
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2003

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

For the transition period from _____ to _____

Commission File Number: 000-23329

Charles & Colvard, Ltd.

(Exact name of Registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

56-1928817

(I.R.S. Employer Identification No.)

3800 Gateway Boulevard, Suite 310, Morrisville, N.C. 27560

(Address of principal executive offices)

919-468-0399

(Registrant's telephone number, including area code)

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

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

As of July 31, 2003 there were 13,177,921 shares of the Registrant's Common Stock, no par value per share, outstanding.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net sales	\$ 4,311,706	\$ 4,075,602	\$ 8,684,849	\$ 8,225,748
Cost of goods sold	1,392,576	1,632,901	3,091,017	3,671,855
Gross profit	2,919,130	2,442,701	5,593,832	4,553,893
Operating expenses:				
Marketing and sales	1,440,832	1,125,730	2,592,844	2,179,376
General and administrative	583,844	732,063	1,186,201	1,339,275
Research and development	5,842	—	7,592	—
Total operating expenses	2,030,518	1,857,793	3,786,637	3,518,651
Operating income	888,612	584,908	1,807,195	1,035,242
Interest income, net	28,989	52,879	63,909	102,755
Income before taxes	917,601	637,787	1,871,104	1,137,997
Income tax expense	415,370	—	836,422	—
Net income	\$ 502,231	\$ 637,787	\$ 1,034,682	\$ 1,137,997
Net income per share:				
Basic	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.09
Diluted	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08
Weighted-average common shares:				
Basic	13,219,530	13,377,484	13,260,836	13,375,626
Diluted	13,521,463	13,707,458	13,584,854	13,641,479

See Notes to Condensed Consolidated Financial Statements.

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Condensed Consolidated Balance Sheets

	June 30, 2003	December 31, 2002
	(Unaudited)	
Assets		
Current Assets:		
Cash and equivalents	\$ 12,354,223	\$ 13,282,245
Accounts receivable	2,165,735	2,195,952
Interest receivable	8,170	11,926
Inventories (Note 2)	23,919,123	22,365,325
Prepaid expenses	337,956	327,179
Deferred income taxes	250,601	250,601
Total current assets	39,035,808	38,433,228
Long Term Assets:		
Equipment, net	492,928	449,947
Patent and license rights, net	273,501	272,291
Deferred income taxes	6,000,874	6,793,296
Total long term assets	6,767,303	7,515,534
Total assets	\$ 45,803,111	\$ 45,948,762
Liabilities and Shareholders' Equity		
Current Liabilities:		
Accounts payable:		
Cree, Inc.	\$ 836,665	\$ 780,029
Other	201,045	122,931
Accrued payroll	179,869	723,467
Accrued expenses and other liabilities	252,621	387,417
Deferred revenue	253,793	183,367
Total current liabilities	1,723,993	2,197,211
Commitments and contingencies (Note 4)		
Shareholders' Equity:		
Common stock (Note 3)	54,258,882	54,972,302
Additional paid-in capital—stock options	2,446,039	2,439,734
Accumulated deficit	(12,625,803)	(13,660,485)
Total shareholders' equity	44,079,118	43,751,551
Total liabilities and shareholders' equity	\$ 45,803,111	\$ 45,948,762

See Notes to Condensed Consolidated Financial Statements

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

	Six Months Ended June 30,	
	2003	2002
Operating Activities:		
Net income	\$ 1,034,682	\$ 1,137,997
Adjustments:		
Depreciation and amortization	77,652	63,537
Stock option compensation	12,476	62,358
Deferred income taxes	792,422	—
Change in operating assets and liabilities:		
Net change in assets	(1,530,602)	963,396
Net change in liabilities	(473,218)	201,796
Net cash provided by (used in) operating activities	(86,588)	2,429,084
Investing Activities:		
Capital expenditures	(121,843)	(128,793)
Net cash used in investing activities	(121,843)	(128,793)
Financing Activities:		
Stock options exercised	28,412	6,160
Purchase of common stock	(748,003)	—
Net cash provided by (used in) financing activities	(719,591)	6,160
Net change in cash and equivalents	(928,022)	2,306,451
Cash and equivalents, beginning of period	13,282,245	10,236,319
Cash and equivalents, end of period	\$ 12,354,223	\$ 12,542,770

See Notes to Condensed Consolidated Financial Statements.

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

1. Basis Of Presentation

The accompanying unaudited financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America for interim financial information. However, certain information or footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the financial statements include all normal recurring adjustments which are necessary for the fair presentation of the results of the interim periods presented. Interim results are not necessarily indicative of results for the year. Certain reclassifications have been made to prior year's financial statements to conform to the classifications used in fiscal 2003. These financial statements should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2002, as set forth in the Company's Form 10-K, filed with the Securities and Exchange Commission on March 26, 2003.

In preparing financial statements that conform with accounting principles generally accepted in the United States of America, management must make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and amounts of revenues and expenses reflected during the reporting period. Actual results could differ from those estimates.

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

All the Company's activities are within a single business segment. During the three and six months ended June 30, 2003, export sales aggregated approximately \$600,000 and \$1,100,000, respectively. Export sales aggregated approximately \$600,000 and \$1,400,000 for the three and six months ended June 30, 2002, respectively.

2. Inventories

Inventories are stated at the lower of cost or market determined on a first in, first out basis. Based on current estimates and assumptions, the Company believes that a substantial amount of inventories will be sold or consumed during its operating cycle. A significant amount of inventory must be maintained at all times to be prepared to react to possible customer demand for large purchases and for a variety of jewel styles.

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

Finished goods are shown net of a reserve for excess jewelry inventory of \$190,000 and \$230,000 at June 30, 2003 and December 31, 2002, respectively. In addition, finished goods are shown net of a lower of cost or market reserve of \$400,000 at June 30, 2003 and December 31, 2002. This reserve was established to allow for the carat weight loss associated with the re-cutting of a portion of the finished goods inventory. There are certain shapes and sizes of jewels in inventory that will be re-cut to achieve higher quality standards. These jewels can be re-cut into shapes and sizes that have a higher demand without the purchase of additional raw material.

	June 30,	December 31,
	2003	2002
Raw materials	\$ 408,443	\$ 217,815
Work-in-process	4,934,676	4,625,425
Finished goods	18,576,004	17,522,085
Total Inventory	<u>\$23,919,123</u>	<u>\$22,365,325</u>

3. Common Stock

In October 2002, the Board of Directors authorized a follow-on repurchase program for up to 1,100,000 shares of the Company's common stock. At the discretion of management, the repurchase program can be implemented through open market or privately negotiated transactions at prices at or below prevailing prices. The Company will determine the time and extent of repurchases based on its evaluation of market conditions and other factors. During the three months ended June 30, 2003, the Company repurchased 83,000 shares of common stock at an average cost of \$4.35 per share. Of this amount, 50,000 shares were purchased from an affiliate of Chester L. F. Paulson, at a purchase price of \$4.35 per share. During the six months ended June 30, 2003, the Company repurchased 163,300 shares of common stock at an average cost of \$4.58 per share. Of this amount, 100,000 shares were purchased from an affiliate of Chester L. F. Paulson at an average purchase price of \$4.58 per share. Chester L.F. Paulson was a director of the Company from May 2001 through May 2003. He is no longer a director of the company.

4. Commitments and Contingencies

Operating Lease

The Company leases approximately 12,700 square feet of mixed use space from an unaffiliated third party at a base cost of approximately \$11,000 per month, plus contingent rentals based on the Company's proportionate share of the lessor's operating costs, as defined in the lease agreement. The lease expires August 31, 2004 and provides for escalations of the base rent throughout the lease term, up to \$11,700 at September 1, 2003.

The future minimum lease payments of the Company, including its Hong Kong subsidiary, are as follows: \$95,000 for the remainder of 2003, \$130,000 in 2004, and \$9,000 in 2005, totaling \$234,000. Rental expense incurred for operating leases and leases whose terms are less than one year in duration for the three and six months ended June 30, 2003 was \$53,000 and \$107,000, respectively. For the three and six months ended June 30, 2002, such expense was \$57,000 and \$107,000, respectively.

Purchase Commitment

On June 6, 1997, the Company entered into an Amended and Restated Exclusive Supply Agreement ("Exclusive Supply Agreement") with Cree. The Exclusive Supply Agreement has an initial term of ten years which may be extended for an additional ten years by either party if the Company orders in any 36-month period SiC crystals with an aggregate purchase price in excess of \$1 million. The Company has met this order threshold and expects to extend the term of the Exclusive Supply Agreement. In connection with the Exclusive Supply Agreement, the Company has committed to purchase a minimum of 50% (by dollar volume) of its requirements for SiC crystals from Cree. If the Company's orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. In August 2002, we agreed with Cree on a framework for purchases through September 2007. The Company is obligated to purchase a minimum quantity of usable material on a quarterly basis if Cree meets certain minimum quality levels. For each quarter through September 2007, the Company has committed to purchase between \$504,000 and \$2,016,000 of raw material depending upon the quality of material received. If Cree's material quality is consistent with that received in 2002 and thus far in 2003, which has been better than the quality produced in previous years, future purchases are expected to be at the high end of this range. If the Company does not meet the minimum quarterly purchase commitment, the Company will be obligated to pay Cree an unused capacity charge for the idle crystal growers. This charge will not be greater than \$110,000 in any given quarter. During the three and six months ended June 30, 2003, we purchased \$1.4 million and \$3.5 million of raw material from Cree, respectively.

Contingencies

C. Eric Hunter, one of the founders of the Company, and his wife, Jocelyn Hunter, filed suit against the Company and Jeff Hunter, the Company's former CEO and Eric Hunter's brother, on June 17, 2003 in the U.S. District Court for the Middle District of North Carolina. The plaintiffs allege fraud and other actionable conduct in violation of the Securities Act of 1933 as well as other unspecified federal laws and regulations, breach of contract, breach of fiduciary duty (with respect to defendant Jeff Hunter) and unfair and deceptive trade practices. In particular, among other claims, the plaintiffs allege that Jeff Hunter, acting as CEO of the Company, along with Neal Hunter, Chairman of Cree, Inc., entered into a "side agreement" between the Company and Cree, Inc. whereby the Company was compelled to take unlimited amounts of moissanite (also known as silicon carbide (SiC) crystals) from Cree, Inc., in an effort to artificially augment the operating income of Cree, Inc., and that the Company did not properly

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disclose the existence of such agreement. Plaintiff Eric Hunter also alleges that he is entitled to receive royalty payments under a license agreement between him and the Company concerning certain patents used in the manufacture of SiC crystals, and that the Company has failed to make such payments in breach of the agreement. The plaintiffs further allege that defendant Jeff Hunter has breached the fiduciary duty owed to the shareholders of the Company. Finally, the plaintiffs allege that each of the foregoing transactions were unfair business acts in or affecting commerce, in violation of N.C. Gen. Stat. Section 75-1.1. The plaintiffs seek personally to recover damages of \$10 million (with interest) from the defendants for the securities fraud and related claims, an amount from the defendants to be proven at trial (with interest) for the breach of contract claim, \$10 million along with unspecified punitive damages from defendant Jeff Hunter for the alleged breach of fiduciary duty and other misconduct, and \$10 million along with treble damages from defendants for the alleged unfair and deceptive trade practices, as well as costs and expenses related to the litigation including reasonable attorneys' fees.

The Company's position in the litigation is that it has properly disclosed all agreements it has with Cree, Inc. and has conducted its business properly. Since many of the allegations against the Company are vague and the suit is in an early stage, it is premature to speculate on the duration or the costs of the litigation. While the Company will seek to minimize the inevitable costs and distractions that occur from being involved in any litigation, the Company will vigorously defend this suit.

The plaintiffs have also filed a separate lawsuit naming Cree, Inc. and Neal Hunter as defendants, in the same court.

5. Stock Based Compensation

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

In accordance with Accounting Principles Board (APB) Opinion No. 25, and the provision of Statement of Financial Accounting Standards (FAS) No. 123 as applicable to consultants, the Company recorded compensation expense of approximately \$7,000 and \$12,000 during the three and six months ended June 30, 2003, respectively. Compensation expense related to stock options for the three and six months ended June 30, 2002 was approximately \$30,000 and \$62,000, respectively. This compensation expense is recorded as part of general and administrative expenses in the Statements of Operations. Had compensation expense for all stock options been determined consistent with FAS 123, rather than APB 25, the Company's net income and net income per share for the three and six months ended June 30, 2003 and 2002 would have been recorded at the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
Net income, as reported	\$ 502,231	\$ 637,787	\$ 1,034,682	\$ 1,137,997
Pro forma net income	\$ 445,127	\$ 601,403	\$ 652,928	\$ 881,538
Basic and diluted net income per share:				
As reported	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.09
Pro forma	\$ 0.03	\$ 0.04	\$ 0.05	\$ 0.07
Diluted net income per share:				
As reported	\$ 0.04	\$ 0.05	\$ 0.08	\$ 0.08
Pro forma	\$ 0.03	\$ 0.04	\$ 0.05	\$ 0.06

6. Newly Adopted Accounting Pronouncements

In August 2001, FAS No. 143, *Accounting For Asset Retirement Obligations*, was issued. This statement requires recording of the fair value of a liability for an asset retirement obligation in the period in which it is incurred and a corresponding increase in the carrying value of the related long-lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, it is either settled for its recorded amount or a gain or loss upon settlement is recorded.

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FAS 143 is effective for the Company's year ended December 31, 2003. The Company does not have any asset retirement obligations and the adoption of this statement did not have an effect on the Company's unaudited condensed consolidated financial statements.

In April 2002, FAS No. 145, *Rescission of FAS Statements No. 4, 44, and 64, Amendment of FAS No. 13, and Technical Corrections*, was issued. This statement is effective for our year ended December 31, 2003. This statement rescinds the requirement that all gains and losses from extinguishment of debt be classified as extraordinary items. The adoption of FAS 145 did not have a material effect on the Company's unaudited condensed consolidated financial statements.

In July 2002, FAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, was issued. This statement requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. FAS 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The adoption of FAS 146 did not have a material effect on the Company's unaudited condensed consolidated financial statements.

In January 2003, FAS Interpretation No. 46, *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*, was issued. This interpretation provides guidance related to identifying variable interest entities (previously known as special purpose entities or SPEs) and determining whether such entities should be consolidated. This interpretation must be applied immediately to variable interest entities created or obtained after January 31, 2003. The Company does not have any variable interest entities and the adoption of this interpretation had no effect on the Company's unaudited condensed consolidated financial statements.

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

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements represent our judgment on future events. Our business is subject to business and economic risks and uncertainties that could cause our actual performance and results to differ materially from those expressed or implied by any of the forward-looking statements included herein. These risks and uncertainties include but are not limited to the Company’s ability to manage growth effectively, dependence on Cree Inc. for SiC crystals, dependence on a limited number of distributors such as K&G Creations and Stuller Settings, Inc., limited operating history, dependence on continued growth and consumer acceptance of the Company’s products, the risks and uncertainties of litigation including the substantial management time and attention required and substantial expenses incurred regardless of its outcome, in addition to the other risks and uncertainties described under the heading “Business Risks” in our Form 10-K for the year ended December 31, 2002, which was filed with the Securities and Exchange Commission on March 26, 2003, and other filings with the Securities and Exchange Commission.

Overview

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

From our inception in June 1995 through June 30, 1998, we were a development stage enterprise, devoting our resources to fund research and development of colorless, scientifically-made moissanite jewels. We began shipping moissanite to domestic retail jewelers and international distributors during the second quarter of 1998. During the second quarter of 2000, we changed our domestic distribution model to sell through jewel distributors and jewelry manufacturers rather than direct to retail stores.

In March 2000, we entered into distribution agreements with Stuller Settings, Inc. (Stuller) and Rio Grande, two of the largest suppliers of jewelry-related products to the jewelry industry, for the North American distribution of moissanite. We have also entered into several agreements with domestic jewelry manufacturers, including K&G Creations, which is currently our largest customer. Through these agreements with Stuller, Rio Grande and jewelry manufacturers and the brand awareness created by our marketing program, we sought to rapidly increase the introduction of moissanite into the domestic jewelry market while maintaining average selling prices. Although these new distribution and marketing strategies enabled us to achieve profitability and positive cash flow in 2001 and 2002, these strategic efforts are still in an early stage, and we have no assurance that they will be successful in the long-term.

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

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

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During 2002, we continued our focus on the domestic market, while investing limited resources in certain international markets that show the most potential. Our sales were 44% higher than sales in 2001 with sustained profitability. As described below, sales increased 6% in the second quarter and first half of 2003 over the same periods in 2002, and we have remained profitable. Although our goals for the remainder of 2003 are to continue achieving increases in sales and to sustain profitability, we cannot be sure that our goals will be achieved. Our results of operations in a particular reporting period could be impacted by our planned increased advertising and promotional expenditures relative to the timing of the related revenue we generate.

Results of Operations

Three Months ended June 30, 2003 compared with Three Months ended June 30, 2002.

Net sales were \$4,311,706 for the three months ended June 30, 2003 compared to \$4,075,602 for the three months ended June 30, 2002, an increase of \$236,104 or 6%. Although shipments of moissanite jewels decreased to approximately 23,500 carats from 25,300 carats in the same period of 2002, sales increased due to a 13% increase in the average selling price per carat. Domestic carat shipments, which represented 87% of total shipments, decreased by 3% and international carat shipments decreased by 27%. The average selling price per carat increased primarily due to increased sales of larger jewels which have a higher price per carat. Domestic carat shipments decreased during the period due to decreased hours of moissanite sales broadcasting on the television shopping channel ShopNBC. Other domestic retail outlets showed sales growth in the moissanite category. Our two largest customers, K&G Creations and Stuller, accounted for 47% and 20%, respectively, of our sales during the second quarter of 2003. K&G Creations, a domestic manufacturing customer, provides moissanite jewels and jewelry to a large and diversified customer base, including television shopping channels and traditional retail stores. While we believe our current relationship with this manufacturer is good, and alternate manufacturers are available to serve its customer base, a loss of this manufacturer as a customer could cause a material adverse effect on our results of operations in a particular period. International sales decreased due to lower sales into Hong Kong/China, Italy, Thailand, and the United Kingdom.

Our gross profit margin was 67.7% for the three months ended June 30, 2003 compared to 59.9% for the three months ended June 30, 2002. The increased gross margin percentage was primarily caused by a 13% improvement in the average selling price per carat, as well as improved yields of moissanite jewels from SiC crystals during the period being relieved from inventory under our first in, first out accounting policy. Future gross margins will vary depending on our average selling price per carat and the cost of the inventory being relieved from inventory.

Marketing and sales expenses were \$1,440,832 for the three months ended June 30, 2003 compared to \$1,125,730 for the three months ended June 30, 2002, an increase of \$315,102 or 28%. As a percentage of sales, these expenses increased to 33% from 28% in the same period of 2002. The two major components of this increase were \$130,000 of increased print advertising and \$66,000 of increased compensation costs (including the salaries of two new sales and marketing executives). During the three months ended June 30, 2003, we spent approximately \$350,000 on our new print advertising campaign which featured advertisements in the fashion magazines InStyle, Elle, Vanity Fair, and Vogue. We expect to spend approximately \$150,000 in advertising production costs for this program in the third quarter of 2003, and we have committed to spend approximately \$700,000 in the fourth quarter of 2003 for fashion magazine and billboard advertising. We intend for our advertising to support an aggressive schedule of distribution tests by various jewelry chains. The advertising, in each instance, will identify available retail locations for moissanite jewelry.

General and administrative expenses were \$583,844 for the three months ended June 30, 2003 compared to \$732,063 for the three months ended June 30, 2002, a decrease of \$148,219 or 20%. As a percentage of sales, these expenses decreased to 14% from 18% in the same period of 2002. The decrease was primarily caused by decreased compensation costs of \$105,000. The decreased compensation costs are attributable to \$110,000 in costs recorded in 2002 for our Executive Compensation Plan. This plan is effective for 2003; however, no costs were recorded in the three months ended June 30, 2003, as the Company has not met its 2003 internal sales and profit goals.

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Research and development expenses were \$5,842 for the three months ended June 30, 2003 and there were no expenses for the three months ended June 30, 2002. We suspended development efforts with Cree effective January 1, 2001 and terminated our Development Agreement with Cree effective December 31, 2002. During 2003, we will expend minimal resources on research and development as we maintain our focus on increasing sales and profitability.

Net interest income was \$28,989 for the three months ended June 30, 2003 compared to \$52,879 for the three months ended June 30, 2002, a decrease of \$23,890 or 45%. This decrease resulted from a lower interest rate earned on our cash balances.

Income tax expense was \$415,370 for the three months ended June 30, 2003. No income tax expense was recorded during the three months ended June 30, 2002. As a result of sustained profitability in 2001 and 2002, we recorded a one-time \$6.7 million non-operating and non-cash addition to earnings in the fourth quarter of 2002 to reflect the expected future tax benefits from our deferred tax assets (primarily our net operating loss carryforwards). Recognition of this asset has resulted in the recording of income tax expense in each quarter of 2003. However, U.S. federal income tax payments will only resume once the tax net operating loss carryforwards (\$16.0 million at December 31, 2002) have been completely utilized or if alternative minimum taxes are applicable. Pro forma amounts are shown below to compare net income in 2003 vs. 2002 as if we had recorded U.S. income tax expense during 2002 utilizing an effective tax rate of 38% of U.S. taxable income. Management believes that this pro forma information is useful to investors in comparing results of operations on a U.S. tax equivalent basis.

	Three months ended June 30,	
	2003	2002
As reported:		
Income before income tax expense	\$ 917,601	\$ 637,787
Income tax expense	415,370	—
Net income	\$ 502,231	\$ 637,787
Net income per diluted share	\$ 0.04	\$ 0.05
		Three months ended June 30,
		2002
Pro Forma:		
Income before income tax expense		\$ 637,787
Income tax expense (38% of U.S. taxable income)		290,941
Net income		\$ 346,846
Net income per diluted share		\$ 0.03

Six Months ended June 30, 2003 compared with Six Months ended June 30, 2002.

Net sales were \$8,684,849 for the six months ended June 30, 2003 compared to \$8,225,748 for the six months ended June 30, 2002, an increase of \$459,101 or 6%. Although shipments of moissanite jewels decreased to approximately 48,600 carats from 51,000 carats in the same period of 2002, sales increased due to an 11% increase in the average selling price per carat. Domestic carat shipments, which represented 87% of total shipments, increased by 1% and international carat shipments decreased by 31%. The average selling price per carat increased primarily due to increased sales of larger jewels which have a higher price per carat. Domestic carat shipments were relatively flat during the period due to decreased hours of moissanite sales broadcasting on the television shopping channel ShopNBC. Other domestic retail outlets showed sales growth in the moissanite category. Our two largest customers, K&G Creations and Stuller, accounted for 46% and 24%, respectively, of our sales during the 1st half of 2003. K&G Creations, a domestic manufacturing customer, provides moissanite jewels and jewelry to a large and diversified customer base, including television shopping channels and traditional retail stores. While we believe our current relationship with this manufacturer is good, and alternate manufacturers are available to serve its customer base, a loss of this manufacturer as a customer could cause a material adverse effect on our results of operations in a particular period. International sales decreased due to lower sales into Hong Kong/China, Italy, and the United Kingdom.

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Our gross profit margin was 64.4% for the six months ended June 30, 2003 compared to 55.4% for the six months ended June 30, 2002. The increased gross margin percentage was primarily caused by an 11% improvement in the average selling price per carat, as well as improved yields of moissanite jewels from SiC crystals during the period being relieved from inventory under our first in, first out accounting policy. Future gross margins will vary depending on our average selling price per carat and the cost of the inventory being relieved from inventory.

Marketing and sales expenses were \$2,592,844 for the six months ended June 30, 2003 compared to \$2,179,376 for the six months ended June 30, 2002, an increase of \$413,468 or 19%. As a percentage of sales, these expenses increased to 30% from 26% in the same period of 2002. The major components of this increase were \$165,000 of increased compensation costs (including the salaries of two new sales and marketing executives), \$125,000 of production costs for our new print advertising campaign, and \$94,000 of increased costs associated with our Hong Kong subsidiary. During the first quarter of 2003, we incurred production costs for our new print advertising campaign. We spent approximately \$350,000 during the three months ended June 30, 2003 to place our new print advertisement in the fashion magazines InStyle, Elle, Vanity Fair, and Vogue. We expect to spend approximately \$150,000 in advertising production costs for this program in the third quarter of 2003, and we have committed to spend approximately \$700,000 in the fourth quarter of 2003 for fashion magazine and billboard advertising. We intend for our advertising to support an aggressive schedule of distribution tests by various jewelry chains. This advertising, in each instance, will identify available retail locations for moissanite jewelry.

General and administrative expenses were \$1,186,201 for the six months ended June 30, 2003 compared to \$1,339,275 for the six months ended June 30, 2002, a decrease of \$153,074 or 11%. As a percentage of sales, these expenses decreased to 14% from 16% in the same period of 2002. The decrease was primarily caused by decreased compensation costs of \$170,000. The decreased compensation costs are attributable to \$175,000 of costs recorded in 2002 for our Executive Compensation Plan. This plan is effective for 2003; however, no costs were recorded in the six months ended June 30, 2003 as the Company has not met its 2003 internal sales and profit goals.

Research and development expenses were \$7,592 for the six months ended June 30, 2003, and there were no expenses for the six months ended June 30, 2002. We suspended development efforts with Cree effective January 1, 2001 and terminated our Development Agreement with Cree effective December 31, 2002. During 2003, we will expend minimal resources on research and development as we maintain our focus on increasing sales and profitability.

Net interest income was \$63,909 for the six months ended June 30, 2003 compared to \$102,755 for the six months ended June 30, 2002, a decrease of \$38,846 or 38%. This decrease resulted from a lower interest rate earned on our cash balances.

Income tax expense was \$836,422 for the six months ended June 30, 2003. No income tax expense was recorded during the six months ended June 30, 2002. As a result of sustained profitability in 2001 and 2002, we recorded a one-time \$6.7 million non-operating and non-cash addition to earnings in the fourth quarter of 2002 to reflect the expected future tax benefits from our deferred tax assets (primarily our net operating loss carryforwards). Recognition of this asset has resulted in the recording of income tax expense in each quarter of 2003. However, U.S. federal income tax payments will only resume once the tax net operating loss carryforwards (\$16.0 million at December 31, 2002) have been completely utilized or if alternative minimum taxes are applicable. Pro forma amounts are shown below to compare net income in 2003 vs. 2002 as if we had recorded U.S. income tax expense during 2002 utilizing an effective tax rate of 38% of U.S. taxable income. Management believes that this pro forma information is useful to investors in comparing results of operations on a U.S. tax equivalent basis.

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	Six months ended June 30,	
	2003	2002
As reported:		
Income before income tax expense	\$1,871,104	\$1,137,997
Income tax expense	836,422	—
Net income	\$1,034,682	\$1,137,997
Net income per diluted share	\$ 0.08	\$ 0.08
	Six months ended June 30,	
	2002	
Pro Forma:		
Income before income tax expense		\$1,137,997
Income tax expense (38% of U.S. taxable income)		520,244
Net income		\$ 617,753
Net income per diluted share		\$ 0.05

Liquidity And Capital Resources

At June 30, 2003, we had \$12.4 million of cash and cash equivalents and \$37.3 million of working capital. Cash and inventory account for over 90% of our current assets. Our principal sources of liquidity are cash on hand and cash generated by operations. During the six months ended June 30, 2003, we used \$86,588 of cash to fund operations. The major components of the cash used were a \$1,553,798 increase in inventory and a decrease in accrued payroll of \$543,598, offset by pretax income of \$1,871,104. In addition, we used \$121,843 of cash for capital expenditures. The increase in inventories was primarily due to \$3.5 million in raw material purchases during the six months ended June 30, 2003, as described below. The decrease in accrued payroll was primarily due to the payment of executive bonuses earned in 2002 and paid in 2003.

In October 2002, our Board of Directors authorized a follow-on repurchase program for up to 1,100,000 shares of the Company's common stock. At the discretion of management, the repurchase program can be implemented through open market or privately negotiated transactions at prices at or below prevailing prices. The Company will determine the time and extent of repurchases based on its evaluation of market conditions and other factors. During the three months ended June 30, 2003, we repurchased 83,000 shares of common stock at an average cost of \$4.35 per share. Of this amount, 50,000 shares were repurchased from an affiliate of Chester L.F. Paulson at a purchase price of \$4.35 per share. During the six months ended June 30, 2003, we repurchased 163,300 shares of common stock at an average cost of \$4.58 per share. Of this amount 100,000 shares were purchased from an affiliate of Chester L. F. Paulson, at an average purchase price of \$4.58 per share. Chester L. F. Paulson was a director of the Company from May 2001 through May 2003. He is no longer a director of the Company.

In August 2002, we agreed with Cree on a framework for purchases through September 2007. We are obligated to purchase a minimum quantity of usable material on a quarterly basis if Cree meets certain minimum quality levels. For each quarter through September 2007, we have committed to purchase between \$504,000 and \$2,016,000 of raw material depending upon the quality of material received. If Cree's material quality is consistent with that received in 2002 and thus far in 2003, which was better than the quality produced in previous years, future purchases are expected to be at the high end of this range. If we do not meet the minimum quarterly purchase commitment, we will be obligated to pay Cree an unused capacity charge for the idle crystal growers. This charge will not be greater than \$110,000 in any given quarter. During the three and six months ended June 30, 2003, we purchased \$1.4 million and \$3.5 million of raw material from Cree, respectively.

Newly Adopted Accounting Pronouncements

In August 2001, Statement of Financial Accounting Standards (FAS) No. 143, *Accounting for Asset Retirement Obligations*, was issued. This statement requires recording the fair value of a liability for an asset retirement obligation in the period in which it is incurred and a corresponding increase in the carrying value of the related long-

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lived asset. Over time, the liability is accreted to its present value each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, it is either settled for its recorded amount or a gain or loss upon settlement is recorded. FAS 143 is effective for our year ended December 31, 2003. We do not have any asset retirement obligations and the adoption of this statement did not have an effect on our unaudited condensed consolidated financial statements.

In April 2002, FAS No. 145, *Rescission of FAS Statements No. 4, 44, and 64, Amendment of FAS No. 13, and Technical Corrections*, was issued. This statement is effective for our year ended December 31, 2003. This statement rescinds the requirement that all gains and losses from extinguishment of debt be classified as extraordinary items. The adoption of FAS 145 did not have a material effect on our unaudited condensed consolidated financial statements.

In July 2002, FAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, was issued. This statement requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. FAS 146 is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The adoption of FAS 146 did not have a material effect on our unaudited condensed consolidated financial statements.

In January 2003, FAS Interpretation No. 46, *Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51*, was issued. This interpretation provides guidance related to identifying variable interest entities (previously known as special purpose entities or SPEs) and determining whether such entities should be consolidated. This interpretation must be applied immediately to variable interest entities created or obtained after January 31, 2003. We do not have any variable interest entities and the adoption of this interpretation had no effect on our unaudited condensed consolidated financial statements.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Actual results could differ from those estimates. Our critical accounting policies have not changed from those disclosed in our Form 10-K for the year ended December 31, 2002, which was filed with the Securities and Exchange Commission on March 26, 2003.

Item 3: Quantitative and Qualitative Disclosures About Market Risk

We believe that our exposure to market risk for changes in interest rates is not significant because our investments are limited to highly liquid instruments with maturities of three months or less. At June 30, 2003, we had approximately \$11.8 million of short-term investments classified as cash and equivalents. All of our transactions with international customers and suppliers are denominated in U.S. dollars.

Item 4: Controls and Procedures

(a) Evaluation of disclosure controls and procedures

As of June 30, 2003, the Company's Chief Executive Officer and the Chief Financial Officer evaluated the effectiveness of the Company's disclosure controls and procedures in accordance with Rule 13a-15 under the Exchange Act. Based on their evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures enable the Company to record, summarize and report in a timely manner the information that the Company is required to disclose in its Exchange Act reports.

(b) Changes in internal control over financial reporting

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

Part II—Other Information**Item 1. Legal Proceedings**

C. Eric Hunter, one of the founders of the Company, and his wife, Jocelyn Hunter, filed suit against the Company and Jeff Hunter, the Company's former CEO and Eric Hunter's brother, on June 17, 2003 in the U.S. District Court for the Middle District of North Carolina. The plaintiffs allege fraud and other actionable conduct in violation of the Securities Act of 1933 as well as other unspecified federal laws and regulations, breach of contract, breach of fiduciary duty (with respect to defendant Jeff Hunter) and unfair and deceptive trade practices. In particular, among other claims, the plaintiffs allege that Jeff Hunter, acting as CEO of the Company, along with Neal Hunter, Chairman of Cree, Inc., entered into a "side agreement" between the Company and Cree, Inc. whereby the Company was compelled to take unlimited amounts of moissanite (also known as silicon carbide (SiC) crystals) from Cree, Inc., in an effort to artificially augment the operating income of Cree, Inc., and that the Company did not properly disclose the existence of such agreement. Plaintiff Eric Hunter also alleges that he is entitled to receive royalty payments under a license agreement between him and the Company concerning certain patents used in the manufacture of SiC crystals, and that the Company has failed to make such payments in breach of the agreement. The plaintiffs further allege that defendant Jeff Hunter has breached the fiduciary duty owed to the shareholders of the Company. Finally, the plaintiffs allege that each of the foregoing transactions were unfair business acts in or affecting commerce, in violation of N.C. Gen. Stat. Section 75-1.1. The plaintiffs seek personally to recover damages of \$10 million (with interest) from the defendants for the securities fraud and related claims, an amount from the defendants to be proven at trial (with interest) for the breach of contract claim, \$10 million along with unspecified punitive damages from defendant Jeff Hunter for the alleged breach of fiduciary duty and other misconduct, and \$10 million along with treble damages from defendants for the alleged unfair and deceptive trade practices, as well as costs and expenses related to the litigation including reasonable attorneys' fees.

The Company's position in the litigation is that it has properly disclosed all agreements it has with Cree, Inc. and has conducted its business properly. Since many of the allegations against the Company are vague and the suit is in an early stage, it is premature to speculate on the duration or the costs of the litigation. While the Company will seek to minimize the inevitable costs and distractions that occur from being involved in any litigation, the Company will vigorously defend this suit.

The plaintiffs have also filed a separate lawsuit naming Cree, Inc. and Neal Hunter as defendants, in the same court.

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

The Annual Meeting of Shareholders of Charles & Colvard Ltd. was held on May 12, 2003. At the meeting, the shareholders voted on the election of directors and the ratification of the selection of independent auditors. The following five nominees were each elected to the Board for a one-year term: Walter J. O'Brien, Jr., Frederick A. Russ, Robert S. Thomas, George A. Thornton III, and Laura C. Kendall. Additionally, the appointment of Deloitte & Touche LLP as independent auditors for the Company for the fiscal year ending December 31, 2003 was ratified. The number of votes cast for, against or withheld, as well as the number of abstentions, for each proposal are as follows:

A. Election of Directors

Director Nominee	Votes For	Votes Withheld
Walter J. O'Brien, Jr.	11,141,293	1,574,222
Frederick A. Russ	11,476,861	1,238,654
Robert S. Thomas	12,190,305	525,210
George A. Thornton III	12,657,091	58,424
Laura C. Kendall	12,652,105	63,410

B. Ratification of Appointment of Deloitte & Touche LLP as auditors for fiscal year ending December 31, 2002.

	Votes For	Votes Against	Abstentions
Ratification of Appointment of Deloitte & Touche LLP	12,698,599	7,074	9,842

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Item 6: Exhibits and Reports on Form 8-K

(a) Exhibits

<u>Exhibit No.</u>	<u>Description</u>
10.58	Amendment to Severance and Consulting Agreement dated as of May 31, 2003 between Charles & Colvard, Ltd. and Jeff N. Hunter, filed together with the Severance and Consulting Agreement dated as of May 15, 2000 between Charles & Colvard, Ltd. and Jeff N. Hunter.
31.1	Certification of Principal Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Principal Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) of the Exchange Act, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

During the quarter ended June 30, 2003, the Company filed the following report on Form 8-K:

On April 16, 2003, a Form 8-K was furnished under Item 9 to report, pursuant to Item 12, the Company's financial results for the first quarter of 2003.

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Signatures

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

Charles & Colvard, Ltd.

Date: August 11, 2003

/s/ Robert S. Thomas

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

Date: August 11, 2003

/s/ James R. Braun

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

AMENDMENT TO SEVERANCE AND CONSULTING AGREEMENT

This AMENDMENT TO SEVERANCE AND CONSULTING AGREEMENT (the "Amendment") is made effective as of the 31st day of May, 2003 by and between Charles & Colvard, Ltd. (the "Company") and Jeff N. Hunter (the "Consultant").

RECITALS:

The Company and the Consultant entered into a Severance and Consulting Agreement effective as of the 15th day of May, 2000 (the "Agreement") which shall terminate pursuant to its terms as of the close of business on May 31, 2003. The Company desires to continue retain the services of the Consultant and the Consultant desires to continue to provide services pursuant to the terms of such Agreement to the Company.

In consideration for the mutual agreements set forth herein and other valuable consideration, the receipt of which the parties hereto acknowledge, the parties agree as follows:

1. Extension of Term. The Term of the Agreement shall be extended from the close of business May 31, 2003 through and including the close of business on December 31, 2004 (which for all purposes shall be referenced as the "Term"). Prior to the termination of the Term, the parties agree to negotiate for an additional extension of the Agreement. In all other respects the Company and the Consultant reaffirm the existence and validity of the Agreement, subject to this Amendment.

2. Cancellation of Certain Options: The Consultant hereby surrenders, cancels and terminates the option to purchase 70,000 shares at \$15.00 per share which was granted pursuant to the Option Agreement between the Company and the Consultant dated November 19, 1997, and all rights related to such grant. The Consultant represents and warrants that he has full power and authority to surrender for cancellation said grant of options and that said options are free and clear of all security interests, liens, restrictions, charges, encumbrances, conditional sales agreements or other obligations relating to the sale or transfer thereof.

3. Continuation of Non-Disclosure and Non-Competition Agreement. The Company and the Consultant reaffirm the existence and validity of the Non-Disclosure and Non-Competition Agreement dated as of June 22, 2000 entered into pursuant to the Agreement and the continuing agreement of the parties to be bound thereto pursuant to its terms.

IN WITNESS WHEREOF, the parties hereto acknowledge their agreement to be bound by the terms of this Amendment as of the date and year first above written.

COMPANY:

CHARLES & COLVARD, LTD.

By: /s/ Robert S. Thomas

 Robert S. Thomas, President
CONSULTANT:

/s/ Jeff N. Hunter

 Jeff N. Hunter

SEVERANCE AND CONSULTING AGREEMENT

THIS SEVERANCE AND CONSULTING AGREEMENT (the "Agreement"), made effective as of the 15th day of May, 2000, by and between Charles & Colvard, Ltd. (the "Company"), and Jeff N. Hunter (the "Consultant").

RECITALS:

The Company is engaged in the business of designing, developing, manufacturing and selling lab-created moissanite jewels (the "Business"). The Consultant served as Chairman and Chief Executive Officer for the Company pursuant to an Employment Agreement dated June 1, 1997, as amended (the "Employment Agreement"). Consultant has resigned from such position effective May 15, 2000. The Company and the Consultant desire to settle certain outstanding issues between the parties related to the resignation of his employment. Additionally, the Company wishes the Consultant to assist the Company by providing consulting services for the Business related to the Consultant's extensive knowledge of the history and development of moissanite and the development of Charles & Colvard created moissanite jewels and to manufacturing, marketing and sales for moissanite jewels, and the Consultant desires to provide such services to the Company on the terms and for the compensation set forth herein.

NOW, THEREFORE, the parties hereto agree as follows:

1. SEVERANCE. The Company will provide Consultant with the following severance compensation and benefits:
 - a. Salary. The Company agrees to pay Consultant's current salary through May 31, 2001. Payments will be made on the Company's regular payday and will be subject to normal withholding for taxes.
 - b. Health Benefits. The Company will continue to provide health insurance coverage to Consultant and his family until May 31, 2001 on the same terms as were in effect prior to Consultant's resignation from employment with the Company or the same terms as may come into effect for other employees of Company in the event that Company changes or modifies its plan. Consultant's COBRA rights to continuation of health insurance coverage shall commence effective June 1, 2001.
 - c. Immediate Vesting of Existing Options. The Consultant has been previously granted options to purchase an aggregate of 259,240 shares of the Company's Common Stock pursuant to the 1996 Stock Option Plan of C3, Inc. and the 1997 Omnibus Stock Plan of C3, Inc. Of such options, the Company acknowledges that 229,240 have fully vested prior to the date of this Agreement and the remaining 30,000 have future vesting dates and shall continue to be governed by the terms of the applicable stock option agreement and plan.
 - d. Computer Equipment. Consultant will be entitled to ownership of the computer equipment assigned to him by the Company as of May 14, 2000.

- e. Administrative Support. The Company agrees to provide Consultant with reasonable administrative support services for 90 days following the execution of this Agreement.
2. **NONDISPARAGEMENT**. The Company and Consultant agree not to disparage or comment negatively about each other and further agree not to make any statements that would reflect unfavorably or negatively on each other.
3. **CONSULTING ENGAGEMENT**. The Company hereby engages the Consultant as a nonexclusive consultant to perform the Services (as defined below) subject to the terms and conditions of this Agreement, and the Consultant hereby accepts such engagement for and in consideration of the compensation hereinafter provided in paragraph 9 and agrees to use his best efforts performing the Services. The Consultant shall perform his obligations hereunder in compliance with the terms of this Agreement and any and all applicable laws and regulations. The Consultant acknowledges that this is a nonexclusive engagement by the Company and that the Company retains the right to appoint additional consultants as the Company, as in its sole and unrestricted judgment it may from time to time determine to be in the best interests of the Company, without liability or obligation to the Consultant.
4. **SERVICES**.
 - a. The Consultant agrees that, at the request of the Company, the Consultant shall (i) provide consulting services related to the development of manufacturing processes, marketing and sales related to the Consultant's extensive knowledge of the history and development of moissanite and the development of Charles & Colvard created moissanite jewels and moissanite gemstones for the Company and (ii) perform other duties related thereto as the Company may determine from time to time (the "Services"). The Consultant warrants to the Company that the Services will be performed in a professional, timely and workmanlike manner.
 - b. The Consultant shall execute a Nondisclosure and Noncompetition Agreement in substantially the form attached hereto as Exhibit A concurrent with the execution of this Agreement (the "Nondisclosure and Noncompetition Agreement").
5. **LICENSES; TOOLS AND MATERIALS**. The Consultant shall be responsible for obtaining, at the Consultant's own expense, all licenses, permits and bonds as may be required by any federal, state or local law or regulation for the performance of the Consultant's duties hereunder. The Company shall be responsible for supplying at its cost all necessary tools and materials to be used by the Consultant.
6. **LIMITATIONS**. Nothing in this Agreement shall be construed to give the Consultant authority to represent the Company before any court or governmental or regulatory agency without the express prior written authorization of the Company. In addition, all files, books, accounts, records and other information of any nature, however recorded or stored, and related to the Company (the

“Records”) shall at all times belong to the Company and to the extent possessed by the Consultant hereunder, such possession shall be for the benefit of and as agent for the Company. The Consultant’s possession of the Records is at the will of the Company and is solely for the purpose of enabling the Consultant to perform his obligations hereunder. The Records shall be readily separable from the records of the Consultant.

7. **TERM.** The term of this Agreement shall commence on May 31, 2000 and shall continue thereafter through and including the close of business on May 31, 2003 (the “Term”). Notwithstanding the foregoing, the Company may terminate this Agreement for “cause,” as defined herein, by giving written notice at least 30 days in advance of its desire to terminate this Agreement for cause. The Company shall be deemed to have cause for terminating the Consultant’s engagement in the event the Consultant (i) demonstrates any dishonesty or engages in any act of moral turpitude, (ii) improperly performs or fails to perform the Services described herein, (iii) causes intentional damage to substantial property of the Company, or (iv) is unable to perform the Services because of death or a disability which renders him unable to perform the Services for 30 consecutive calendar days.

8. **MUTUAL RELEASE.**

- a. **Release by Consultant.** The Consultant (and any of his respective heirs, agents or assigns) does hereby remise, release and forever discharge the Company and its officers, directors, shareholders, predecessors, successors, agents, counsel, trusts and assigns from any and all rights, actions, suits, debts, sums of money, accounts, causes of action, claims (however and whenever arising and whether in law or equity, and whether arising under statutory or common law of the United States or any state thereof), demands or damages of any kind (whether actual, punitive, compensatory, double, treble or nominal and whether known or unknown) arising prior to the date of this Agreement and related in any way to Consultant’s previous relationship with the Company, all to the end that any and all matters and things which are or might have been claimed now or in the future by the Consultant against the Company pursuant to any previous events that may have occurred or may occur in connection with the subject matter of their previous relationship or any prior contracts or agreements of any kind whatsoever between the Consultant and the Company are forever barred and put to rest. In addition and not in limitation of the foregoing, the Consultant does hereby release and extinguish any and all claims the parties hereto may have against the Company of any kind whatsoever prior to the execution of this Agreement.

The Consultant acknowledges that he has carefully read and reviewed this Agreement (including this paragraph 8 entitled “Mutual Release”) and has hereby been advised in writing to seek, and he has sought and received, the advice of his attorney, Larry Robbins, or other counsel, and he has had a period of 21 days within which to consult with and receive counsel from

his attorney concerning the terms of this Agreement. The Consultant and the Company understand and are satisfied with the terms and contents of this Agreement and each has signed his or its name to the same as a free act and deed, and each agrees that it shall be binding upon them and their agents, attorneys, personal representatives, heirs and assigns. The Consultant has seven (7) days following the date that he executes this Agreement (the "Revocation Period") to revoke it by notifying the Company in writing of his decision to revoke. Payments will begin to be made to Consultant pursuant to this Agreement within five (5) business days after the expiration of the Revocation Period.

- b. Release by Company. The Company does hereby remise, release and forever discharge the Consultant from any and all rights, actions, suits, debts, sums of money, accounts, causes of action, claims (however and whenever arising and whether in law or in equity, and whether arising under statutory or common law of the United States or any state thereof), demands or damages or any kind (whether actual, punitive, compensatory, double, treble or nominal, and whether known or unknown) arising prior to the date of this Agreement and related in any way to Consultant's previous relationship with the Company, all to the end that any and all matters and things which are or might have been claimed now or in the future by the Company against the Consultant pursuant to any previous events that may have occurred or may occur in connection with the subject matter of their previous relationship or any prior contracts or agreements of any kind whatsoever between the Consultant and the Company are forever barred and put to rest. In addition and not in limitation of the foregoing, the Company does hereby release and extinguish any and all claims the parties hereto may have against the Consultant of any kind whatsoever prior to the execution of this Agreement.
9. **FEES.** As compensation for the performance of the Services, concurrently with the execution of this Agreement, the Company and the Consultant shall execute the Nonqualified Stock Option Agreement dated May 15, 2000, attached hereto as Exhibit B, which grants to Consultant the option to purchase 40,000 shares of common stock upon the terms and conditions set forth therein and in the Company's 1997 Omnibus Stock Plan. No amounts (including, without limitation, social security, federal and state withholding taxes) shall be withheld or otherwise subtracted from the compensation paid to the Consultant pursuant to this Section 9 unless required by law. In addition, the Consultant shall be reimbursed for all expenses incurred by the Consultant on behalf (and with the prior written authorization) of the Company within 15 days from the date the Consultant delivers an itemized report of such expenses, together with receipts or other evidence of payment reasonably satisfactory to the Company and its accountant.
10. **INDEMNIFICATION.** The Consultant shall defend, release, indemnify and hold the Company and its directors, officers, shareholders, employees and agents and the personal representatives and assigns of each, harmless from and against any and all claims, suits, liability, costs and expenses, including, without limitation,

attorneys' fees and expenses, in connection with any act or omission of the Consultant, his employees and/or agents which arise from the provision of the Services.

11. INSURANCE REPRESENTATIONS; WORKPLACE SAFETY. Consultant shall be solely responsible for workplace safety, shall maintain the workplace in accordance with industry standards and shall comply with all governmental (including federal, state and local) regulations. If Consultant hires employees, then Consultant agrees to maintain worker's compensation insurance in such amount and with such carrier as the Company may reasonably request.
12. NOTICES. All notices, demands, requests or other communications which may be or are required to be given, served or sent by one party to the other party pursuant to this Agreement shall be in writing and shall be hand delivered or mailed by certified mail return receipt requested, postage prepaid, or sent by telefax, addressed as follows:

If to the Company:

P.O. Box 13533
Research Triangle Park, NC 27709
Attention: Mark W. Hahn, Chief Financial Officer
Telecopy: (919) 468-5052

With a copy to:

Cyrus M. Johnson, Esq.
3300 One First Union Center
301 South College Street
Charlotte, NC 28202-6025
Telecopy: (704) 338-7809

If to the Consultant:

Jeff N. Hunter
1923 Myron Drive
Raleigh, NC 27607
Telecopy: (919) 510-5095

With a copy to:

Larry Robbins, Esq.
Wyrick Robbins Yates & Ponton LLP
4101 Lake Boone Trail, Suite 300
Raleigh, NC 27607
Telecopy: (919) 781-4865

Each party may designate by notice in writing a new address to which any notice, demand, request or communication may thereafter be delivered, given or sent. Documents delivered by hand shall be deemed to have been received upon delivery; documents sent by telefax shall be deemed to have been received when the answer back is received; and documents sent by mail shall be deemed to have

been received upon their receipt or at such time as delivery is refused by the addressee upon presentation.

13. SECURITY. The Consultant agrees that he will at all times comply with all security regulations in effect from time to time at the Company's premises or applicable outside such premises to materials belonging to the Company. The Consultant agrees not to use or disclose to any party any information, systems, equipment, ideas, processor or methods of operation observed in connection with the performance of his obligations hereunder, except as may be required by law.
14. INDEPENDENT CONTRACTOR.
 - a. Acknowledgment by the Consultant. The Consultant acknowledges and agrees that the Consultant will be treated, vis-a-vis the Company, as an independent contractor and not as an employee, agent or authorized representative of the Company. The Consultant shall have no authority to bind the Company to any contract, agreement or obligation whatsoever. The acts of the Consultant shall in no way constitute the acts of the Company, and the Consultant shall not represent to any third party that the Consultant has any express or implied authority to bind the Company to any such contract, agreement or obligation.
 - b. Tax Matters. Because the Consultant is an independent contractor, the Company will not withhold from any compensation paid to the Consultant any amounts for federal or state income taxes, or social security (FICA) for the Consultant, nor will the Company pay any social security or unemployment tax with respect to the Consultant. Such taxes are the responsibility of the Consultant. The Consultant agrees to indemnify and hold the Company (including its employees, officers, directors, agents, subsidiaries or affiliates) harmless, and hereby indemnifies and hold the Company harmless, from and against any damage, claim, assessment, interest charge or penalty incurred by or charged to the Company as a result of any claim, cause of action or assessment by any federal or state government or agency for any nonpayment or late payment by the Consultant of any tax or contribution based upon compensation paid hereunder or because the Company did not withhold any taxes from compensation paid hereunder.
 - c. No insurance. Consistent with the Consultant's status as an independent contractor, the Company will not provide the Consultant with any company, individual or group insurance policy or any other kind of insurance coverage whatsoever in exchange for the Services.
15. ASSIGNMENT AND SUCCESSORS. Neither this Agreement or any interest herein or any rights hereunder shall be sold or assigned by the Consultant, nor shall any of the duties of the Consultant hereunder be delegated to any person, firm or corporation, without prior notice to and consent of the Company. Subject to the preceding sentence, this Agreement will apply to, be binding in all respects upon, and inure to the benefit of the successors and permitted assigns of the parties.

16. **INTELLECTUAL PROPERTY.** Consultant acknowledges the importance to the Company of its intellectual property. Consultant agrees to cooperate with the Company in any adversary proceeding challenging the scope or validity of the Company's intellectual property position. Consultant also acknowledges that copyrightable works prepared by him within the scope of this Agreement are "works for hire" under the Copyright Act and that the Company will be considered the author of these works. Consultant agrees that all work product that (a) are developed within the scope of this Agreement using equipment, supplies, facilities or trade secrets of the Company, (b) result from work performed by the Consultant for the Company within the scope of this Agreement, or (c) are developed within the scope of this Agreement and relate to the Company's business or current or anticipated research and development, will be the sole and exclusive property of the Company and are assigned by Consultant to the Company by this Agreement.

The Company agrees that, in connection with any retail sales of Charles & Colvard created moissanite jewels that Consultant may sell directly to consumers after the execution of this Agreement and pursuant to the exclusion of the noncompetition provisions of the Nondisclosure and Noncompetition Agreement, Consultant may develop proprietary information including but not limited to trademarks, trade secrets, and copyrighted materials, and that such proprietary information shall be owned exclusively by Consultant; provided, however, that for such proprietary information developed during the Term of this Agreement, Company shall be granted a perpetual nonexclusive license to use and sublicense any such proprietary information in consideration of the compensation paid to Consultant pursuant to this Agreement.

17. **STANDARD OF CARE.** The Consultant warrants that he will exercise due diligence to performance Services in a professional manner in compliance with all applicable laws and regulations and the highest ethical standards. In addition, the Consultant represents and warrants that any information which he may supply the Company during the term of this Agreement (i) will have been obtained by the Consultant lawfully and from publicly available sources and (ii) will not be confidential or proprietary to any third person. Nothing in this Agreement shall be construed as authorizing or encouraging the Consultant to obtain information for the Company in violation of any third party's rights to copyright or trade secret protection.

18. **MISCELLANEOUS.**

- a. The provisions of this Agreement may be waived, altered, amended or repealed, in whole or in part, only on the written consent of the Company and the Consultant.
- b. Section headings and numbers used in this Agreement are included for convenience of reference only, and, if there is any conflict between any such numbers and headings and the text of this Agreement, the text shall control. Each of the statements set forth in the premises of this Agreement is incorporated into the Agreement as a valid and binding representation of the party or parties to whom it relates.

- c. This Agreement shall be governed by and construed in accordance with the laws of the State of North Carolina without reference to the choice of law principles thereof. If any dispute arises hereunder, the parties hereto agree that any suit brought by either party shall be heard in the courts of North Carolina or any federal court sitting in North Carolina, and the parties hereto consent to the jurisdiction of such courts.
- d. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.
- e. This Agreement, together with the Stock Option Agreement and the Nondisclosure and Noncompetition Agreement herein referenced represent the entire agreement of the parties with respect to the subject matter hereof and supersede in their entirety any and all prior written or oral agreements with respect thereto including but not limited to the Employment Agreement and the Summary of Material Terms dated May 15, 2000.
- f. Neither party shall have the right under this Agreement to use the name, trademark or trade names of the other, unless prior written approval has been obtained. Any such approval or authorization shall cease upon termination of this Agreement.

IN WITNESS WHEREOF, the duly authorized representations of the parties have executed this Severance and Consulting Agreement as of the date and year first above written.

COMPANY

Charles & Colvard, Ltd.

By: /s/ Mark W. Hahn

Mark W. Hahn, Chief Financial Officer

CONSULTANT

/s/ Jeff N. Hunter

Jeff N. Hunter

I, Robert S. Thomas, certify that:

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

August 11, 2003

/s/ Robert S. Thomas

Robert S. Thomas
President & Chief Executive Officer

I, James R. Braun, certify that:

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

August 11, 2003

/s/ James R. Braun

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

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

In connection with the Quarterly Report of Charles & Colvard, Ltd. (the "Company") on Form 10-Q for the period ending June 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert S. Thomas, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ Robert S. Thomas

Robert S. Thomas
President and Chief Executive Officer
August 11, 2003

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

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

In connection with the Quarterly Report of Charles & Colvard, Ltd. (the "Company") on Form 10-Q for the period ending June 30, 2003 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James R. Braun, Vice President of Finance and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that:

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

/s/ James R. Braun

James R. Braun
Vice President of Finance and Chief Financial Officer
August 11, 2003

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