-line basis over the requisite service period of each award.

Fair value of stock options using the Black-Scholes-Merton option pricing model is estimated on the date of grant utilizing certain assumptions for dividend yield, expected volatility, risk-free interest rate, and expected lives of the awards, as follows:

- *Dividend yield* - Although the Company issued dividends in prior years, a dividend yield of zero is used due to the uncertainty of future dividend payments.
- *Expected volatility* - 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.
- *Risk-free interest rate* - 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.
- *Expected lives* - The expected lives of the stock options issued in 2014 represent the estimated period of time until exercise or forfeiture and are based on the simplified method of using the mid-point between the vesting term and the original contractual term. Stock options issued prior to 2014 were expensed using expected lives that represented the time until exercise or forfeiture using historical information.

The assumptions used in calculating the fair value of share-based payment awards represent management’s best estimates, but these estimates involve inherent uncertainties and the application of management’s judgment. As a result, if factors change and the Company uses different assumptions, the Company’s stock-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rates of stock-based awards and only recognize expense for those shares expected to vest. In estimating the Company’s forfeiture rates, the Company analyzed its historical forfeiture rates, the remaining lives of unvested stock-based awards, and the amount of vested awards as a percentage of total awards outstanding. If the Company’s actual forfeiture rates are materially different from its estimates, or if the Company re-evaluates the forfeiture rates in the future, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

Income Taxes - Deferred income taxes are recognized for the income tax consequences of “temporary” differences by applying enacted statutory income tax rates applicable to future years to differences between the financial statement carrying amounts and the income tax bases of existing assets and liabilities. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount that is more likely than not to be realized.

Other Comprehensive Income - For the years ended December 31, 2014 and 2013, the Company did not have any other comprehensive income.

Net Loss per Common Share - Basic net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss 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.

The following table reconciles the differences between the basic and diluted net loss per share presentations:

	Year Ended December 31,	
	2014	2013
Numerator:		
Net loss	<u>\$ (13,097,023)</u>	<u>\$ (1,291,098)</u>
Denominator:		
Weighted average common shares outstanding:		
Basic	20,295,618	19,904,170
Stock options	-	-
Diluted	<u>20,295,618</u>	<u>19,904,170</u>
Net loss per common share:		
Basic	<u>\$ (0.65)</u>	<u>\$ (0.06)</u>
Diluted	<u>\$ (0.65)</u>	<u>\$ (0.06)</u>

For the years ended December 31, 2014 and 2013 stock options to purchase approximately 1.67 million and 1.20 million shares, respectively, were excluded from the computation of diluted net loss 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 per common share.

Recently Adopted/Issued Accounting Pronouncements - In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09

defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is currently evaluating the impact of the pending adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which the Company will adopt the standard in 2017.

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern* (ASU 2014-15). The amendments in ASU 2014-15 are intended to define management’s responsibility to evaluate whether there is substantial doubt about an organization’s ability to continue as a going concern and to provide related footnote disclosures. Under U.S. GAAP, financial statements are prepared under the presumption that the reporting organization will continue to operate as a going concern, except in limited circumstances. The going concern basis of accounting is critical to financial reporting because it establishes the fundamental basis for measuring and classifying assets and liabilities. Currently, U.S. GAAP lacks guidance about management’s responsibility to evaluate whether there is substantial doubt about the organization’s ability to continue as a going concern or to provide related footnote disclosures. This ASU provides guidance to an organization’s management, with principles and definitions that are intended to reduce diversity in the timing and content of disclosures that are commonly provided by organizations today in the financial statement footnotes. This standard is effective for annual periods ending after December 15, 2016, and interim periods within annual periods beginning after December 15, 2016. Early application is permitted for annual or interim reporting periods for which the financial statements have not previously been issued. The Company does not expect this ASU will have a material impact on its consolidated financial statements.

All other 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.

During 2014, the Company began managing its business primarily through the three distribution channels that it uses to sell its product lines, loose jewels and finished jewelry. Accordingly, the Company determined its three operating and reportable segments to be wholesale distribution transacted through the parent entity, and the two direct-to-consumer distribution channels transacted through the Company’s wholly owned operating subsidiaries, Moissanite.com, LLC and Charles & Colvard Direct, LLC. The accounting policies of these three segments are the same as those described in Note 2, “Basis of Presentation and Significant Accounting Policies.”

Previously, the Company determined it managed its business through two distribution channels, wholesale distribution and direct-to-consumer. While the Company has always managed its businesses as three separate operating segments, it previously aggregated the Moissanite.com, LLC and Charles & Colvard Direct, LLC operating segments into a single operating segment for reporting purposes. The two wholly owned operating subsidiaries that previously were aggregated under the direct-to-consumer segment are now each being presented as a separate reportable segment. The Company believes aggregation of the two subsidiaries into one reportable segment for reporting purposes is no longer warranted due to changes in how it sources product and sells directly to consumers, including changes in the management structure, strategic initiatives and changes in sales models, made during the year ended December 31, 2014 for each of the two wholly owned subsidiaries. Certain amounts from 2013 have been reclassified to conform to the current year presentation as a result of this change in reportable segments.

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). Product line cost of goods sold is defined as product cost of goods sold in each of the Company’s wholesale distribution and two

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 expenses from its parent entity to its two direct-to-consumer distribution segments primarily based on net sales and number of employees. Unallocated expenses, which also include interest and taxes, remain in the parent entity's wholesale distribution segment.

Summary financial information by reportable segment is as follows:

	Year Ended December 31, 2014			
	Wholesale	Moissanite.com	Charles & Colvard Direct	Total
Net sales				
Loose jewels	\$ 12,324,045	600,505	1,820	12,926,370
Finished jewelry	8,452,800	2,812,158	1,449,321	12,714,279
Total	<u>\$ 20,776,845</u>	<u>3,412,663</u>	<u>1,451,141</u>	<u>25,640,649</u>
Product line cost of goods sold				
Loose jewels	\$ 7,458,355	100,851	7,623	7,566,829
Finished jewelry	6,584,937	1,371,056	472,189	8,428,182
Total	<u>\$ 14,043,292</u>	<u>1,471,907</u>	<u>479,812</u>	<u>15,995,011</u>
Product line gross profit				
Loose jewels	\$ 4,865,690	499,654	(5,803)	5,359,541
Finished jewelry	1,867,863	1,441,102	977,132	4,286,097
Total	<u>\$ 6,733,553</u>	<u>1,940,756</u>	<u>971,329</u>	<u>9,645,638</u>
Operating loss	\$ (4,802,435)	(1,265,035)	(2,976,754)	(9,044,224)
Depreciation and amortization	\$ 887,287	174,562	46,106	1,107,955
Total assets	\$ 51,183,888	128,049	114,460	51,426,397
Capital expenditures	\$ 1,093,055	1,386	1,262	1,095,703

	Year Ended December 31, 2013			
	Wholesale	Moissanite.com	Charles & Colvard Direct	Total
Net sales				
Loose jewels	\$ 18,136,062	347,933	-	18,483,995
Finished jewelry	7,438,340	2,152,018	412,834	10,003,192
Total	<u>\$ 25,574,402</u>	<u>2,499,951</u>	<u>412,834</u>	<u>28,487,187</u>
Product line cost of goods sold				
Loose jewels	\$ 7,588,838	53,941	3,596	7,646,375
Finished jewelry	4,094,157	1,095,489	109,926	5,299,572
Total	<u>\$ 11,682,995</u>	<u>1,149,430</u>	<u>113,522</u>	<u>12,945,947</u>
Product line gross profit				
Loose jewels	\$ 10,547,224	293,992	(3,596)	10,837,620
Finished jewelry	3,344,183	1,056,529	302,908	4,703,620
Total	<u>\$ 13,891,407</u>	<u>1,350,521</u>	<u>299,312</u>	<u>15,541,240</u>
Operating income (loss)	\$ 3,652,153	(1,951,526)	(3,280,911)	(1,580,284)
Depreciation and amortization	\$ 481,993	263,372	117,318	862,683
Total assets	\$ 61,702,449	469,217	152,186	62,323,852
Capital expenditures	\$ 744,679	47,801	7,887	800,367

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:

	Year Ended December 31,	
	2014	2013
Product line cost of goods sold	\$ 15,995,011	\$ 12,945,947
Non-capitalized manufacturing and production control expenses	949,385	532,928
Freight out	284,944	201,911
Inventory valuation allowances	295,000	264,000
Other inventory adjustments	488,995	655,391
Cost of goods sold	<u>\$ 18,013,335</u>	<u>\$ 14,600,177</u>

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

	December 31,	
	2014	2013
Loose jewels		
Raw materials	\$ 4,658,692	\$ 3,311,375
Work-in-process	5,752,103	9,526,769
Finished goods	21,495,873	20,002,881
Finished goods on consignment	46,284	32,948
Total	<u>\$ 31,952,952</u>	<u>\$ 32,873,973</u>
Finished jewelry		
Raw materials	\$ 258,707	\$ 270,043
Work-in-process	540,576	764,355
Finished goods	5,557,417	8,117,035
Finished goods on consignment	578,200	299,514
Total	<u>\$ 6,934,900</u>	<u>\$ 9,450,947</u>

Supplies inventories of approximately \$51,000 and \$87,000 at December 31, 2014 and 2013, 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's two operating subsidiaries comprising the two direct-to-consumer distribution segments carry no net inventories, and inventory is transferred without intercompany markup from the parent entity's wholesale distribution segment as product line cost of goods sold when sold to the end consumer.

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 U.S. retailers. Sales to international end consumers made by the Company's two direct-to-consumer distribution segments 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:

	Year Ended December 31,	
	2014	2013
Net sales		
United States	\$ 22,101,974	\$ 20,684,397
International	3,538,675	7,802,790
Total	<u>\$ 25,640,649</u>	<u>\$ 28,487,187</u>
Property and equipment, net		
United States	\$ 1,859,355	\$ 1,717,692
International	-	-
Total	<u>\$ 1,859,355</u>	<u>\$ 1,717,692</u>
Intangible assets, net		
United States	\$ 39,050	\$ 70,830
International	177,897	255,037
Total	<u>\$ 216,947</u>	<u>\$ 325,867</u>

4. 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, trade accounts payable, and accrued expenses. All instruments are reflected in the consolidated balance sheets at carrying value, which approximates fair value due to the short-term nature of these instruments.

Assets that are measured at fair value on a non-recurring basis include property and equipment, leasehold improvements, and intangible assets, comprising patents, license rights, and trademarks. These items are recognized at fair value when they are considered to be impaired. As of December 31, 2014, no assets were identified for impairment. 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.

5. INVENTORIES

The Company's total inventories, net of reserves, consisted of the following as of December 31, 2014 and 2013:

	December 31,	
	2014	2013
Raw materials	\$ 4,917,399	\$ 3,581,418
Work-in-process	6,292,679	10,291,124
Finished goods	27,985,067	28,771,098
Finished goods on consignment	677,484	407,462
Less inventory reserves	(934,000)	(639,000)
Total	<u>\$ 38,938,629</u>	<u>\$ 42,412,102</u>
Short-term portion	\$ 13,320,639	\$ 13,074,428
Long-term portion	25,617,990	29,337,674
Total	<u>\$ 38,938,629</u>	<u>\$ 42,412,102</u>

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 December 31, 2014 and 2013 are net of shrinkage reserves of \$53,000 and \$75,000, 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 December 31, 2014 and 2013, including inventory on consignment net of reserves, were \$31.95 million and \$32.87 million, respectively. The loose jewel inventories at December 31, 2014 and 2013 include shrinkage reserves of \$17,000 and \$2,000, respectively, which includes \$17,000 and \$0 of shrinkage reserves on inventory on consignment at December 31, 2014 and 2013, respectively. Loose jewel inventories at December 31, 2014 and 2013 also include recuts reserves of \$216,000 and \$172,000, respectively.

Total net jewelry inventories at December 31, 2014 and December 31, 2013, 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 \$6.93 million and \$9.45 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 December 31, 2014, the balance decreased to \$101,000 from \$106,000 at December 31, 2013 as a result of sell down of the inventory during the year and scraping the finished jewelry. 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. The finished jewelry inventories at December 31, 2014 and December 31, 2013 also include shrinkage reserves of \$192,000 and \$180,000, respectively, which includes shrinkage reserves of \$36,000 and \$75,000 on inventory on consignment, respectively; and a repairs reserve of \$127,000 and \$51,000, respectively. During the years ended December 31, 2014 and 2013, the Company identified certain fashion finished jewelry inventory that could not be sold due to damage or branding issues, and established an obsolescence reserve of \$250,000 and \$128,000, respectively, for the carrying costs in excess of any estimated scrap values. As of December 31, 2014, we identified certain finished jewelry featuring moissanite that was obsolete and established an obsolescence reserve of \$31,000 for the carrying costs in excess of any estimated scrap values. No obsolescence reserve requirement relating to our finished jewelry featuring moissanite existed as of December 31, 2013.

6. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31,	
	2014	2013
Computer software	\$ 1,622,806	\$ 1,739,734
Machinery and equipment	818,362	850,039
Computer hardware	750,776	820,535
Leasehold improvements	1,002,357	457,856
Furniture and fixtures	259,944	319,100
Total	4,454,245	4,187,264
Less accumulated depreciation	(2,594,890)	(2,469,572)
Property and equipment, net	\$ 1,859,355	\$ 1,717,692

Depreciation expense for the years ended December 31, 2014 and 2013 was approximately \$946,000 and \$731,000, respectively.

7. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31,		Weighted Average Amortization Period (in Years)
	2014	2013	
Patents	\$ 912,862	\$ 858,397	1.4
Trademarks	50,208	51,356	3.0
License rights	6,718	6,718	0.0
Total	969,788	916,471	
Less accumulated amortization	(752,841)	(590,604)	
Intangible assets, net	\$ 216,947	\$ 325,867	

Amortization expense for the years ended December 31, 2014 and 2013 was approximately \$162,000 and \$131,000, respectively. Amortization expense on existing intangible assets is estimated to be \$146,000 per year for 2015, \$61,000 for 2016, and \$8,000 for 2017.

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 included 3% annual rent escalations and a one-time option to terminate the lease effective as of July 31, 2014. The Company exercised this right to terminate the lease by giving notice to the lessor prior to October 31, 2013. The cost to terminate the lease effective July 31, 2014 was approximately \$112,000, which the Company paid at the time notice was given to terminate the lease. This amount reflects all unamortized lease transaction costs, including, without limitation, all rent abated since January 1, 2011, plus two months' rent at the then-current rental rate. On December 9, 2013, the Company entered into a Lease Agreement, as amended on December 23, 2013 and April 15, 2014 (the "Lease Agreement"), for a new corporate headquarters, which occupies approximately 36,350 square feet of office, storage, and light manufacturing space. The Company took possession of the leased property on May 23, 2014 once certain improvements to the leased space were completed, and did not have access to the property before this date. These improvements and other lease signing and moving incentives offered by the

landlord totaled approximately \$550,000 and \$73,000, respectively, which will be amortized over the life of the lease until October 31, 2021. Included in the Lease Agreement is a seven-month rent abatement period effective June 2014 through December 2014.

The Company recognizes rent expense on a straight-line basis, giving consideration to the rent holidays and escalations, the lease signing and moving allowance to be paid to the Company, and the rent abatement.

As of December 31, 2014, the Company's future minimum payments under the operating leases were as follows:

2015	\$	553,905
2016		569,138
2017		584,789
2018		600,871
2019		617,395
Thereafter		1,176,330
Total	\$	<u>4,102,428</u>

Rent expense for the years ended December 31, 2014 and 2013 was approximately \$373,000 and \$336,000, respectively.

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 committed to purchase from Cree a minimum of 50%, by dollar volume, of its raw material SiC crystal requirements. If the Company's orders required Cree to expand beyond specified production levels, the Company committed to purchase certain minimum quantities. Effective February 8, 2013, the Company entered into an amendment to a prior letter agreement with Cree, which provided 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 agreed to issue non-cancellable, quarterly orders that must equal or exceed a set minimum order quantity. The total purchase commitment under the amendment (as subsequently amended) until July 2015, including the initial new order, was dependent upon the grade of the material and ranged between approximately \$7.64 million and approximately \$18.56 million.

On December 12, 2014, the Company entered into a new exclusive supply agreement with Cree (the "New Supply Agreement"), which superseded and replaced (with respect to materials ordered subsequent to the effective date of the New Supply Agreement) the exclusive supply agreement that was set to expire in 2015. Under the New Supply Agreement, subject to certain terms and conditions, the Company agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of the Company's required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the New Supply Agreement will expire on June 24, 2018, unless extended by the parties. The Company also has one option to unilaterally extend the term of the agreement for an additional two-year period, subject to certain conditions. The Company's total purchase commitment under the New Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately \$29.6 million and approximately \$31.5 million.

During the year ended December 31, 2014 and 2013, the Company purchased approximately \$5.84 million and \$12.56 million, respectively, of SiC crystals from Cree.

9. LINE OF CREDIT

On September 20, 2013, the Company obtained a \$10,000,000 revolving line of credit (the "Line of Credit") from PNC Bank, National Association ("PNC Bank") for general corporate and working capital purposes. The Line of Credit was evidenced by a Committed Line of Credit Note, dated September 20, 2013 (the "Note"), which was set to mature on June 15, 2015. The interest rate under the Note was the one-month LIBOR rate (adjusted daily) plus 1.50%, calculated on an actual/360 basis.

The Line of Credit was also governed by a loan agreement, dated September 20, 2013, and was guaranteed by Charles & Colvard Direct, LLC, and Moissanite.com, LLC. The Line of Credit was secured by a lien on substantially all assets of the Company and its subsidiaries.

Effective June 25, 2014, the Line of Credit was terminated concurrent with the Company entering into a new banking relationship with Wells Fargo Bank, National Association (“Wells Fargo”). The Company had not utilized the Line of Credit. The Company recognized the remaining \$19,000 of deferred legal expenses associated with this Line of Credit upon termination.

On June 25, 2014, the Company and its wholly owned subsidiaries, Charles & Colvard Direct, LLC, and Moissanite.com, LLC (collectively, the “Borrowers”), obtained a \$10,000,000 asset-based revolving credit facility (the “Credit Facility”) from Wells Fargo. The Credit Facility will be used for general corporate and working capital purposes, including transaction fees and expenses incurred in connection therewith and the issuance of letters of credit up to a \$1,000,000 sublimit. The Credit Facility will mature on June 25, 2017.

The Credit Facility includes a \$5,000,000 sublimit for advances that are supported by a 90% guaranty provided by the U.S. Export-Import Bank. Advances under the Credit Facility are limited to a borrowing base, which is computed by applying specified advance rates to the value of the Borrowers’ eligible accounts and inventory, less reserves. Advances against inventory are further subject to an initial \$3,000,000 maximum. The Borrowers must maintain a minimum of \$1,000,000 in excess availability at all times. There are no other financial covenants.

Each advance accrues interest at a rate equal to Wells Fargo’s 3-month LIBOR rate plus 2.50%, calculated on an actual/360 basis and payable monthly in arrears. Principal outstanding during an event of default accrues interest at a rate of 3% in excess of the above rate. Any advance may be prepaid in whole or in part at any time. In addition, the maximum line amount may be reduced by the Company in whole or part at any time, subject to a fee equal to 2% of any reduction in the first year after closing, 1% of any reduction in the second year after closing, and 0% thereafter. There are no mandatory prepayments or line reductions.

The Credit Facility is secured by a lien on substantially all assets of the Borrowers, each of which is jointly and severally liable for all obligations thereunder. Wells Fargo’s security interest in certain SiC materials is subordinate to Cree’s security interest in such materials pursuant to the New Supply Agreement and an Intercreditor Agreement with Wells Fargo.

The Credit Facility is evidenced by a credit and security agreement, dated as of June 25, 2014 and amended as of September 16, 2014 and December 12, 2014 (collectively, the “Credit Agreement”), and customary ancillary documents. The Credit Agreement contains customary covenants, representations and cash dominion provisions, including a financial reporting covenant and limitations on dividends, distributions, debt, contingent obligations, liens, loans, investments, mergers, acquisitions, divestitures, subsidiaries, affiliate transactions, and changes in control.

Events of default under the Credit Facility include, without limitation, (1) any impairment of the Export-Import Bank guaranty, unless the guaranteed advances are repaid within two business days, (2) an event of default under any other indebtedness of the Borrowers in excess of \$200,000, and (3) a material adverse change in the ability of the Borrowers to perform their obligations under the Credit Agreement or in the Borrowers’ assets, liabilities, businesses or prospects, or other circumstances that Wells Fargo believes may impair the prospect of repayment. If an event of default occurs, Wells Fargo is entitled to take enforcement action, including acceleration of amounts due under the Credit Agreement and foreclosure upon collateral.

The Credit Agreement contains other customary terms, including indemnity, expense reimbursement, yield protection, and confidentiality provisions. Wells Fargo is permitted to assign the Credit Facility.

As of December 31, 2014, the Company had not borrowed against the Credit Facility.

10. SHAREHOLDERS' EQUITY AND STOCK-BASED COMPENSATION

Common Stock

The Company is authorized to issue 50,000,000 shares of common stock, no par value. As of December 31, 2014 and 2013, it had 20,382,333 and 20,197,301 shares of common stock outstanding, respectively. Holders of common stock are entitled to one vote for each share held.

In November 2009, the Board of Directors authorized a repurchase program for up to 1,000,000 shares of the Company's common stock. On August 6, 2013, the Board authorized the extension of the Company's share repurchase program for an additional 12 months. The program, which was originally authorized on November 13, 2009, authorized the Company to repurchase up to 1,000,000 shares of the Company's common stock until August 12, 2014 in open market or in privately negotiated transactions. The Company expected to use available cash to finance these purchases and would determine the timing and amount of stock repurchases based on the Company's evaluation of market conditions, the market price of the Company's common stock, and management's assessment of the Company's liquidity and cash flow needs. The Company had no obligations to repurchase shares under the program and the program could be suspended or terminated at any time. As of December 31, 2013, the Company had repurchased an aggregate of 190,787 shares, and 809,213 shares of the Company's common stock remained available for repurchase under the program. The Company did not repurchase any shares under this program during the years ended December 31, 2014 or 2013. The Company did not extend the plan past its expiration due to covenants within the Credit Facility described in Note 9, "Line of Credit."

Preferred Stock

The Board of Directors is authorized, without further shareholder approval, to issue up to 10,000,000 shares of preferred stock, no par value. The preferred stock may be issued from time to time in one or more series. No shares of preferred stock had been issued as of December 31, 2014.

Equity Compensation Plans

1997 Omnibus Stock Plan

In 1997, the Company adopted the 1997 Omnibus Stock Plan of Charles & Colvard, Ltd. (the "1997 Omnibus Plan"). The 1997 Omnibus Plan authorized the Company to grant stock options, stock appreciation rights, and restricted stock awards (collectively, "awards") to selected employees, independent contractors, and directors of the Company and related corporations in order to promote a closer identification of their interests with those of the Company and its shareholders. All stock options granted under the 1997 Omnibus Plan have an exercise price equal to the market price of the Company's common stock on the date the stock option was granted. Stock options granted to employees under the 1997 Omnibus Plan generally vest over three years and have terms of up to 10 years, with the exception of stock options granted in 2005 under the Executive Compensation Plan (which is governed by and subject to the 1997 Omnibus Plan) that vested immediately and stock options granted in 2006 under the Executive Compensation Plan that vested at the end of three years. Stock options granted to the Board of Directors under the 1997 Omnibus Plan generally vested over one year and have terms of up to 10 years. The terms of stock options granted to independent contractors varied depending on the specific grant, but the terms are no longer than 10 years. Restricted stock awards granted to members of the Board of Directors vested at the end of one year. The 1997 Omnibus Plan expired (with respect to future grants) on September 30, 2007. As of December 31, 2014 and 2013, there were 11,776 and 20,051 stock options outstanding under the 1997 Omnibus Plan, respectively.

2008 Stock Incentive Plan

In May 2008, the shareholders of the Company approved the adoption of the Charles & Colvard, Ltd. 2008 Stock Incentive Plan (the "2008 Plan"), which replaced the 1997 Omnibus Plan. The 2008 Plan authorizes the Company to grant stock options, stock appreciation rights, restricted stock, and other equity awards to selected employees, directors, and independent contractors. The aggregate number of shares of the Company's common stock that may be issued pursuant to awards granted under the 2008 Plan shall not exceed the sum of 3,000,000 plus any shares of common stock subject to an award granted under the 1997 Omnibus Plan or any other stock incentive plan maintained by the Company prior to the 2008 Plan (each, a "Prior Plan") that is forfeited, cancelled, terminated, expires, or lapses for any reason without the issuance of shares pursuant to the award, or shares subject to an award granted under a Prior Plan which shares are forfeited to, or repurchased or reacquired by, the Company. Stock

options granted to employees under the 2008 Plan generally vest over three years and have terms of up to 10 years. The vesting schedules and terms of stock options granted to independent contractors vary depending on the specific grant, but the terms are no longer than 10 years. Restricted stock awards granted to members of the Board of

Directors vest at the end of one year on the date of the Annual Meeting of Shareholders. The vesting schedules of restricted stock awards granted to employees or independent contractors vary depending on the specific grant but are generally three years or less. Only stock options and restricted stock have been granted under the 2008 Plan. As of December 31, 2014 and 2013, there were 1,654,170 and 1,186,846 stock options outstanding under the 2008 Plan, respectively.

Stock-Based Compensation

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

	Year Ended December 31,	
	2014	2013
Employee stock options	\$ 840,568	\$ 791,833
Restricted stock awards	846,955	886,274
Income tax benefit	-	(309,607)
Total	<u>\$ 1,687,523</u>	<u>\$ 1,368,500</u>

Due to the Company's valuation allowance against deferred tax assets as discussed further in Note 11, "Income Taxes," the income tax benefit for 2014 was fully reserved.

No stock-based compensation was capitalized as a cost of inventory during the years ended December 31, 2014 and 2013.

Stock Options

The following is a summary of the stock option activity for the years ended December 31, 2014 and 2013:

	Shares	Weighted Average Exercise Price
	Outstanding, December 31, 2012	1,147,847
Granted	436,002	\$ 4.59
Exercised	(197,848)	\$ 2.13
Forfeited	(101,831)	\$ 2.47
Expired	(79,873)	\$ 2.36
Outstanding, December 31, 2013	1,204,297	\$ 3.14
Granted	535,000	\$ 2.49
Exercised	-	-
Forfeited	(30,775)	\$ 2.51
Expired	(42,576)	\$ 3.64
Outstanding, December 31, 2014	<u>1,665,946</u>	\$ 2.93

The weighted average grant date fair value of stock options granted during the years ended December 31, 2014 and 2013 was \$1.67 and \$3.25, respectively. The total fair value of stock options that vested during the years ended December 31, 2014 and 2013 was approximately \$805,000 and \$691,000, respectively. 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 years ended December 31, 2014 and 2013:

	Year Ended December 31,	
	2014	2013
Dividend yield	0.0%	0.0%
Expected volatility	81.1%	92.9%
Risk-free interest rate	1.77%	1.01%
Expected lives (years)	5.8	5.0

The following table summarizes information about stock options outstanding at December 31, 2014:

Options Outstanding			Options Exercisable			Options Vested or Expected to Vest		
Balance as of 12/31/2014	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 12/31/2014	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 12/31/2014	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
1,665,946	7.66	\$ 2.93	1,056,203	6.85	\$ 2.73	1,585,478	7.57	\$ 2.93

As of December 31, 2014, the unrecognized stock-based compensation expense related to unvested stock options was approximately \$1.09 million, which is expected to be recognized over a weighted average period of approximately 23 months.

The aggregate intrinsic value of stock options outstanding, exercisable, and vested or expected to vest at December 31, 2014 was approximately \$301,000, \$288,000, and \$298,000, respectively. These amounts are before applicable income taxes and represent the closing market price of the Company's common stock at December 31, 2014 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 years ended December 31, 2014 and 2013, the aggregate intrinsic value of stock options exercised was approximately \$0 and \$819,000, respectively.

Restricted Stock

The following is a summary of the restricted stock activity for the years ended December 31, 2014 and 2013:

	Shares	Weighted Average Grant Date Fair Value
Unvested, December 31, 2012	191,843	\$ 3.38
Granted	345,403	\$ 4.48
Vested	(186,343)	\$ 3.76
Canceled	-	\$ -
Unvested, December 31, 2013	350,903	\$ 4.26
Granted	185,032	\$ 2.09
Vested	(248,929)	\$ 3.77
Canceled	-	\$ -
Unvested, December 31, 2014	<u>287,006</u>	\$ 3.29

As of December 31, 2014, the unrecognized stock-based compensation expense related to unvested restricted stock was approximately \$570,000, which is expected to be recognized over a weighted average period of approximately 14 months.

Dividends

The Company has not paid any cash dividends during the years ended December 31, 2014 and 2013.

11. INCOME TAXES

The Company accounts for income taxes under the liability method. Under the liability method, deferred income taxes are recognized for the income tax consequences of "temporary differences" by applying enacted statutory income tax rates applicable to future years to differences between the financial statement carrying amounts and the income tax bases of existing assets and liabilities.

Income tax net (expense) benefit comprises the following:

	Year Ended December 31,	
	2014	2013
Current:		
Federal	\$ -	\$ -
State	(7,749)	(22,929)
Total	<u>(7,749)</u>	<u>(22,929)</u>
Deferred:		
Federal	(3,691,163)	408,871
State	(353,051)	(116,657)
Total	<u>(4,044,214)</u>	<u>292,214</u>
Income tax net (expense) benefit	<u>\$ (4,051,963)</u>	<u>\$ 269,285</u>

Significant components of the Company's deferred income tax assets are as follows:

	December 31,	
	2014	2013
Current:		
Reserves and accruals	\$ 1,472,997	\$ 1,298,557
Prepaid expenses	(48,427)	(42,801)
Valuation allowance	(1,424,570)	(57,924)
Total	<u>\$ -</u>	<u>\$ 1,197,832</u>

	December 31,	
	2014	2013
Noncurrent:		
Federal NOL carryforwards	\$ 4,185,179	\$ 1,884,118
State NOL carryforwards	616,655	460,652
Hong Kong NOL carryforwards	995,566	995,566
Federal benefit on state taxes under uncertain tax positions	128,026	123,865
Stock-based compensation	189,045	30,724
Investment loss	9,373	9,429
Research tax credit	434,637	434,637
Alternative minimum tax credit	348,264	348,264
Contributions carryforward	3,929	1,095
Depreciation	(418,154)	(366,863)
Accrued rent	297,362	-
Loss on impairment of long-lived assets	53,533	53,395
Valuation allowance	(6,843,415)	(1,132,991)
Total	-	2,841,891
Total deferred income tax assets, net	\$ -	\$ 4,039,723

A reconciliation between expected income taxes, computed at the statutory federal income tax rate of 34% applied to pretax accounting loss, and the income tax benefit (expense) included in the consolidated statements of operations for the years ended December 31, 2014 and 2013 is as follows:

	Year Ended December 31,	
	2014	2013
Anticipated income tax benefit at statutory rate	\$ 3,075,321	\$ 530,529
State income tax benefit (expense), net of federal tax effect	215,109	(90,099)
Capital loss carryforward expiration	-	(44,750)
Income tax effect of uncertain tax positions	(8,080)	(12,180)
Return to provision adjustments	(2,751)	(8,092)
Stock-based compensation	(279,985)	(81,564)
Other changes in deferred income tax assets, net	25,493	(25,416)
(Increase) decrease in valuation allowance	(7,077,070)	857
Income tax net (expense) benefit	\$ (4,051,963)	\$ 269,285

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. The Company determined that sufficient positive evidence existed as of December 31, 2013 to conclude that it is more likely than not that certain deferred tax assets of \$4.04 million were realizable and recorded approximately \$281,000 of income tax benefit to adjust these deferred tax assets. A valuation allowance remained at December 31, 2013 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 remained at December 31, 2013 against certain deferred tax assets relating to investment loss carryforwards because the Company did not anticipate it would generate sufficient investment income to utilize the carryforwards. The Company also previously considered various strategic alternatives, resulting in management determining that a valuation allowance was not necessary at that time. During the three months ended June 30, 2014, the Company's management determined that such strategic alternatives were no longer in the best interest of the Company. Accordingly, the Company's management concluded that the positive evidence was no longer sufficient to offset available negative evidence, primarily as a result of the pre-tax operating losses incurred during the six months ended June 30, 2014, and forecasted to continue through the remainder of 2014. As a result, the Company's management concluded that it was uncertain that the Company would have sufficient future taxable income to utilize its deferred tax assets, and therefore, the Company established a valuation allowance against its deferred tax assets, resulting in a tax expense of \$4.04 million for the year ended December 31, 2014. During the year ended December 31, 2014, the Company also recognized approximately \$12,000 of income tax expense for interest associated with uncertain tax positions.

As of December 31, 2014, the Company had approximately \$882,000 of remaining federal income tax credits, \$533,000 of which expire between 2018 and 2021 and the balance without an expiration, which can be carried forward to offset future income taxes. As of December 31, 2014, the Company had federal tax net operating loss carryforwards under U.S. GAAP of approximately \$12.44 million, expiring between 2020 and 2034, which can be used to offset against future federal taxable income, North Carolina tax net operating loss carryforwards across all of the entities of approximately \$14.64 million expiring between 2023 and 2029, and various other state tax net operating loss carryforwards expiring between 2016 and 2034, which can be used to offset against future state taxable income.

As of December 31, 2014, there was approximately \$6.03 million in net operating loss carryforwards in Hong Kong. In accordance with the Hong Kong tax code, these amounts can be carried forward indefinitely to offset future taxable income in Hong Kong. The Company's deferred tax assets in Hong Kong were fully reserved with a valuation allowance of \$996,000 as of December 31, 2014 and 2013 and had been fully reserved in all prior periods due to the uncertainty of future taxable income in this jurisdiction to utilize the deferred tax assets.

Uncertain Tax Positions

The gross liability for income taxes associated with uncertain tax positions at December 31, 2014 was approximately \$506,000. This amount is shown net of approximately \$98,000 recorded as a direct reduction to the associated deferred tax asset. The gross liability, if recognized, would favorably affect the Company's effective tax rate.

The Company's policy for recording interest and penalties associated with tax audits is to record such items as a component of the provision for income taxes. For each of the years ended December 31, 2014 and 2013, the Company accrued approximately \$12,000 of interest and penalties associated with uncertain tax positions. Including the interest and penalties recorded for uncertain tax positions, there is a total of approximately \$139,000 and \$127,000 of interest and penalties included in the accrued income tax liability for uncertain tax positions at December 31, 2014 and 2013, respectively. To the extent interest and penalties are not ultimately incurred with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision.

In all of the significant federal and state jurisdictions where it is required to file income tax returns, the Company has analyzed filing positions for all tax years in which the statute of limitations is open. The only periods subject to examination by the major tax jurisdictions where the Company does business are the 2011 through 2013 tax years. The Company does not believe that the outcome of any examination will have a material impact on its consolidated financial statements and does not expect settlement on any uncertain tax positions within the next 12 months.

The following summarizes the activity related to the Company's gross liability for uncertain tax positions from January 1, 2013 through December 31, 2014:

Balance as of January 1, 2013	\$ 482,510
Increases related to prior year tax positions	11,712
Balance as of December 31, 2013	<u>494,222</u>
Increases related to prior year tax positions	12,241
Balance as of December 31, 2014	<u><u>\$ 506,463</u></u>

12. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

As of December 31, 2014 and 2013, one customer accounted for 28% and 21%, respectively, of trade accounts receivable. One other customer accounted for 11% of trade accounts receivable as of December 31, 2014, but did not account for a significant amount in the prior year.

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:

	<u>Year Ended December 31,</u>	
	<u>2014</u>	<u>2013</u>
Customer A	28%	19%
Customer B	10%	9%

13. EMPLOYEE BENEFIT PLAN

All full-time employees who meet certain age and length of service requirements are eligible to participate in the Company's 401(k) Plan. The plan provides for matching contributions by the Company in such amounts as the Board of Directors may annually determine, as well as a 401(k) option under which eligible participants may defer a portion of their salaries. The Company contributed a total of \$129,000 and \$79,000 to the plan during the years ended December 31, 2014 and 2013, respectively.

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

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2014. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2014, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting. We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. During the three months ended December 31, 2014, we made no changes to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control system was designed to provide reasonable assurance to our management and Board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Our internal control over financial reporting includes those policies and procedures that:

- (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and
- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to the reliability of financial reporting and the preparation of financial statements.

In making the assessment of internal control over financial reporting, our management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework (2013)*. Based on that assessment and those criteria, management determined that our internal control over financial reporting was effective as of December 31, 2014.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Item 11. Executive Compensation

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

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

Item 14. Principal Accounting Fees and Services

The information called for in Items 10 through 14 is incorporated by reference from our definitive Proxy Statement relating to our 2015 Annual Meeting of Shareholders, which will be filed with the SEC within 120 days after the end of fiscal 2014.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) and (2). The consolidated financial statements and report of our independent registered public accounting firm are filed as part of this report (see “Index to Financial Statements,” at Part II, Item 8). The financial statement schedules are not included in this Item as they are either not applicable or the information is otherwise included in the consolidated financial statements or the notes to the consolidated financial statements.

(a)(3). The following exhibits have been or are being filed herewith and are numbered in accordance with Item 601 of Regulation S-K:

<u>Exhibit No.</u>	<u>Description</u>
3.1	Restated Articles of Incorporation of Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 3.1 to our Annual Report on Form 10-K for the year ended December 31, 2004)
3.2	Bylaws of Charles & Colvard, Ltd., as amended and restated, effective May 19, 2011 (incorporated herein by reference to Exhibit 3.1 to our Current Report on Form 8-K, as filed with the SEC on May 24, 2011)
4.1	Specimen Certificate of Common Stock (incorporated herein by reference to Exhibit 4.1 to our Annual Report on Form 10-K for the year ended December 31, 1998)
10.1	Amended and Restated Exclusive Supply Agreement, dated as of June 6, 1997, between Cree Research, Inc. and C3, Inc. (incorporated herein by reference to Exhibit 10.11 to our Registration Statement on Form S-1 (File No. 333-36809), as filed with the SEC on September 30, 1997)*
10.2	Notice of Extension of Amended and Restated Exclusive Supply Agreement, dated January 6, 2005, from Charles & Colvard, Ltd. to Cree, Inc. (incorporated herein by reference to Exhibit 10.69 to our Current Report on Form 8-K, as filed with the SEC on January 7, 2005)
10.3	Letter Agreement, dated January 31, 1996, between Cree Research, Inc. and C3, Inc. (incorporated herein by reference to Exhibit 10.14 to our Registration Statement on Form S-1 (File No. 333-36809), as filed with the SEC on September 30, 1997)*
10.4	Letter Agreement, dated November 12, 2007, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.108 to our Current Report on Form 8-K, as filed with the SEC on November 13, 2007)*
10.5	Letter Agreement, dated September 18, 2008, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.123 to our Current Report on Form 8-K, as filed with the SEC on September 24, 2008)
10.6	Letter Agreement, effective March 22, 2010, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.6 to our Annual Report on Form 10-K for the year ended December 31, 2009)*
10.7	Amendment to Letter Agreement, effective February 8, 2013, between Charles & Colvard, Ltd. and Cree, Inc. (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K, as filed with the SEC on February 14, 2012)*
10.8	Second Amendment to Letter Agreement, dated September 5, 2013, between Charles & Colvard, Ltd. and Cree, Inc. (incorporated by reference to Exhibit 10.4 to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2013)*

- 10.9 Exclusive Supply Agreement, dated as of December 12, 2014, by and among Charles & Colvard, Ltd., Cree, Inc. and, solely for purposes of Section 6(c) of the Exclusive Supply Agreement, Charles & Colvard Direct, LLC and Moissanite.com, LLC (incorporated herein by reference to Exhibit 10.1 to our Current Report on Form 8-K, as filed with the SEC on December 16, 2014)*
- 10.10 Letter Agreement, dated February 9, 2005 and effective February 21, 2005, between The Bell Group, d/b/a Rio Grande and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.73 to our Current Report on Form 8-K, as filed with the SEC on February 23, 2005)*
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- 21.1 Subsidiaries of Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 21.1 to our Annual Report on Form 10-K for the year ended December 31, 2013)
- 23.1 Consent of BDO USA, LLP
- 31.1 Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
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- 101 The following materials from Charles & Colvard, Ltd.'s Annual Report on Form 10-K for the year ended December 31, 2014 formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Operations; (iii) Consolidated Statements of Shareholders' Equity; (iv) Consolidated Statements of Cash Flows; and (v) Notes to Consolidated Financial Statements.

* Asterisks located within the exhibit denote information which has been redacted pursuant to a request for confidential treatment filed with the SEC.

+ Management contract or compensatory plan or arrangement.

SIGNATURES

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

CHARLES & COLVARD, LTD.

March 13, 2015 By: /s/ Randy N. McCullough
Randy N. McCullough
President and Chief Executive Officer

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

March 13, 2015 By: /s/ Randy N. McCullough
Randy N. McCullough
Director, President and Chief Executive Officer

March 13, 2015 By: /s/ Kyle Macemore
Kyle Macemore
Senior Vice President, Chief Financial Officer and
Treasurer
(Principal Financial Officer and Chief Accounting
Officer)

March 13, 2015 By: /s/ Neal I. Goldman
Neal I. Goldman
Executive Chairman of the Board of Directors

March 13, 2015 By: /s/ David B. Barr
David B. Barr
Director

March 13, 2015 By: /s/ H. Marvin Beasley
H. Marvin Beasley
Director

March 13, 2015 By: /s/ Anne M. Butler
Anne M. Butler
Director

March 13, 2015 By: /s/ George R. Cattermole
George R. Cattermole
Director

March 13, 2015 By: /s/ Ollin B. Sykes
Ollin B. Sykes
Director

EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>
3.1	Restated Articles of Incorporation of Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 3.1 to our Annual Report on Form 10-K for the year ended December 31, 2004)
3.2	Bylaws of Charles & Colvard, Ltd., as amended and restated, effective May 19, 2011 (incorporated herein by reference to Exhibit 3.1 to our Current Report on Form 8-K, as filed with the SEC on May 24, 2011)
4.1	Specimen Certificate of Common Stock (incorporated herein by reference to Exhibit 4.1 to our Annual Report on Form 10-K for the year ended December 31, 1998)
10.1	Amended and Restated Exclusive Supply Agreement, dated as of June 6, 1997, between Cree Research, Inc. and C3, Inc. (incorporated herein by reference to Exhibit 10.11 to our Registration Statement on Form S-1 (File No. 333-36809), as filed with the SEC on September 30, 1997)*
10.2	Notice of Extension of Amended and Restated Exclusive Supply Agreement, dated January 6, 2005, from Charles & Colvard, Ltd. to Cree, Inc. (incorporated herein by reference to Exhibit 10.69 to our Current Report on Form 8-K, as filed with the SEC on January 7, 2005)
10.3	Letter Agreement, dated January 31, 1996, between Cree Research, Inc. and C3, Inc. (incorporated herein by reference to Exhibit 10.14 to our Registration Statement on Form S-1 (File No. 333-36809), as filed with the SEC on September 30, 1997)*
10.4	Letter Agreement, dated November 12, 2007, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.108 to our Current Report on Form 8-K, as filed with the SEC on November 13, 2007)*
10.5	Letter Agreement, dated September 18, 2008, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.123 to our Current Report on Form 8-K, as filed with the SEC on September 24, 2008)
10.6	Letter Agreement, effective March 22, 2010, between Cree, Inc. and Charles & Colvard, Ltd. (incorporated herein by reference to Exhibit 10.6 to our Annual Report on Form 10-K for the year ended December 31, 2009)*
10.7	Amendment to Letter Agreement, effective February 8, 2013, between Charles & Colvard, Ltd. and Cree, Inc. (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K, as filed with the SEC on February 14, 2012)*
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CORPORATE INFORMATION

DIRECTORS

H. MARVIN BEASLEY

President & Chief Executive Officer,
Charles & Colvard, Ltd.

ANNE M. BUTLER

Chief Executive Officer,
Butler Advisors

GEORGE R. CATTERMOLE

Retired former Chairman of the Board,
President & Chief Executive Officer of
Outlast Technologies Inc.

NEAL I. GOLDMAN

President, Goldman Capital
Management, Inc.

OLLIN B. SYKES

President, Sykes & Co., P.A.

STOCK LISTINGS

NASDAQ Global Select Market
Symbol: CTHR

EXECUTIVE OFFICERS

H. MARVIN BEASLEY

President & Chief Executive Officer

KYLE S. MACEMORE

Sr. Vice President & Chief Financial
Officer/Treasurer

STEVEN M. LARKIN

Chief Operating Officer

CORPORATE HEADQUARTERS

170 Southport Drive
Morrisville, NC 27560

TRANSFER AGENT & REGISTRAR

American Stock Transfer & Trust Company
Operation Center
6201 15th Avenue
Brooklyn, NY 11219
info@amstock.com

INVESTOR RELATIONS

For investor relations and
shareholder inquiries, please contact:

CHRIS SCHREIBER
Managing Director
Taglich Brothers, Inc.
790 New York Avenue
Suite 209
Huntington, NY 11743
917.445.6207

Sign up for investor-related e-mail
alerts by visiting our website:
charlesandcolvard.com/ir/ealerts

ANNUAL MEETING OF SHAREHOLDERS

Wednesday, May 20, 2015, 10:00 A.M.
Sheraton Imperial Hotel
4700 Emperor Boulevard
Durham, NC 27703

CAUTIONARY NOTE:

The annual report contains forward-looking statements relating to the company's business. Our business is subject to numerous risks and uncertainties, which could cause actual results to differ materially from those expressed or implied by these forward-looking statements. We refer you to our annual report on form 10-K for a discussion of such risk and uncertainties.



CHARLES & COLVARD®

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CHARLESANDCOLVARD.COM

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