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

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**FORM 10-K**

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(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, 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

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**Charles & Colvard, Ltd.**

(Exact name of Registrant as specified in its charter)

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**North Carolina**  
(State or other jurisdiction of incorporation)

**56-1928817**  
(I.R.S. Employer Identification No.)

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

**27560**  
(Zip Code)

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

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

None

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

Common Stock, no par value per share

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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 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 an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes  No .

The aggregate market value of the voting stock held by non-affiliates of the Registrant as of June 30, 2003 was \$47,088,484.

On February 27, 2004, there were 13,214,281 outstanding shares of the Registrant's common stock.

**DOCUMENT INCORPORATED BY REFERENCE**

Certain portions of the Proxy Statement of the Registrant for the Annual Meeting of Shareholders to be held on May 11, 2004 have been incorporated by reference into Part III of this Annual Report on Form 10-K.

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## FORWARD LOOKING STATEMENTS

*This Annual Report on Form 10-K contains forward-looking statements that relate to any plans, objectives, estimates and goals. Words such as “expects,” “anticipates,” “intends,” “plans,” “believes” and “estimates” and variations of such words and similar expressions identify such forward-looking statements. Our business is subject to numerous risks and uncertainties, including our ability to manage growth effectively, our limited operating history, our dependence on continued growth and consumer acceptance of our products, any trends in the general economy that would adversely affect consumer spending, limited distribution channels, risks of conducting significant operations in foreign countries and our dependence on third parties. These and other risks and uncertainties, many of which are addressed in more detail below in the sections entitled “Business Risks” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” could cause our actual results and developments to be materially different from those expressed or implied by any of these forward-looking statements.*

### Part I

#### ITEM 1. BUSINESS

##### Introduction

We are Charles & Colvard, Ltd., a North Carolina corporation that manufactures, markets and distributes Charles & Colvard created moissanite jewels (also called moissanite or moissanite jewels) 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, we are creating 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.

Our moissanite jewels are made from SiC crystals grown by Cree, Inc. Cree has an exclusive license to a patent related to a process for growing large single crystals of SiC. We know of no other producers of SiC that could currently supply lab-grown SiC crystals in qualities, sizes or volumes suitable for use as moissanite jewels. We have certain exclusive licenses and supply rights with Cree for SiC materials to be used for gemstone applications.

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. At that time, we launched limited consumer-focused advertising and promotion activities.

Through the first half of 1999, we limited our efforts to expand the distribution of moissanite jewels as a result of insufficient product availability and our lack of confidence in the quality of the SiC crystals we were receiving. Late in the second quarter of 1999, we began to receive indications that the quality of the SiC crystals was improving rapidly. The rate of improvement in the quality of the SiC crystals continued to accelerate through the end of 1999, far exceeding our expectations. At the same time, we experienced a decline in sales of moissanite jewels during the third quarter of 1999.

The improved supply of SiC crystals along with the decrease in sales led to a significant increase in inventories of moissanite jewels. Inventory increased to \$23.1 million at December 31, 2000 from \$14.8 million at December 31, 1999. During 2001 and 2002, we purchased \$1.2 million and \$5.5 million of raw materials, respectively. In 2003, raw material purchases increased to \$6.0 million to accommodate our need for additional inventory of selected shapes and sizes and to support anticipated growth. With our growth in sales, inventory increased \$1.0 million from December 31, 2000 to December 31, 2003.

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With the improvements in the supply of saleable moissanite jewels, we launched our strategic global marketing program in the fourth quarter of 1999 to spur consumer awareness of moissanite jewels. Primarily as a result of our investment in this program, our net losses were \$5.2 million and \$7.1 million in 1999 and 2000, respectively, as inventories increased to \$23.1 million at December 31, 2000 and cash equivalents decreased to \$3.8 million at December 31, 2000. During 2000, the Company's current Chief Executive Officer was elected and a number of strategic sales, marketing and financial steps were taken. On February 21, 2001, the Company completed a rights offering of common stock to its shareholders at \$1 per share, raising net proceeds of approximately \$6.0 million. During 2001, the global marketing program was refocused to emphasize use of public relations activities to increase consumer brand awareness while reducing higher cost print and media advertising. In addition, 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 and phased out of the direct sales to retail jewelers. 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, our goal is to rapidly increase the introduction of moissanite into the domestic jewelry market while maintaining average selling prices.

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 Far Eastern markets. The importance of having a presence in this market is twofold; Hong Kong is the headquarters city for a very large number of jewelry manufacturing companies with sales and distribution worldwide, and Hong Kong is the gateway to the markets of Mainland China. To enhance our presence in this market, we established a Charles & Colvard controlled company in China in August 2003.

Our significant investments in our branding program and in developing our manufacturing and operational infrastructures during the fourth quarter of 1999 and through 2000 were in anticipation of future significant and rapid growth. During 2000, we restructured our operations to reduce our overall general and administrative expense levels in order to conserve cash and attempt to position the Company to achieve profitability in the future. Additionally, mandatory research and development expenses under the Development Agreement with Cree were eliminated through termination of the Development Agreement.

Our strategy for 2001 was to become profitable during the year by achieving modest growth in sales while reducing marketing and advertising costs, maintaining our lower general and administrative expense levels and curtailing research and development expenses. We succeeded in achieving profitability and positive cash flow from operations in 2001, while sales declined by 10%. Our strategy for 2002 was to achieve sales growth, primarily in the domestic market, and to maintain profitability. We achieved both of those goals in 2002. The domestic distribution of moissanite expanded into additional retail stores and home shopping channels. Domestic sales increased from approximately 82% of total sales in 2001 to 86% of total sales in 2002. In 2003, we continued to expend the majority of our resources on the domestic market, which were 85% of total sales, while investing in certain international markets that we believe show the most long-term potential. We remained profitable during 2003, achieving our primary goal, on 4% sales growth. Our management believes that our current infrastructure and stage of product development can support a significant growth in sales. Our goal for 2004 is to increase sales while remaining profitable.

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### **The Jewelry Market\***

In 2003, the consumer market for fine jewelry sales in the United States was approximately \$45.0 billion. Worldwide jewelry sales have historically been 2.5 times greater than sales in the U.S.

*Diamond Jewelry.* In 2003, diamond jewelry sales in the U.S. were \$28.8 billion. Over 90% of the diamond jewelry pieces sold domestically used settings other than engagement rings (i.e., pendants, bracelets, other rings, earrings, etc.).

*Distribution Channels.* Traditionally, consumers have purchased jewelry through independent and chain jewelry stores and department stores. However, in the past two decades, non-traditional distribution channels such as catalog showrooms, mass-market discounters, price clubs, mail order, TV shopping channels and electronic commerce on the Internet have emerged. Moissanite is sold to consumers through single- and multiple-location independent jewelry stores, jewelry store chains, TV shopping channels and in catalogs.

\* Information in this section derived from [Rapaport Research Report](#).

### **Moissanite**

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

It is generally accepted that, in addition to carat size, the most important characteristics of a gemstone are beauty, durability and rarity. The beauty of a gemstone is determined by its color, brilliance, “fire” and luster. The brilliance of a gemstone is measured by its refractive index, or the extent, when coupled with the facet design, to which the gemstone reflects light. The “fire” of a gemstone, or the breaking of light rays into the spectrum of colors, is measured by its dispersion. Luster is the amount of light that is reflected back to the observer from the surface of the gemstone. The durability of a gemstone is determined by its hardness, or resistance to scratching, and its toughness, or resistance to chipping or cleaving. The gemstone’s hardness also determines the extent to which brilliance and “fire” can be highlighted by cutting with sharp, highly polished facets. Rarity is the availability or perceived availability of a gemstone.

Moissanite jewels have unique fire, brilliance, luster, durability and rarity. The refractive index and dispersion of moissanite jewels are higher than those found in other fine gemstones. We believe that the hardness of moissanite jewels is greater than all known gemstone materials except diamond. As a result, moissanite jewels, like diamond, can be cut with sharp, highly polished facets that accentuate their brilliance and “fire.” The cutting specifications for moissanite jewels are designed to maximize the brilliance and fire inherent in 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 very rare natural occurrence of moissanite and the proprietary and technical limitations in producing mass quantities of jewel quality moissanite, we believe that moissanite is among the rarest of jewels.

In addition, other physical properties of moissanite jewels compare favorably to fine gemstones and will aid in jewelers’ acceptance of our products. Moissanite jewels, like diamond, can withstand high temperatures, which allows jewelers to make extensive repairs to the jewelry setting without removing the jewel and to use the same basic methods that are used to repair diamond jewelry.

Because of its unique atomic structure, moissanite can be grown in a variety of colors including blue, green or yellow. Additionally, although none have been produced to date, the color red is theoretically possible to grow. To date, we have focused our development, manufacturing and distribution efforts on the colorless form of moissanite, although we have sold limited quantities of green moissanite.

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

Comparison Chart (1)

Description	Hardness (Mohs Scale) (2)	Toughness	Refractive Index	Dispersion	Specific Gravity
Diamond	10	Excellent*	2.42	.044	3.52
C&C Created Moissanite (3)	9.25-9.50	Excellent	2.65-2.69	.090-.104	3.14-3.22
Sapphire & Ruby	9	Excellent	1.76-1.78	.018	3.90-4.00
Emerald	7.5	Poor to Good	1.56-1.60	.014	2.69-2.75

\* Except in cleavage directions.

1. Sources: Gemological Institute Of America, Gem Reference Guide For The 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 891-906 (4<sup>th</sup> Ed. 1994); Institution Of Electrical Engineers, Properties Of Silicon Carbide (Gary L. Harris, Ed., 1995); Robert Webster, Gems: Their Sources, Descriptions and Identification 889-940 (5<sup>th</sup> Ed. 1994); W. Von Muench, "Silicon Carbide" in Landolt-Boemstein 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, 1999, 425-438; Kurt Nassau.
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 gemstones are approximately one-half to one-third as hard as diamond.
3. With the exception of the "Moissanite: A New Synthetic Gemstone Material" and "Synthetic Moissanite: A New Diamond Substitute" articles, the physical properties of moissanite jewels set forth in the preceding table utilized materials from SiC crystals produced by parties other than Cree or us. These crystals had various sizes, colors and atomic structures that we believe made them unsuitable for use as a gemstone. We have conducted tests on the hardness, toughness and refractive index of samples of our jewels, and the results of these tests are consistent with the results reported in this table.

### Products and Product Development

*Moissanite Jewels.* We primarily sell near-colorless moissanite jewels cut in a variety of shapes including round, princess, radiant, oval, marquise, heart, cushion, square brilliant, pear and trillion shapes in sizes ranging from 2 to 10mm (approximately .03 to 3.1 carats). We distribute a limited quantity of green moissanite jewels to evaluate the market potential of colored moissanite. We may elect to offer, from time to time, additional cuts, sizes and colors of moissanite jewels.

*Amended and Restated Exclusive Supply Agreement with Cree.* On June 6, 1997, we entered into an Amended and Restated Exclusive Supply Agreement (Exclusive Supply Agreement) with Cree pursuant to which we have agreed to purchase from Cree at least 50%, by dollar volume, of our SiC crystal requirements for the production of gemstones in each calendar quarter during the term of the Agreement and Cree has agreed to supply this amount of crystals to us. Although we are obligated to purchase only

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50% of our requirements from Cree, we do not believe there are currently any other alternative sources of supply for SiC crystals suitable for gemstones. Therefore, at the present time, we are dependent on Cree as our sole source of supply of lab-grown SiC crystals. Under the Exclusive Supply Agreement, Cree has agreed not to sell SiC crystals for gemstone applications to anyone other than us. In December 2003, we agreed with Cree on a framework for purchases during 2004. 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 during 2004, we have committed to purchase between \$400,000 and \$1,600,000 of raw material depending upon the quality of material received. If Cree's material quality is consistent with that received in 2003, which was better than the quality produced in previous years, future purchases are expected to be at the high end of this range. We purchased \$6.0 million of material during 2003.

Under the terms of the Exclusive Supply Agreement, when our orders for SiC crystals exceed the capacity of the existing crystal growth systems, Cree may, at its sole discretion, require us to purchase the additional growth systems needed or fund the cost of the systems on its own and recoup its costs by incorporating the costs of the additional systems into the cost of the SiC crystals. If we fund the costs of the crystal growth systems, Cree must use 100% of the output from these systems for our needs, unless the excess production exceeds our then-current needs, in which case Cree may sell such SiC crystals to any of its other customers for any use other than jewel applications. The title to these crystal growth systems passes to Cree once we have fully depreciated them. If Cree elects to fund the cost of additional growth systems on its own, we have no assurance that Cree will sell all of the output from these crystal growth systems to us or fill all of our orders, but Cree will be obligated to use the capacity to supply the quantities that we are required to purchase. Additionally, when Cree adds new crystal growth systems, we must commit to purchase all of the output of the new systems for at least six months. Any delay or reduction in the availability of SiC crystals could delay or limit our ability to deliver and sell our moissanite jewels, which would have a material adverse effect on our operating results.

The Exclusive Supply Agreement has an initial term through June 2005, which may be extended for an additional ten years by either party if an order threshold is met. We have met this order threshold and expect to extend the term of the Agreement.

The Exclusive Supply Agreement with Cree prohibits us, without Cree's consent, from entering into an exclusive marketing or distribution agreement with DeBeers or any party that Cree reasonably believes is affiliated with any of the following parties:

- DeBeers;
- the Central Selling Organization (the international cartel of diamond producers);
- any party whose primary business is the development, manufacture, marketing or sale of diamond gemstones; or
- any non-gemstone and non-jewelry industry competitor of Cree.

These provisions may limit our potentially available avenues of distribution and could prevent us from entering into certain potentially profitable transactions.

*Amended and Restated Development Agreement with Cree.* On July 1, 1998, we entered into an Amended and Restated Development Agreement (Development Agreement) with Cree in order to increase the yield of useable material in each SiC crystal manufactured by Cree for use in the production of moissanite jewels. In June 1998, Cree began to produce two-inch crystals, and in March 1999 Cree produced a three-inch crystal meeting mutually agreed upon volumes of useable material. A three-inch crystal can produce approximately twice as many moissanite jewels as a two-inch crystal with the same percentage yield of useable material. The Development Agreement established performance milestones,

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primarily focused on yield improvement, and contemplated that we, along with Cree, would revise the performance milestones annually to provide both parties with more flexibility to pursue further color and yield improvements on both two-inch and three-inch diameter crystals. Our funding obligations under the Development Agreement terminated on December 31, 2002. We did not spend any funds under the Development Agreement with Cree in the three years ended December 31, 2003.

*Moissanite/Diamond Test Instrument.* Jewelry industry employees commonly rely on gemstone test instruments using thermal properties to distinguish diamond from other gemstones or diamond simulants such as synthetic cubic zirconia. Because the thermal properties of moissanite jewels are relatively close to those of diamond, such instruments cannot reliably differentiate between diamond and moissanite jewels. Although gemologists trained in the physical properties of moissanite jewels may find a number of ways to distinguish moissanite from diamond, we believed that a moissanite/diamond test instrument had to be available to jewelers and pawnbrokers to help prevent fraud. We introduced our moissanite/diamond test instrument, the Tester Model 590, which distinguishes moissanite jewels from diamonds in the colors and clarities most commonly sold by retail jewelers. We have achieved our goal of assuring a reliable means for the jewelry industry to distinguish moissanite from diamond. Therefore, during 2002, we sold our entire tester inventory and licensed the related patents to a major customer, who will handle the future manufacture and distribution of testers.

*GeoLink.* On December 15, 2003, we announced that we entered into a Memorandum of Understanding (“MOU”) with GeoLink™ Technologies of Oxnard Shores, CA to supply faceted moissanite jewels and provide technical support to GeoLink™ through 2005 in connection with the use of moissanite jewels in its development and commercialization of pervasive mobile ultra-high capacity optical/laser phased array communications data-links. While testing is currently taking place for the government/military market, GeoLink™ is also working on adaptations and advances of this technology for the commercial, industrial and non-military governmental, and maritime markets.

The MOU gives GeoLink™ worldwide exclusive rights for the use of moissanite jewels for GeoLink’s application areas, while GeoLink™ has agreed to meet certain minimum annual moissanite purchasing requirements commencing in July 2004. While the required minimum purchases through 2005 are not material for Charles & Colvard, they do represent incremental sales and the opportunity for Charles & Colvard to add a new dimension to, and expand the scope of, its business. The MOU provides for the parties to negotiate a long-term supply agreement during the development phase of the relationship.

### **Intellectual Property**

*Intellectual Property of the Company.* 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 United States. We have pending applications for these same patents in a number of foreign jurisdictions. In addition, we have a U.S. apparatus and method patent for the Tester Model 590, expiring in 2016, that covers the physical structure and the testing techniques employed in the Tester Model 590. This patent gives us exclusive rights to manufacture and sell the Tester Model 590 in the United States. As discussed above, we sold our entire test instrument inventory in 2002 and do not expect to manufacture any additional test instruments. We also have other patents and patent applications pending related to certain methods of producing moissanite jewels and related technologies. In addition, we have certain trademarks and pending trademark applications that support the Charles & Colvard moissanite branding strategy. Although we intend to enforce our patent and trademark rights and vigorously prosecute all our patent applications, we cannot be sure that such actions will be successful, that any additional patents will be issued, that any issued patent will not be challenged, invalidated or circumvented or that any issued patent will have any competitive or commercial value.

Our success and our ability to compete successfully depends heavily upon our proprietary technology. In addition to our patents and pending patents, we rely on trade secret laws and employee, consultant and

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customer confidentiality agreements to protect certain aspects of our technology. We cannot be sure that we will be able to protect our proprietary technology from disclosure or that others will not develop technologies that are similar or superior to our technology.

While we have not received any claims that our products or processes infringe on the proprietary rights of third parties, we have no assurance that third parties will not assert such claims against us with respect to our existing and future products. 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.

*Proprietary Technology of Cree.* Cree, our current source for development and supply of lab-grown SiC crystals, has developed or licensed numerous proprietary processes for the growth of SiC crystals for use in semiconductor, laser and other applications. Our founders recognized the potential use of SiC as a moissanite jewel and obtained the exclusive right to purchase SiC crystals from Cree for moissanite jewels and gemological instrumentation. We believe that Cree is currently the only producer of SiC crystals in sizes and qualities suitable for commercial production of moissanite jewels. Cree has significant proprietary rights related to its processes for growing SiC crystals, including an exclusive license on a patent for a process of growing large single crystals of SiC. This patent expires in years ranging from 2006 to 2011, depending on the country in which issued. In addition, Cree has a patent for a process for growing colorless SiC and other patents relating to certain aspects of its SiC crystal growth process. To further protect its proprietary SiC crystal growth process, Cree internally produces the crystal growth systems used to produce its SiC crystals. We have a royalty-free, perpetual license to use the technology covered by Cree's colorless SiC patent in moissanite jewel applications.

We depend heavily for our success on Cree's technology and ability to successfully produce SiC crystals suitable for the production of Charles & Colvard created moissanite.

### **Manufacturing**

The production of moissanite jewels includes the following steps:

- growing SiC crystals;
- designing shapes with proportions unique to moissanite jewels;
- cutting crystals into preforms that will yield jewels of an approximate carat weight and millimeter size;
- faceting preforms into jewels; and
- inspecting, sorting and grading faceted jewels.

*Growth of SiC Crystals.* Cree grows SiC crystals for us in accordance with the terms of the Exclusive Supply Agreement. Under the Exclusive Supply Agreement, Cree is required to sell to us all of the crystals grown in a specified number of crystal growth systems without charging us for such crystal growth systems. In addition, Cree must sell to us all the crystals grown in the crystal growth systems acquired by us from Cree, unless Cree's capacity exceeds our then-current needs, in which case Cree may sell SiC crystals produced by these systems to any of its other customers for any use other than moissanite jewel applications. Currently, we are not using 100% of our available crystal growth capacity at Cree. We may increase our production capacity from Cree upon appropriate notice to Cree. If we order a quantity of crystals that will require Cree to acquire additional crystal growth systems, Cree may elect, in its sole discretion, to have us purchase the additional growth systems that will be needed or to fund the costs on its own and recoup its costs by incorporating the costs of the systems into the cost of the SiC crystals sold to us.



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We routinely evaluate the yield and quality of saleable moissanite jewels from SiC crystals being produced by Cree. The yield of saleable moissanite jewels from each crystal is the most significant factor affecting the volume and cost of moissanite jewels available for sale. Yield of saleable moissanite jewels is dependent on the quality of the crystals. Improvements in crystal quality increase the volume, or yield, of moissanite jewels from a crystal and decrease the cost of each moissanite jewel produced.

*Designing Shapes with Proportions Unique to Moissanite Jewels.* Maximizing the light reflected from a faceted moissanite jewel requires the design of shapes with unique proportions and angles. We create proprietary designs, using computer modeling, to display the maximum light reflection based on the optical properties (i.e., refractive index, dispersion and luster) of moissanite jewels. The first shape we developed applying these computer models was a unique version of the round brilliant cut. Most recently, we have designed castle, square brilliant and baguette shapes. We believe these proprietary designs are the basis for the superior optical performance quality observed in faceted moissanite jewels.

*Preforms.* We divide all SiC crystals through slicing and dicing processes into preforms in sizes suitable for faceting into predetermined calibrated-size moissanite jewels. We use readily available automated and computerized equipment along with proprietary technology developed in-house to slice and dice crystals into preforms. We believe that this equipment will enable us to maximize the number of preforms we can obtain from each SiC crystal.

*Faceting Moissanite Jewels.* The faceting of preforms is a critical stage in obtaining quality jewels. The techniques and skills used in faceting moissanite jewels differ somewhat from those used in faceting diamonds and other gemstones. We currently outsource the faceting of our moissanite jewels, other than faceting for research and product development purposes, which we conduct internally. We have two suppliers of volume faceting services, which are both located in Asia, and we have been satisfied with the capabilities and performance of these suppliers. During 2004, we intend to continue to outsource faceting services to these existing suppliers, and we will depend on their ability to provide an adequate quantity of quality faceted moissanite jewels. We cannot be sure that they will be able to continue to produce our quality specifications for faceting and meet our quantity and time requirements.

In 1997, we entered into a multi-year agreement with our primary supplier of faceting services, John M. Bachman, Inc. (JMB). Pursuant to this agreement and related amendments, we advanced \$380,000 to JMB to expand the production facilities of its affiliate which facets our moissanite jewel preforms. This advance was completely repaid in 2001. We have a right of first refusal to acquire any excess gemstone cutting capacity from JMB's affiliate and any equity securities offered by JMB or its affiliate. Our agreement with JMB expires December 31, 2004; however, we have the right to terminate the agreement at any time upon 90 days written notice. Under this agreement, JMB has agreed to grant, and to cause its affiliates to grant, to us a perpetual, non-exclusive, royalty-free license to use any inventions or proprietary information developed by or for JMB or its affiliates that is useful in the faceting of moissanite jewels. The Company intends to negotiate an extension of its agreement with JMB. If no extension is agreed upon, management believes that alternative suppliers of faceting services are available. In April 2002, we purchased from JMB 200 used custom faceting machines for \$60,000, in order to ensure that the machines are available in the event we have increased faceting requirements. JMB has agreed to store and maintain these machines and to repurchase the machines from us if higher faceting levels are required. If our agreement with JMB is extended, we anticipate reaching those increased monthly faceting levels within the next few years and expect JMB to begin repurchasing the machines at a price of \$300 per machine.

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*Inspection, Sorting and Grading.* Once faceted moissanite jewels are returned to us, we inspect, sort and grade them. During this stage, specially trained personnel individually examine and grade each moissanite jewel against certain quality parameters. In addition, we process a sample of each batch through an image analyzer for exacting quality control. 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 an independent third party. We will require third parties to which we outsource these processes to adhere to our rigorous quality control and monitoring standards. We have no assurance that we will be able to hire or retain sufficient numbers of appropriately skilled personnel for this phase of manufacturing or find and enter into acceptable agreements with third party vendors or that such vendors will be able to provide accurate inspection, sorting and grading services on a timely basis.

### **Marketing and Distribution**

#### *Marketing*

*Domestic.* Beginning late in the first quarter of 2002, we executed a global marketing strategy focusing on advertising to our target consumer in the United States. In mid-fourth quarter 2002, we conducted a two-phase marketing research project aimed at further defining our primary U.S. target market and canvassing the opinions and buying attitudes of women who purchase jewelry. We narrowed our primary market and re-defined it to consist of self-purchasing, women between the ages of 35 and 55, with an annual income of at least US\$45,000 (if married, combined household income of \$75,000). In 2003, we focused on consumer print advertising in high-end consumer magazines with ads placed in fashion publications with United States and Asian distribution. We expect to continue those consumer fashion ads through 2004.

We believe our marketing and advertising continued to strengthen the image and reputation of our brand, Charles & Colvard, and our product, moissanite. In late fourth quarter 2002 and throughout 2003 our advertising message to the jewelry trade focused on moissanite jewelry being a new product category and the business opportunity (new customer base – the self-purchasing woman, higher average retail ticket sales, product differentiation, higher profit margins, and a new source of revenue) it represented to both retailers and manufacturers. We believe that no other gem material occupies the newly identified marketing niche called “reward for achievement” jewelry specifically focused on women self-purchasers. Diamond occupies the market of jewelry symbolizing romance and a gift of love. Charles & Colvard will continue focusing its main message as the perfect reward for a woman’s achievement (large or small, personal or professional) to its primary market, the self-purchasing woman.

We continued to support our existing customers and moissanite retailers with marketing collateral, advertising, and public relations efforts. We believe that this marketing and advertising program resulted in a consistent and positive message for moissanite and set the stage for our future public relations and marketing efforts, positioning moissanite as a new product category in the jewelry industry and a unique and desirable jewel for consumers.

In the fourth quarter of 2003, we created a series of outdoor advertising billboards and duratrans tagged with specific retailers and store locations. We plan to continue supporting our retailers with outdoor advertising, listing them in our consumer fashion ads, and supplying them with marketing tools to increase their moissanite jewelry sales.

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Public relations activities are an important component of our marketing strategy and are integral to supporting the launch of new moissanite retailers. Our key public relations activities in 2003 included the following:

- Generating coverage in fashion, jewelry industry trade, and general national press.
- Developing new stories to be carried on local television news programs and local newspaper markets throughout the U.S.
- Capitalizing on public relations activities that promote both Charles & Colvard as a brand, and moissanite as product, to include but not limited to sponsorships.

Our domestic marketing goal for 2004 is to create more consumer impressions for Charles & Colvard created moissanite than were achieved in 2003 (without significantly increasing the public relations budget) and thereby increasing the overall public's and our primary market's moissanite awareness and desire to purchase. We will focus primarily on public relations programs specifically targeted to reach our primary market, the self-purchasing, independent decision-making, woman, between the ages of 35 and 55, with an annual income of at least \$45,000 who takes pride in her achievements, is fashion conscious, influenced by style, and aspires to enrich her lifestyle.

We have also implemented focused advertising using a new consumer lifestyle image advertisement which debuted in 2003 in a mix of fashion publications that included: Elle, InStyle, Marie Claire, Vanity Fair, and Vogue. While the selection of publications chosen may vary in the future, this consumer campaign will continue throughout 2004.

In 2004, Charles & Colvard will continue to advertise in jewelry trade publications such as JCK, Modern Jeweler, and National Jeweler. We will continue to promote the message of moissanite being a new product category and its unique business opportunity (new customer base – the self-purchasing woman, higher average retail ticket sales, higher profit margins, and a new source of revenue) to the retailer.

*International.* Internationally, we work with our distributors to develop advertising and marketing campaigns targeting specific geographic regions, building on the marketing images, strategies, and themes developed in the United States. Pursuant to our international distribution agreements, we provide incentives to our customers to use advertising that supports the brand image for moissanite created by Charles & Colvard. We may provide other advertising and promotion incentives in international markets to increase jewelry trade and consumer awareness.

*Trade Shows.* Charles & Colvard will continue to participate in jewelry trade shows as an exhibitor. With a new domestic U.S. exhibition booth in 2003, we exhibited in the Manufacturing Jewelers and Suppliers of America (MJSA) Expo in New York and our new international booth debuted at the Basel 2003 Worldwide Watch and Jewellery Show in Switzerland. Also in 2003, we participated in the VicenzaOro Show in Italy, and attended the JCK Show in Orlando and the Jewelers of America Show in New York. As of March 2004, we exhibited at VicenzaOro in Italy, the JCK Show Phoenix, and MJSA Expo in New York. We also plan to exhibit at BaselWorld 2004, the JCK Las Vegas, The Hong Kong Jewellery Show and a host of other international jewelry trade shows.

### *Distribution*

*Domestic.* We believe that moissanite is best sold through retail channels in which the retailer has an adequate opportunity to effectively educate the consumer on moissanite's unique qualities.

We began shipping moissanite to our authorized retail jewelers in Atlanta and Miami/Ft. Lauderdale during the second quarter of 1998, and in July 1998 we launched limited consumer-focused advertising and promotion activities in those areas. During the second half of 1998, and through the first half of 1999, we limited our efforts to expand the distribution of moissanite jewels as a result of insufficient

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product availability and our lack of confidence in the quality of the SiC crystals we were receiving. As our confidence in our supply of moissanite increased, we attempted to expand the number of retailers carrying moissanite during the second half of 1999. However, we were not able to increase the number of these jewelers necessary to achieve our business objectives.

By the end of 1999, 237 domestic independent jewelers were carrying Charles & Colvard created moissanite. Sales in 1999 to our independent jewelers totaled approximately \$4.1 million. In order to more rapidly expand the distribution of moissanite, in May 2000 we transitioned from selling moissanite jewels directly to independent retail jewelers to allowing independent retail jewelers to access loose moissanite jewels and moissanite jewelry through respected, established jewelry distributors. We have entered into distribution agreements for North America with two large distributors, Stuller Settings, Inc. (Stuller) and Rio Grande, and certain jewelry manufacturers. Established in 1970, Stuller is one of the world's largest suppliers of jewelry-related products, providing over 100,000 different items to the jewelry industry. Through its innovative manufacturing and distribution techniques, Stuller provides timely delivery of its products to over 40,000 retail jewelry customers, primarily in North America. Stuller's products include findings (jewelry ready to have a gemstone mounted in it), finished jewelry, loose diamonds, colored gemstones, tools and supplies and metals. In December 2003, the Company agreed with Stuller that it would not add an additional distributor of loose moissanite jewels during 2004. Rio Grande was started over 50 years ago and is a respected industry leader in jewelry manufacture and distribution. Rio Grande carries over 24,000 products for the jewelry trade, and the Rio Grande Gems & Findings catalog is the largest catalog of its type in the world. Rio Grande's customer base consists primarily of manufacturers of jewelry from independent jewelers that create custom jewelry to the largest manufacturers of jewelry in North America.

Additionally, we have entered into arrangements with several jewelry manufacturers, most notably K&G Creations, that design and manufacture lines of jewelry containing moissanite jewels. We have granted these jewelry manufacturers non-exclusive rights to sell their lines of jewelry to independent retail jewelers as well as jewelry store chains and department stores that meet certain predetermined criteria. Jewelry retailers have access to loose moissanite jewels from Stuller and Rio Grande and to jewelry containing moissanite jewels from Stuller, K&G Creations, and other jewelry manufacturers.

Our two largest customers, K&G Creations and Stuller, accounted for 44% and 23%, respectively, of our sales during 2003. While we believe our current relationship with these customers is good, and alternate manufacturers and distributors are available to serve their customer base, a loss of these customers could cause a material adverse effect on our results of operations in a particular period.

We believe that moissanite jewels provide retailers with an opportunity to earn a profit margin comparing favorably to other jewelry products and allow the retailer to distinguish our product line from other jewelers in the highly competitive retail jewelry market. We also believe these margins create incentives for retailers to maximize their sales and promotional efforts, resulting in additional consumer demand for our moissanite jewels.

We believe that distributing moissanite jewels through Stuller and Rio Grande as well as certain jewelry manufacturers and designers provides retail jewelers with maximum flexibility to develop their businesses with moissanite. Those jewelers that prefer to create their own jewelry to meet the needs of their individual market areas will be able to purchase the loose jewels through Stuller or Rio Grande, with which many of them already have relationships. Those jewelers that wish to purchase finished jewelry for sale in their stores may do so either through Stuller or any of the jewelry manufacturers working with moissanite.

The quality, design and workmanship of the settings chosen by Stuller, manufacturers, designers and retailers affects consumer perception and acceptance of our products, and our control over these elements

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is limited to our pricing and licensing policies. Beyond that, we believe that the success of Charles & Colvard created moissanite will be determined by the power and the precision of our brand-building program. We continue to evaluate the most appropriate structure for distribution in North America and may, in certain circumstances, enter into additional distribution arrangements, including arrangements with selected department stores and distribution channels such as moissanite retail stores, catalog sales or Internet sales.

As our retail customer base has grown and we have gained distribution with prominent regional and national outlets, we believe we are beginning to see the benefit of our distribution model. By combining the manufacturers' strength of jewelry design and program execution with our beautiful jewel, our distribution message is that we can provide a compelling revenue pipeline to retailers. Several manufacturers have successfully introduced moissanite with multi-door chains. In 2002, we supported our partners efforts in expanding and developing distribution with several notable retailers. These include but are not limited to ShopNBC, Shop At Home, Landau, Army Air Force Exchange System (AAFES), and Morgan Jewelers. In 2003, we supported additional traditional retailer test distributions at Kings Jewelers and Carlyle & Company, as well as a number of other retailers. The majority of the organizations that conducted tests in 2003 are planning rollouts in 2004, which should have a favorable impact on sales. Additional test distribution programs are being planned in 2004. The most notable tests currently scheduled are in 15 stores in the 125-store Samuel Jewelers, Inc. chain and a 16 store test in the Lifestyle Jewelry chain in the United Arab Emirates and China.

We believe that we have developed a testing template that can enable us to gain distribution. Generally, we seek to participate with the retailers in training their sales and marketing personnel in moissanite sales positioning and strategies and in working with them to create focused advertising and promotional efforts to publicize "trunk shows" and other special sales events at the test store locations.

We believe that our sales on television shopping channels demonstrate that the consumer understands the value and beauty of our jewel. As a result, we have seen increased interest from key traditional jewelry retailers. We believe that we can achieve long-term growth as we introduce this jewel into the traditional jewelry channels of distribution such as King's and Carlyle.

We will also continue to seek other "non-traditional" channels such as catalog, showrooms, mass-market discounters, price clubs, mail order, TV shopping channels, Internet, department store, specialty stores and mass retail. A test on HSN.com was begun in December 2003. The growing consumer acceptance of moissanite would allow Charles and Colvard to expand into these various channels. As we expand, we will manage the issues surrounding the multiple channel distribution method with the need for a consistent brand-building program.

Aggregate domestic sales were equal to approximately \$14.7 million, \$14.2 million, and \$9.4 million in 2003, 2002 and 2001, respectively. We plan to add additional sales professionals in 2004 to focus on new business development. The additional personnel will enable us to increase our presence at trade shows and other important sales opportunities.

*International.* We currently distribute moissanite jewels in substantially all of Western Europe and certain territories in Southeast Asia. We have approximately forty international distributors and intend to increase this number. All sales to international customers are denominated in U.S. dollars. Generally, we require full payment before merchandise is shipped to these customers. However, once a customer has established a purchase history, we may grant net 30 day payment terms to our international customers. Export sales aggregated approximately \$2.6 million, \$2.3 million, and \$2.1 million, in 2003, 2002, and 2001, respectively.

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Similar to the US, we have begun distributing through TV retailers internationally. Specifically in the UK, we have developed a partnership with a leading manufacturer and with Ideal World Shopping channel. In June 2003 moissanite began being sold on Eastern Home Shopping Network in Taiwan. We believe that we are positioned for future growth in this distribution channel.

We have also continued our investment in the Asian market. Our Hong Kong office is working on obtaining business relationships that will expand our distribution. A multi-pronged distribution approach, including manufacturers, retailers and Company owned moissanite only retail stores, is positioning Charles and Colvard for greater consumer and jewelry industry awareness.

### **Competition**

*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 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.

Our moissanite jewel, which is positioned as a unique new jewel, may compete with fine gemstones such as ruby, sapphire, emerald and tanzanite as well as with natural and treated diamonds and existing synthetic gemstones such as synthetic cubic zirconia. We may also face competition from additional gemstones such as synthetic diamonds, synthetic diamond films and other sources of synthetic moissanite not presently available in qualities, sizes and volumes suitable for use as gemstones. Many of the suppliers of diamonds and other fine gemstones, as well as the suppliers of synthetic gemstones, have substantially greater financial, technical, manufacturing and marketing resources and greater access to distribution channels than we do.

The worldwide market for large, uncut high-quality diamonds is significantly consolidated through the Central Selling Organization, a cartel led by DeBeers. This cartel has a major impact on the worldwide supply and pricing of these diamonds at both the wholesale and retail levels. Although we believe that our jewels appeal primarily to the consumer who would not otherwise purchase comparable diamond jewelry, 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 diamonds. Treated diamonds, which are natural diamonds with imperfections or flaws that have been altered in some manner to enhance their appearance, are presently available in the jewelry industry and are generally less expensive than diamonds of similar size, cut and color which have not been altered. Synthetic diamond in gemstones or film form may also become available in the marketplace and compete with our jewels. Synthetic diamonds are regularly produced for industrial applications, but we believe that gemstone-quality synthetic diamonds presently cannot be produced at prices competitive with those currently offered for our near-colorless moissanite jewels. The primary producers of these synthetic diamonds are DeBeers, Sumitomo and GE. There are also a number of Russian producers of synthetic diamonds for industrial uses. In addition, development-stage companies, such as the Gemesis Corporation headquartered in Florida, are working to develop cost-effective means of producing gem quality synthetic diamonds. Synthetic diamond films can be grown at commercially viable prices in thicknesses that can be applied to other surfaces, but these films adhere well to only a few minerals such as diamond, silicon and SiC (moissanite). There could, however, be technological advances that would enable competitively priced synthetic diamond in gemstone or film form to be offered.

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Although we believe that our products have 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, for abrasive uses, and Cree, Siemens AG, Okmetic, Inc., Bridgestone, ABB and Northrup Grumman Corporation, for semiconductor uses. We believe that Cree is currently the only supplier of SiC crystals in colors, sizes and volumes suitable for gemstone applications, and we believe that the patents owned or pending by Cree or us provide substantial technological, legal and cost barriers to other companies' development of near-colorless moissanite jewels. 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.

We may also face competition from synthetic cubic zirconia, the principal existing diamond simulant and, to a lesser degree, other synthetic gemstones. The largest producer of synthetic cubic zirconia gemstones is Signity. In addition, there are a significant number of other producers of jewelry containing synthetic gemstones. Three of the largest retailers of synthetic cubic zirconia jewelry in the United States are QVC, Home Shopping Network and Wal-Mart. Some of the major retailers of synthetic cubic zirconia, including QVC, have captive manufacturing divisions that produce synthetic cubic zirconia jewelry. These producers and sellers may see their markets being eroded by the introduction of our moissanite jewels. We believe that price is the primary basis upon which these products will compete with our moissanite jewels.

We intend to compete primarily on the basis that the unique qualities of our moissanite jewels are distinct from all other jewels based on their fire, brilliance, luster and durability. In addition, we believe that the Charles & Colvard created moissanite brand, which is being developed pursuant to our marketing program, can create a long-term competitive advantage for our products. Additionally, we believe that moissanite jewels have a significant cost advantage over other fine gemstones, especially in the one-carat size and larger. Our competitive success depends on the following:

- the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers and designers to market and promote moissanite jewels to the retail jewelry trade;
- the willingness of distributors, retailers and others in the channel of distribution to purchase loose moissanite jewels and the willingness of manufacturers, designers and retail jewelers to undertake setting of the loose jewels;
- the ability of manufacturers, designers and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;
- the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in jewelry with high quality workmanship; and
- the ability of retail jewelers to effectively market and sell moissanite jewelry to consumers.

### **Government Regulation**

Our products are subject to regulation by the Federal Trade Commission (FTC). 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. While we intend to comply fully with all FTC regulations, we cannot be sure that the FTC or a competitor will not challenge our promotional or marketing activities. Such a challenge could result in significant expense and divert the efforts of our management, whether or not such challenge is resolved in our favor. If our actions were found to be in violation of FTC regulations, we could be forced to suspend marketing and sales of our products and could incur significant expenses in developing new marketing strategies and materials that would not violate FTC regulations. We cannot be sure that we would be successful in developing new marketing strategies and materials that would comply with FTC regulations or that such strategies, once developed, would allow us to market our products profitably.

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### **Employees**

At February 27, 2004, we had 52 employees. We believe that our future prospects will depend, in part, on our ability to retain our current employees and to obtain additional management, marketing, sales, manufacturing, scientific and technical personnel. Competition for such personnel is substantial, and the number of persons with relevant experience is limited. None of our employees is represented by a labor union. We believe that our employee relations are good.

### **Business Risks**

In addition to the other information in this Form 10-K, you should carefully consider the following important factors that in some cases have affected, and in the future could affect, our actual performance and results and could cause our actual results of operations to differ materially from those expressed in any of our forward-looking statements.

*Our business operations could be adversely affected if we do not manage our growth effectively.* Our strategy will require us to achieve rapid growth while limiting expenditures and motivating our employee base. Periods of rapid growth would place a significant strain on our personnel and other resources. We will continue to be required to manage multiple relationships with various customers and other third parties. If we are unable to manage growth effectively, our business, financial condition and results of operations would be materially adversely affected.

*We have a limited operating history which may impact our ability to achieve market acceptance of our products and our ability to produce our products.* We have a limited operating history and are in the early stages of commercializing moissanite jewels, building consumer brand awareness and growing distribution channels for our jewels. The timing or existence of any significantly increased revenues is dependent on market acceptance of moissanite jewels and increasing distribution and sales. Our business may also be subject to risks inherent in rapid increases in sales and production levels. Likewise, our products are subject to risks inherent in the development and marketing of new products, including unforeseen design, manufacturing or other problems or failure to develop market acceptance. Failure by us to expand distribution and achieve market acceptance of our products or to develop the ability to produce our products in higher quantities and qualities would have a material adverse effect on our business, operating results and financial condition. Accordingly, our prospects must be considered in light of the risks and difficulties frequently encountered by companies in their early stage of development, particularly technology-based companies, operating in the early stages of manufacturing and distributing unproven products.

*Our future financial performance depends upon continued growth and consumer acceptance of our products.* We believe that many retail jewelers and most consumers are not generally aware of the existence and attributes of moissanite jewels. The market for moissanite jewels among retail jewelers and consumers is in the early stages of development, as we shipped approximately 97,000 carats during the year ended December 31, 2003. The degree of future market acceptance and demand are subject to a significant amount of uncertainty. Our future financial performance will depend upon greater consumer acceptance of the Company's moissanite jewels as distinct from all other jewels based on their fire, brilliance, luster, durability and rarity. In addition, consumer acceptance may be impacted by retail jewelers' and jewelry manufacturers' acceptance of moissanite jewels. We market loose jewels which jewelry distributors, manufacturers and retailers set in jewelry and in turn distribute or sell to consumers.

The quality, design and workmanship of the jewelry settings selected by retail jewelers, which is not within our control, could impact our consumers' perception and acceptance of our jewels. Thus, our future financial performance may be impacted by:

- the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers and designers to market and promote moissanite jewels to the retail jewelry trade;



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- the willingness of distributors, retailers and others in the channel of distribution to purchase loose moissanite jewels and the willingness of manufacturers, designers and retail jewelers to undertake setting of the loose jewels;
- the ability of manufacturers, designers and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;
- the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in jewelry with high quality workmanship; and
- the ability of retail jewelers to effectively market and sell moissanite jewelry to consumers.

If our products do not receive greater market acceptance, our business, operating results and financial condition would be materially adversely affected.

*We are substantially dependent on the distribution of our jewels in North America through K&G Creations (a jewelry manufacturer and distributor) and Stuller Settings, Inc. as well as a limited number of other distributors and jewelry manufacturers.* In March 2000, we entered into distribution agreements with two of the largest national wholesale distributors, Stuller Settings, Inc. and Rio Grande, for distribution of moissanite jewels throughout the entire North American market. In 2001 and after, we entered into sales agreements with a limited number of jewelry manufacturers. There is no assurance, however, that our distribution arrangements with Stuller and our sales agreements with manufacturers, such as K&G Creations, will sufficiently increase sales in North America. We anticipate that the majority of the moissanite jewels that we sell in North America will be distributed through K&G Creations and Stuller as well as our other manufacturers, and therefore, we are substantially dependent upon these companies for distribution of moissanite jewels in North America.

*A prolonged economic downturn and the uncertainties caused by war and terrorism could adversely affect our operations.* Purchases of jewelry, including purchases of our products, may be affected by any prolonged, negative trends in the general economy that adversely affect consumer spending. Any reduction in consumer confidence or disposable income may adversely affect jewelry companies, in general, and our Company, in particular, more significantly than companies that rely less on discretionary consumer spending. Further, the affect that war and possible additional terrorist attacks may have on consumers and the economies of the United States, as well as other countries in which our products are sold, is unpredictable and uncertain. Any significant reduction in demand for our products would have a material adverse affect on our results of operations and could, if it continued, have a material adverse affect on our financial condition.

*We are subject to certain risks due to our international distribution channels and vendors.* Charles & Colvard created moissanite jewels are currently being distributed in substantially all of Western Europe and certain territories in Southeast Asia. We currently have a total of approximately 40 international distributors. Our long-term strategy is to expand the number of international markets for our products. In addition, we expect to continue to use certain companies based outside the United States to facet our moissanite jewels. 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 United States. These risks include the following:

- the adverse effects on United States-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;
- 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; and
- the burdens of complying with a variety of foreign laws and other factors beyond our control.

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Additionally, while all 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 these 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.

*We currently depend upon a single source for the supply of SiC crystals.* We currently depend on a single source, Cree Inc. (Cree), for the supply of SiC crystals. Cree has certain proprietary rights relating to its process for growing large single crystals of SiC and its process for growing colorless SiC crystals. Under our Exclusive Supply Agreement with Cree, we are obligated to buy from Cree, and Cree is obligated to sell to us, 50%, by dollar volume, of our requirements for SiC material for the production of gemstones in each calendar quarter. Although we are only required to purchase 50% of our SiC requirements from Cree, we do not currently believe that any other SiC producer could readily supply crystals in the qualities, sizes and volumes needed for our products. Therefore, at the present time, we are wholly dependent on Cree as our sole source for our principal raw material.

While Cree has improved its production processes and is currently producing SiC crystals sufficient to meet our requirements, we experienced difficulties in the past in obtaining crystals from Cree in the quality, sizes and volumes that we desired. We from time to time enter into purchase agreements with Cree with respect to the specific timing, pricing and other terms of future delivery of SiC crystals and our purchase commitments. There can be no assurance that Cree will be able to continue to produce and supply us with raw materials of sufficient quality, sizes and volumes nor that we will negotiate purchase commitments that enable us to manage our inventories and raw material costs effectively.

*We rely upon our ability to protect our intellectual property.* We have United States product and method patents for moissanite jewels under which we believe that we have broad, exclusive rights to manufacture, use and sell moissanite jewels in the United States. We have applications pending in a number of foreign jurisdictions for these same patents. We believe that these patents create substantial technological barriers to our potential competitors. We also have other patents and patent applications pending related to certain methods of producing moissanite jewels and related technologies. There can be no assurance that any other patents will be granted or that any issued patent will have any commercial or competitive value.

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 colorless 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 to us or Cree, that we or Cree will have sufficient resources to prosecute our respective patents or that any patents will be upheld by a court should we, Cree or Cree's licensor seek to enforce our respective rights against an infringer. The existence of valid patents does not prevent other companies from independently developing competing technologies. Existing producers of SiC 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 or to us or Cree. In addition, existing producers of SiC, existing producers of other synthetic or natural gemstones or other parties may develop new technologies for producing moissanite jewels in a manner that does not infringe patents owned or licensed by or to us or Cree.

As a result of the foregoing factors, 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, operating results and financial condition.

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*Our success depends upon our ability to identify, reach agreements with and work successfully with third parties.* In addition to our current dependence on Cree and on third party distribution channels, our prospects depend upon our ability to identify, reach agreements with and work successfully with other third parties. In particular, we rely on third parties to facet our jewels. Faceting moissanite jewels requires different techniques than faceting diamond and other gemstones. There can be no assurance that we can maintain our relationships with our faceting vendors on terms satisfactory to us or that faceting vendors will continue to be able to provide faceting services in the quality and quantities required by us or that we will be able to find suitable replacements if we are unable to maintain such relationships. Our failure to achieve any of the above would have a material adverse effect on our business, operating results 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. In particular, the Federal Trade Commission has the power to restrict the offer and sale of products that could deceive or have the tendency or effect of misleading or deceiving purchasers or prospective purchasers with regard to the type, kind, quality, character, origin or other characteristics of a diamond. 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 products. If our production or marketing of moissanite jewels is challenged by governmental agencies or competitors, or if regulations are issued that restrict our ability to produce and market our products, our business, operating results and financial condition could be materially adversely affected.

*Our reputation amongst jewelers and consumers could be damaged if low-quality gemstones or synthetics are marketed as moissanite.* It is possible that low-quality gemstones or other synthetics could be marketed as moissanite. The sale of low-quality products as moissanite could damage our ability to foster the perception of moissanite as a unique jewel that compares favorably to other fine gemstones like diamond, ruby and emerald. This could damage our reputation among retail jewelers and consumers and result in a loss of consumer confidence in our products. The introduction of low-quality imitation moissanite jewels and our inability to limit the adverse effects thereof could have a material adverse effect on our business, operating results and financial condition.

*We do not expect to pay common stock dividends.* We have not paid cash dividends in the past and do not expect to pay cash dividends on our common stock for the foreseeable future. In determining whether to pay dividends, our Board of Directors will consider many factors, including our earnings, capital requirements and financial condition.

*Some anti-takeover provisions of our charter documents, agreements and plans 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 may be deemed to have an anti-takeover effect and may delay or prevent takeover attempts not first approved by the 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 all of our shareholders.

Under the terms of the Exclusive Supply Agreement, we are prohibited from entering into an exclusive marketing or distribution agreement with DeBeers or its affiliates or the Central Selling Organization (the international cartel of diamond producers) or any party whose primary business is the development, manufacture, marketing or sale of diamond gemstones or any non-gemstone and non-jewelry industry competitor of Cree. The Agreement also prohibits us from entering into certain merger, acquisition, sale of assets or similar transactions with a prohibited party. These provisions of the Exclusive Supply Agreement could limit the price that third parties might be willing to pay in the future for some or all of the shares of our common stock. In addition, this agreement could prevent us from entering into certain potentially profitable transactions with such prohibited parties.

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On February 21, 1999, we adopted a Shareholder Rights Plan under which all shareholders of record as of March 8, 1999, received rights to purchase shares of a new series of Preferred Stock. Each share of common stock issued after March 8, 1999 has received the same rights.

The Rights Plan is designed to enable all of our shareholders to realize the full value of their investment and to provide for fair and equal treatment for all shareholders in the event that an unsolicited attempt is made to acquire us. The adoption of the Rights Plan is intended as a means to guard against abusive takeover tactics and is not in response to any particular proposal. The Rights, which expire in 2009, will be exercisable only if a person or group acquires 20% or more of our common stock or announces a tender offer for 20% or more of the common stock. If a person or group acquires 20% or more of our common stock, all shareholders except the purchaser will be entitled to acquire our common stock at a 50% discount. The effect will be to discourage acquisitions of more than 20% of our common stock without negotiations with the Board.

The Rights will trade with our common stock, unless and until they are separated upon the occurrence of certain future events. Our Board of Directors may redeem the Rights prior to the expiration of a specified period following the acquisition of more than 20% of our common stock.

### **Available Information**

Our internet website is [www.moissanite.com](http://www.moissanite.com) or [www.charlesandcolvard.com](http://www.charlesandcolvard.com). We make available free of charge through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

### **ITEM 2. PROPERTIES**

We lease approximately 12,700 square feet of mixed-use space (general office, light manufacturing and laboratory) in the Research Triangle Park area of North Carolina from an unaffiliated third party. This lease expires in August 2004. This space houses all United States personnel, including our executive offices, sales offices, administrative personnel and production facilities. We believe that comparable mixed-use space could be obtained from other parties on terms substantially the same or more favorable than the current lease. Our management considers this space to be sufficient for our foreseeable needs over the next 12 months. However, continued growth will cause the need for a larger facility. Management is therefore exploring options to obtain additional space.

We also have five leases associated with our companies in Hong Kong and China. Two of these leases are for general office space and the other three leases are for retail establishments. These leases expire at various dates from December 2004 to August 2006.

### **ITEM 3. LEGAL PROCEEDINGS**

We are not a party to any material legal proceedings.

On October 22, 2003, we announced the settlement of all claims made by C. Eric Hunter and his wife, Jocelyn Hunter, in their lawsuit against Charles & Colvard. The terms of the settlement are confidential, but excluding attorneys' fees, will not have any impact on Charles & Colvard's results of operations. At the time of the settlement, Eric Hunter issued a statement to the effect that, after extensive investigations, the plaintiffs had concluded that the Company is not accountable for the misconduct that gave rise to the lawsuit. Charles & Colvard expensed, in the aggregate, approximately \$280,000 of attorneys' fees and

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other litigation costs in the third and fourth quarters of 2003. The suit was originally filed 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 alleged 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 alleged 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 alleged that he was entitled to receive royalty payments under a license agreement between he and the Company concerning certain patents used in the manufacture of SiC crystals, and that the Company failed to make such payments in breach of the agreement. The plaintiffs further alleged that defendant Jeff Hunter breached the fiduciary duty owed to the shareholders of the Company. Finally, the plaintiffs alleged that each of the foregoing transactions were unfair business acts in or affecting commerce, in violation of N.C. Gen. Stat. Sections 75-1.1.

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

Not Applicable.

**Part II**

**ITEM 5. MARKET FOR REGISTRANT’S COMMON STOCK AND RELATED STOCKHOLDER MATTERS**

Our common stock is traded on the NASDAQ National 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 National Market. As of February 27, 2004 there were 243 shareholders of record of the common stock.

	2003		2002	
	High	Low	High	Low
First Quarter	\$ 5.55	\$ 3.83	\$ 5.36	\$ 1.54
Second Quarter	4.95	3.05	6.09	3.70
Third Quarter	5.39	3.63	4.81	3.07
Fourth Quarter	6.23	3.87	6.52	3.66

We have never paid dividends on our capital stock. We intend to retain earnings, if any, for use in our business and do not anticipate paying any cash dividends in the foreseeable future.

In 2001, the Company engaged Tatum CFO Partners, LLC (“Tatum”) to provide temporary financial management services. As partial consideration for such services, Tatum received an option to purchase a total of 2,500 shares of Common Stock at an option price of \$1.04 per share, which option became exercisable in 33.3% installments over three years. Pursuant to the option, Tatum purchased 208 shares on August 14, 2002 and an additional 208 shares on August 29, 2003. The Company granted the option and issued the shares pursuant to an exemption provided from the registration provisions of the Securities Act of 1933, as amended (the “1933 Act”), provided by Section 4(2) thereof. The shares purchased pursuant to the option were mistakenly issued without restrictive legends, as if they had been issued pursuant to the Company’s 1997 Omnibus Stock Plan, and Tatum subsequently resold these 416 shares in ordinary brokerage transactions. Any shares issued in the future pursuant to the option will bear restrictive legends to the effect that any subsequent transfer will require registration under the 1933 Act or an opinion of counsel or other assurances reasonably satisfactory to the Company that the shares can be transferred pursuant to an applicable exemption from the 1933 Act.

**Equity Compensation Plan Information**

The following table sets forth information as of December 31, 2003 with respect to compensation plans under which our equity securities are authorized for issuance.

Plan Category	(A) Number of Securities To be Issued upon Exercise of Outstanding Options, Warrants and Rights	(B) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	(C) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (A) (1))
Equity Compensation Plans Approved by Security Holders	1,585,863	\$ 6.31	1,056,993
Equity Compensation Plans Not Approved by Security Holders	—	\$ —	—
<b>Total</b>	<b>1,585,863</b>	<b>\$ 6.31</b>	<b>1,056,993</b>

(1) The 1997 Omnibus Stock Plan of Charles & Colvard, Ltd. includes an “evergreen” or “replenishment” formula which provides that the number of sales authorized for issuance may be increased from time to time to 20% of the authorized and issued shares of Common Stock less the number of shares granted under the 1996 Stock Option Plan of C3, Inc. or any other prior stock plan. The shares shown in column (C) may be the subject of awards other than options, warrants or rights under the 1997 Omnibus Plan.

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**ITEM 6. SELECTED FINANCIAL DATA**

The following selected statement of operations data for the years ended December 31, 2003, 2002 and 2001, and the selected balance sheet data at December 31, 2003 and 2002 have been derived from, and are qualified by reference to, our financial statements included elsewhere in this report which have been audited by Deloitte & Touche LLP, independent auditors. The selected statement of operations data for the years ended December 31, 2000 and 1999 and the selected balance sheet data at December 31, 2001, 2000 and 1999 have been derived from audited financial statements not included herein. The selected financial data set forth below should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the Financial Statements and Notes thereto included elsewhere in this report.

CHARLES & COLVARD, LTD. (FORMERLY C3, INC.)

	Year Ended December 31,				
	2003	2002	2001	2000	1999
<b>Statements of Operations Data</b>					
Net sales	\$ 17,240,383	\$ 16,513,515	\$ 11,505,129	\$ 12,795,125	\$ 12,272,907
Cost of goods sold	6,575,931	6,586,925	5,137,630	5,828,319	6,405,887
Gross profit	10,664,452	9,926,590	6,367,499	6,966,806	5,867,020
Operating expenses:					
Marketing and sales	6,080,829	4,967,215	3,222,743	9,348,272	6,410,042
General and administrative (1)	2,462,404	2,401,087	2,104,180	3,372,083	3,039,595
Research and development	26,702	7,259	21,977	1,439,526	2,710,692
Other	—	(450)	119,460	313,538	—
Total operating expenses	8,569,935	7,375,111	5,468,360	14,473,419	12,160,329
Operating income (loss)	2,094,517	2,551,479	899,139	(7,506,613)	(6,293,309)
Interest income, net	112,359	199,084	325,596	428,081	1,141,626
Income (loss) before taxes	2,206,876	2,750,563	1,224,735	(7,078,532)	(5,151,683)
Income tax expense (benefit) (2)	1,163,501	(6,657,874)	—	—	—
Net income (loss)	\$ 1,043,375	\$ 9,408,437	\$ 1,224,735	\$ (7,078,532)	\$ (5,151,683)
Net income (loss) per share					
Basic	\$ 0.08	\$ 0.70	\$ 0.10	\$ (0.99)	\$ (0.73)
Diluted	\$ 0.08	\$ 0.69	\$ 0.10	\$ (0.99)	\$ (0.73)
Weighted-average common shares					
Basic	13,228,758	13,355,027	12,546,108	7,167,088	7,040,891
Diluted	13,544,616	13,644,177	12,555,630	7,167,088	7,040,891
<b>December 31,</b>					
	2003	2002	2001	2000	1999
<b>Balance Sheet Data</b>					
Cash and equivalents	\$ 11,559,123	\$ 13,282,245	\$ 10,236,319	\$ 3,826,402	\$ 13,161,665
Working capital	37,745,292	36,236,017	33,444,926	25,937,806	26,709,142
Total assets	46,447,288	45,948,762	35,241,930	29,607,994	36,780,902
Long term debt	—	—	—	—	—
Shareholders’ equity	44,123,957	43,751,551	34,077,776	26,859,784	33,494,143

1. Compensation expense related to the issuance of stock options for 2003, 2002, 2001, 2000 and 1999 was \$34,283, \$92,497, \$37,262, \$149,368, and \$282,572 respectively. See Note 7 of Notes to Financial Statements.
2. The Company recorded a one-time \$6.7 million non-operating and non-cash addition to earnings during 2002, due to the expected realization of deferred tax assets. See Note 8 of Notes to Financial Statements.

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION**

All statements, trend analysis and other information contained in the following discussion relative to markets for our products and trends in revenue, gross margins and anticipated expense levels, as well as other statements, including words such as "anticipate," "believe," "plan," "estimate," "expect" and "intend" and other similar expressions constitute forward-looking statements. Our business is subject to business and economic risks and uncertainties, and our actual results of operations may differ materially from those expressed or implied in the forward-looking statements. The following discussion and the Section in Item 1 of this report entitled "Business Risks" describes some, but not all, of the factors that could cause these differences.

### **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.

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

In March 2000, we entered into distribution agreements with Stuller Settings, Inc. (Stuller) and Rio Grande, two of the largest suppliers of jewelry-related products to the jewelry industry, for the North American distribution of moissanite. We have also entered into several agreements with domestic jewelry manufacturers, including K&G Creations, which is currently our largest customer. Through these agreements with Stuller, Rio Grande and jewelry manufacturers and the brand awareness created by our marketing program, we have sought to rapidly increase the introduction of moissanite into the domestic jewelry market while maintaining average selling prices. Although these new distribution and marketing strategies enabled us to achieve profitability in the three years ended December 31, 2003, 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. To enhance our presence in this market, we established a Charles & Colvard controlled company in China in August 2003.

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



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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 and positive cash flow. In 2003, we increased our sales & marketing expenses to expand product awareness and accelerate sales growth. The majority of the increased expenses were focused on the domestic market, and we also increased our marketing and sales investment in Hong Kong & China. Our sales were 4% higher in 2003 over 2002. We hope that our increased investment in sales & marketing expenses leads to an increased growth rate in 2004 and beyond. Although our goals for 2004 are to continue increasing sales while sustaining profitability, we cannot be sure that either goal will be achieved.

### Results of Operations

The following table is intended to illustrate a tabular analysis of certain Consolidated Statement of Operations data as a percentage of sales for all periods presented. A detailed explanation of our results of operations follows this table.

	Year Ended December 31,					
	2003		2002		2001	
Sales	100%	\$ 17,240,383	100%	\$ 16,513,515	100%	\$ 11,505,129
Gross Profit	62%	10,664,452	60%	9,926,590	55%	6,367,499
Marketing & Sales expenses	35%	6,080,829	30%	4,967,215	28%	3,222,743
G&A expenses	14%	2,462,404	15%	2,401,087	18%	2,104,180
Operating Income	12%	2,094,517	15%	2,551,479	8%	899,139

*Year ended December 31, 2003 compared with Year ended December 31, 2002.*

Net sales were \$17,240,383 for the year ended December 31, 2003 compared to \$16,513,515 for the year ended December 31, 2002, an increase of \$726,868 or 4%. Although shipments of moissanite jewels decreased by 1% in 2003 to approximately 97,000 carats from 98,000 carats in 2002, sales increased due to a 4% increase in the average selling price per carat. The average selling price per carat increased primarily due to a product mix in which a greater percentage of larger size jewels, which have a higher price per carat, were sold. Domestic sales accounted for approximately 85% of sales in 2003 and 86% in 2002. Domestic carat shipments in 2003 decreased by 1% and international carat shipments were flat.

The decrease in domestic carat shipments during 2003 is due to decreased hours of moissanite sales broadcasting on the television shopping channel ShopNBC. ShopNBC announced, starting in February 2003, their intention to decrease jewelry as a percentage of total sales. Other domestic retail outlets showed sales growth in the moissanite category. Our two largest customers, K&G Creations and Stuller, accounted for 44% and 23%, respectively, of our sales during 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. Stuller, the largest supplier to domestic independent jewelers, provides both moissanite jewels and a limited line of moissanite jewelry to its customers. While we believe our current relationship with these customers is good, and alternate manufacturers and distributors are available to serve their customer base, a loss of these customers could cause a material adverse effect on our results of operations in a particular period.

Increased international sales into Taiwan and Vietnam were offset by a sales decrease into England. The increase in Taiwan can be attributed to the successful introduction of moissanite on a television shopping channel and the increase in Vietnam is due to the opening of a moissanite only store in that country. The reduced England sales were caused by a de-emphasis of moissanite by our English manufacturer. In 2004, we have received indications from this manufacturer that it intends to re-emphasize moissanite.

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Our gross profit margin was 61.9% for the year ended December 31, 2003 compared to 60.1% for the year ended December 31, 2002. The gross margin percentage in 2002 was negatively impacted by the establishment of a \$400,000 lower of cost or market reserve. See “Critical Accounting Policies and Estimates” for an explanation of this reserve. Our gross margin percentage for 2002 would have been 62.5% ignoring the effect of this inventory reserve. The gross margin percentage in 2003 was adversely affected by decreased yields of moissanite jewels from SiC crystals during the period being relieved from inventory (September 2000-April 2001) under our first in, first out accounting policy, partially offset by the 4% increase in the average selling price per carat. While the Company makes no prediction as to the future sales of moissanite jewels or the specific mix of sizes which will be sold, assuming a continuation of the Company’s sales levels and mix of sizes as experienced in 2003, the Company’s inventory costs for the periods being relieved under the Company’s first-in, first-out accounting during 2004 will trend lower than the costs relieved during 2003, with variations from quarter to quarter. Future gross margins will also fluctuate based upon our average selling price per carat.

Marketing and sales expenses were \$6,080,829 for the year ended December 31, 2003 compared to \$4,967,215 for the year ended December 31, 2002, an increase of \$1,113,614 or 22%. As a percentage of sales, these expenses increased to 35% from 30% in 2002. The primary reason for the increase was our 2003 advertising campaign designed to support the new jewelry chains that are testing moissanite jewelry and to stimulate moissanite tests by other chains. Our campaign featured a new advertising message and expanded the placement of advertisements in fashion magazines and billboards. We incurred \$326,000 of production costs associated with changing the look and feel of our advertising message. The increased number of advertisement placements resulted in \$518,000 of increased costs over 2002. During 2003, we incurred \$326,000 of increased marketing and sales costs over 2002 associated with the expansion of our offices in Hong Kong and China. The increases discussed above were partially offset by a \$213,000 decrease in our co-op advertising expense. Our co-op advertising program reimburses a portion of our customers’ marketing costs based on the amount of their purchases from us. The decrease in this expense during 2003 is due to the reduction in the amount of allowable credit given to one of our major customers. In 2004, we have budgeted approximately \$4,000,000 in advertising costs (\$600,000 more than in 2003) and expect to continue our strategy of long-term marketing and sales investments into Hong Kong and China.

General and administrative expenses were \$2,462,404 for the year ended December 31, 2003 compared to \$2,401,087 for the year ended December 31, 2002, an increase of \$61,317 or 3%. Although there was an increase in these expenses, as a percentage of sales these expenses decreased to 14% from 15% in 2002. Increased professional fees of \$400,000 were offset by decreased compensation costs of \$408,000 pertaining to our Executive Compensation Plan. The primary reason for the increase in professional fees was legal fees of approximately \$280,000 in 2003 related to the now settled litigation with C. Eric Hunter, one of the founders of the Company, and his wife, Jocelyn Hunter. Other than these legal fees, the settlement of the lawsuit did not have any material impact on our results of operations. The plaintiffs alleged fraud and other actionable conduct. Our Executive Compensation Plan was effective for 2003, however, no costs were recorded in 2003 as the Company did not meet its 2003 internal sales and profit goals.

Net interest income was \$112,359 for the year ended December 31, 2003 compared to \$199,084 for the year ended December 31, 2002, a decrease of \$86,725 or 44%. This decrease resulted from a lower interest rate earned on our cash balances.

Income tax expense was \$1,163,501 for the year ended December 31, 2003 compared to an income tax benefit of \$6,657,874 for the year ended December 31, 2002, as discussed below. Our effective income tax rate for 2003 was 53%. This rate is higher than our statutory rate of 38.5% due to our inability to deduct currently \$770,000 of non-U.S. operating losses.

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As a result of sustained profitability in 2001 and 2002, we recorded a one-time \$6,657,874 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). The benefit is due to the reversal of the deferred tax valuation allowance that existed in prior periods. We established a valuation allowance in prior periods due to the uncertainty of whether we would generate sufficient taxable income to realize the benefit of our deferred tax assets. We believe our sustained profitability in 2001 and 2002 was an indication that it became more likely than not that we would fully utilize our deferred tax assets. Recognition of this asset resulted in the recording of income tax expense in each quarter of 2003 and this expense will be recorded in all future profitable periods. However, U.S. federal income tax payments will only resume once the tax net operating loss carryforwards (\$13.1 million at December 31, 2003) 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, excluding this one-time gain and as if we had recorded U.S. income tax expense during 2002 utilizing a combined state and federal effective tax rate of 38.5% 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.

	Year ended December 31,	
	2003	2002
<b>As reported:</b>		
Income before income tax expense	\$ 2,206,876	\$ 2,750,563
Income tax expense (benefit)	1,163,501	(6,657,874)
Net income	\$ 1,043,375	\$ 9,408,437
Net income per diluted share	\$ 0.08	\$ 0.69
		Year ended December 31,
		2002
<b>Pro Forma:</b>		
Income before income tax expense		\$ 2,750,563
Income tax expense (38.5% of U.S. taxable income)		1,287,639
Net income		\$ 1,462,924
Net income per diluted share		\$ 0.11

### *Year ended December 31, 2002 compared with Year ended December 31, 2001.*

Net sales were \$16,513,515 for the year ended December 31, 2002 compared to \$11,505,129 for the year ended December 31, 2001, an increase of \$5,008,386 or 44%. Shipments of moissanite jewels increased in 2002 to approximately 98,000 carats from 63,000 carats in 2001. Domestic carat shipments, which represented 85% of total shipments, increased by 63%, and international carat shipments increased by 26%. The average selling price per carat decreased by 7%, primarily due to increased sales of smaller jewels which have a lower price per carat. Increased domestic sales are primarily attributable to direct marketing efforts on the television shopping channels ShopNBC and the Shop At Home network. In addition, distribution has increased through our manufacturing partners at traditional retail stores. One of our domestic manufacturing customers, K&G Creations, accounted for approximately 42% of our sales during 2002, while another, Stuller Settings, Inc. accounted for 23% of 2002 sales. K&G Creations provides moissanite jewels and jewelry to a large and diversified customer base, including television shopping channels and traditional retail stores. International sales also increased due to increased sales through television shopping channels. Specifically, Ideal World and the infomercial company, Best Direct, began selling moissanite jewels in the United Kingdom in 2002. International sales also increased in Hong Kong, China, and Italy.

Our gross profit margin was 60.1% for the year ended December 31, 2002 compared to 55.3% for the year ended December 31, 2001. The increased gross margin percentage was primarily caused by improved yields of moissanite jewels from SiC crystals during the period being relieved from inventory (April 2000-August 2000) under our first in, first out accounting policy, partially offset by a 7% decrease in the average selling price per carat and the establishment of a \$400,000 lower of cost or market reserve.

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Marketing and sales expenses were \$4,967,215 for the year ended December 31, 2002 compared to \$3,222,743 for the year ended December 31, 2001, an increase of \$1,744,472 or 54%. The increase resulted primarily from \$720,000 of increased costs associated with our co-op advertising program, \$400,000 of increased print media advertising, increased compensation (including costs associated with the hiring of two sales and marketing executives) and increased costs associated with our Hong Kong subsidiary. Our co-op advertising program, which reimburses a portion of our customers' marketing costs based on the amount of their purchases from us, increased primarily as a result of higher sales to our customers. Our print media advertising expanded in 2002 into national magazines, jewelry trade publications, and newspapers in certain markets to support sales events. As a percentage of sales, marketing and sales expenses increased from 28% in 2001 to 30% in 2002.

General and administrative expenses were \$2,401,087 for the year ended December 31, 2002 compared to \$2,104,180 for the year ended December 31, 2001, an increase of \$296,907 or 14%. The increase resulted primarily from \$470,000 of increased compensation costs, including \$366,000 in additional costs associated with our Executive Compensation Plan, offset by \$175,000 of decreased professional fees. Although there was an increase in general and administrative expenses, as a percentage of sales these expenses decreased from 18% to 15%.

Research and development expenses were \$7,259 for the year ended December 31, 2002 compared to \$21,977 for the year ended December 31, 2001, a decrease of \$14,718 or 67%. We suspended development efforts with Cree effective January 1, 2001, and terminated our Development Agreement with Cree effective December 31, 2002.

Other expenses of \$119,460 for the year ended December 31, 2001 resulted from the write-off of certain patent costs and a loss on the disposition of certain other assets.

Net interest income was \$199,084 for the year ended December 31, 2002 compared to \$325,596 for the year ended December 31, 2001, a decrease of \$126,512 or 39%. This decrease resulted from a lower interest rate earned on our cash balances, partially offset by higher average cash balances.

For the year ended December 31, 2002, we recorded an income tax benefit of \$6,657,874 as explained above. Pro forma amounts are shown below to compare the results of operations for 2002 and 2001, excluding this one-time gain and giving effect to income tax expense utilizing an effective tax rate of 38.5% of U.S. taxable income.

	Year Ended December 31,	
	2002	2001
<b>As reported:</b>		
Income before income tax expense	\$ 2,750,563	\$ 1,224,735
Income tax benefit	(6,657,874)	—
Net Income	\$ 9,408,437	\$ 1,224,735
Net Income per diluted share	\$ 0.69	\$ 0.10
<b>Pro Forma:</b>		
Income before income tax expense	\$ 2,750,563	\$ 1,224,735
Income tax expense (38.5% of U.S. taxable income)	1,287,639	591,180
Net Income	\$ 1,462,924	\$ 633,555
Net Income per diluted share	\$ 0.11	\$ 0.05

## **Liquidity and Capital Resources**

At December 31, 2003, we had \$11.6 million of cash and cash equivalents and \$37.7 million of working capital. Cash and inventory account for 89% of our current assets. Our principal sources of liquidity are cash on hand and cash generated by operations. During the year ended December 31, 2003, we used \$908,761 of cash to fund operations. The major components of the cash used were a \$1,700,667 increase in inventory and a \$1,496,143 increase in receivables, offset by pretax income of \$2,206,876. In addition, we used \$168,387 of cash for capital expenditures and patent and license rights costs. The increase in inventories was primarily due to \$6.0 million in raw material purchases during 2003, as described below. The increase in receivables is primarily due to a \$620,000 increase during 2003 in “memo” sales, as well as the timing of cash receipts. Our receivables balance should increase in 2004 due to increasing sales and expanded use of “memo” sales. “Memo” sales are discussed in more detail below. See “Critical Accounting Policies and Estimates”.

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

Our four-year Development Agreement with Cree, as amended, required us to fund a development program at Cree for \$1.44 million annually through December 31, 2002. Our funding obligations under the Development Agreement were suspended from January 2001 through December 31, 2002, and the Agreement terminated at the end of 2002.

In September 2001, our Board of Directors authorized a common stock repurchase program. The program authorized management, in its discretion, to repurchase up to 1,300,000 shares of the Company’s common stock through open market or privately negotiated transactions at prices at or below prevailing prices. This program expired in September 2002. During 2001, the Company repurchased 76,000 shares at a cost of \$1 per share from an affiliate of Chester L.F. Paulson. 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. During 2002, the Company repurchased 57,800 shares at an average price of \$3.88 under this program.

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. This program expired in September 2003. There were no shares repurchased during 2002 under the follow-on program. During 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 repurchased from an affiliate of Chester L.F. Paulson, at an average purchase price of \$4.58 per share.

In December 2003, the Board of Directors authorized a follow-on repurchase program for up to 900,000 shares of the Company’s common stock. As of December 31, 2003, there were no shares repurchased since the adoption of the follow-on program. Management will determine the time and extent of any future repurchases based on its evaluation of market conditions and other factors.

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

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### *Contractual Obligations and Commercial Commitments*

Our contractual obligations consist of our purchase commitments with Cree, the operating lease on our building and the operating leases for our companies in Hong Kong and China. Below are the amounts of these commitments in tabular form.

<u>Contractual Obligations</u>	<u>Payments Due by Period</u>				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1-3 years</u>	<u>4-5 years</u>	<u>More than 5 years</u>
Purchase Commitments	\$ 6,400,000 <sup>(1)</sup>	\$ 6,400,000	\$ —	\$ —	\$ —
Operating Leases	\$ 330,000	\$ 220,000	\$ 110,000	\$ —	\$ —

- (1) During 2004, we are committed to purchase between \$400,000 and \$1,600,000 of raw material each quarter depending upon the quality of material received. If Cree's material quality is consistent with that received in 2003, future purchases are expected to be at the high end of this range. The numbers in the table above are based on the high end of the range.

### *Net Operating Loss Carryforward*

As of December 31, 2003, we had a United States net operating loss (NOL) carryforward of approximately \$13.1 million, which expires between 2012 and 2020. In accordance with Section 382 of the Internal Revenue Code of 1986, as amended, a change in equity ownership of greater than 50% within a three-year period will result in an annual limitation on our ability to utilize our NOL carryforwards that were created during tax periods prior to the change in ownership. As a result of various equity offerings and certain shareholder transactions, the utilization of a portion of our NOL carryforwards has become limited, but this limitation will not have a material effect on our ability to utilize the NOL carryforward.

As of December 31, 2003, there was approximately \$1.6 million in NOL 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. Due to the uncertainty of sufficient future taxable income in Hong Kong to utilize this NOL, we have established a valuation allowance against this deferred tax asset.

### *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. The most significant estimates impacting our consolidated financial statements relate to costing and classification of inventories, revenue recognition, accounts receivable reserves, and co-op advertising.

Inventories are stated at the lower of cost or market determined on a first in, first out basis. Our inventories consist primarily of colorless moissanite jewels that meet rigorous grading criteria and are of cuts and sizes most commonly used in the jewelry industry. Moissanite jewels that do not meet our grading criteria and therefore are not deemed to be saleable are not included in inventories. We carry only a limited amount of moissanite jewels in finished jewelry settings. As a result, our inventories do not degrade in quality over time and are not subject to fashion trends. Our distribution channels include two of the largest suppliers of jewelry-related products to the jewelry industry, jewelry manufacturers, home shopping channels and catalogs. Consequently, significant amounts of inventories must be maintained at all times. Given our current assumptions, we believe that a substantial amount of inventories will be sold or consumed during our operating cycle, which is greater than one year. However, no assurances can be given that this reduction will occur. During 2002, we established a lower

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of cost or market reserve of \$400,000 to allow for a portion of the finished goods inventory to be re-cut. There are certain shapes and sizes of jewels in inventory that can be re-cut to achieve higher quality standards. The reserve is necessary to allow for the carat weight loss during the re-cutting process. To determine this reserve, we estimated the amount of inventory that is anticipated to be re-cut and the amount of weight loss that will occur during the process. Since the establishment of this reserve, we have not yet re-cut any jewels. At December 31, 2003, the reserve remained at \$400,000.

Revenue is generally recognized when products are shipped. From time to time, we ship certain items on “memo” terms. For goods shipped on memo terms, the customer receives title to the goods and assumes the risk of loss; however, the customer has an absolute right of return during the specified memo period. We recognize revenue on these transactions upon the earlier of (1) the customer informing us that they will keep the product or (2) the expiration of the memo period. The gross profit associated with these “memo” sales is shown on the balance sheet as deferred gross profit. This amount was \$448,270 and \$183,367 at December 31, 2003 and 2002, respectively. We expect these amounts to continue increasing in the future as we expand the distribution of moissanite into new outlets.

Estimates are used to determine the amount of two reserves against accounts receivable. First, an “Allowance for Doubtful Accounts” is established to reduce accounts receivable to an amount expected to be collected. Based on our collection history, we determine a percentage based on the age of the receivable that we deem collectible. The allowance is then calculated by applying the appropriate percentage to each of our receivables. Any increases or decreases to this allowance are charged or credited to general and administrative expenses. This allowance for doubtful accounts was \$130,000 and \$140,000 at December 31, 2003 and 2002, respectively. The second reserve against accounts receivable is the “Allowance for Returns”. At the time revenue is recognized, we estimate future returns and reduce sales and accounts receivable by this estimated amount. This amount is estimated using the historical return rate for our Company. The allowance for returns was \$80,000 and \$110,000 at December 31, 2003 and 2002, respectively. This reserve has been reduced during 2003 due to fewer returns as a percentage of sales.

We offer a co-op advertising program to our customers that reimburses 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 co-op advertising expense that has not yet been submitted for credit by our customers. These amounts were \$363,000 and \$305,000 at December 31, 2003 and 2002, respectively and are included on the balance sheet under “Accrued Expenses and Other Liabilities.” We estimate this amount based on our historical experience with each customer.

### *Newly Adopted Accounting Pronouncements*

In August 2001, Statement of Financial Standards (“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. FAS 143 was 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 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 was 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 an effect on our consolidated financial statements.

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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 an effect on the Company's consolidated financial statements.

In December 2002, FAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, was issued. FAS No. 148 presents additional alternatives for transitioning to the fair value method of accounting for stock-based compensation, prescribes the format to be used for pro forma disclosures and requires the inclusion of similar pro forma disclosures in interim financial statements. We have not adopted the fair value based method of accounting for employee stock options; however, the disclosure requirements of this statement have been adopted.

In April 2003, FAS No. 149, *Amendments of Statement No. 133 on Derivative Instruments and Hedging Activities*, was issued. FAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This Statement was effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement did not have an effect on our consolidated financial statements.

In May 2003, FAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, was issued. FAS 150 established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement was generally effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective on July 1, 2003. We do not have any financial instruments with characteristics of both liabilities and equity within the scope of this statement and the adoption of this statement did not have an effect on our consolidated financial statements.

In January 2003, FAS Interpretation ("FIN") No. 46, *Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51*, was issued (revised December 2003, FIN 46R). 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, however certain provisions of the interpretation were deferred until the period ending after March 15, 2004. We do not have any variable interest entities, and the adoption of this interpretation did not have an effect on our consolidated financial statements.

### *Off-Balance Sheet Arrangements*

We have not engaged in any off-balance sheet financing arrangements.

### **ITEM 7A. 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 December 31, 2003, we had approximately \$10.6 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.



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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Index to Financial Statements

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<a href="#">Independent Auditors' Report</a>	34
<a href="#">Consolidated Statements of Operations for the years ended December 31, 2003, 2002 and 2001</a>	35
<a href="#">Consolidated Balance Sheets as of December 31, 2003 and 2002</a>	36
<a href="#">Consolidated Statements of Shareholders' Equity for the years ended December 31, 2003, 2002 and 2001</a>	37
<a href="#">Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2002 and 2001</a>	38
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<a href="#">Financial Statement Schedule</a>	
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All other schedules are omitted due to the absence of the conditions under which they are required or because the required information is included within the financial statements or the notes thereto included in Item 8.

*INDEPENDENT AUDITORS' REPORT*

To the Board of Directors and Stockholders of  
Charles & Colvard, Ltd.  
Morrisville, North Carolina

We have audited the accompanying consolidated balance sheets of Charles & Colvard, Ltd. and subsidiary (the "Company") as of December 31, 2003 and 2002, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index at Item 8. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

DELOITTE & TOUCHE LLP

March 2, 2004

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CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,		
	2003	2002	2001
Net sales	\$ 17,240,383	\$ 16,513,515	\$ 11,505,129
Cost of goods sold	6,575,931	6,586,925	5,137,630
Gross profit	10,664,452	9,926,590	6,367,499
Operating expenses:			
Marketing and sales	6,080,829	4,967,215	3,222,743
General and administrative (Note 7)	2,462,404	2,401,087	2,104,180
Research and development	26,702	7,259	21,977
Other expenses (income)	—	(450)	119,460
Total operating expenses	8,569,935	7,375,111	5,468,360
Operating income	2,094,517	2,551,479	899,139
Interest income, net	112,359	199,084	325,596
Income before taxes	2,206,876	2,750,563	1,224,735
Income tax expense (benefit) (Note 8)	1,163,501	(6,657,874)	—
Net income	\$ 1,043,375	\$ 9,408,437	\$ 1,224,735
Net Income per share (Note 2)			
Basic	\$ 0.08	\$ 0.70	\$ 0.10
Diluted	\$ 0.08	\$ 0.69	\$ 0.10
Weighted-average common shares (Note 2)			
Basic	13,228,758	13,355,027	12,546,108
Diluted	13,544,616	13,644,177	12,555,630

See notes to consolidated financial statements.

[Table of Contents](#)CHARLES & COLVARD, LTD. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2003	2002
<b>Assets</b>		
Current Assets:		
Cash and equivalents	\$ 11,559,123	\$ 13,282,245
Accounts receivable, net of allowance for doubtful accounts of \$130,000 and \$140,000 respectively	3,702,095	2,195,952
Interest receivable	6,792	11,926
Inventory, net (Note 3)	24,065,992	22,365,325
Prepaid expenses and other assets	499,442	327,179
Deferred income taxes (Note 8)	235,179	250,601
Total current assets	40,068,623	38,433,228
Long Term Assets:		
Equipment, net (Note 4)	453,836	449,947
Patent and license rights, net (Note 4)	274,890	272,291
Deferred income taxes (Note 8)	5,649,939	6,793,296
Total long term assets	6,378,665	7,515,534
Total assets	\$ 46,447,288	\$ 45,948,762
<b>Liabilities and Shareholders' Equity</b>		
Current Liabilities:		
Accounts payable:		
Cree, Inc. (Note 9)	\$ 778,516	\$ 780,029
Other	538,943	122,931
Accrued payroll	164,943	723,467
Accrued expenses and other liabilities	392,659	387,417
Deferred gross profit	448,270	183,367
Total current liabilities	2,323,331	2,197,211
Commitments (Note 9)		
Shareholders' Equity (Notes 5 and 6)		
Common stock, no par value; 50,000,000 shares authorized; 13,214,281 and 13,324,555 shares issued and outstanding at December 31, 2003 and 2002, respectively	54,333,287	54,972,302
Additional paid-in capital—stock options	2,407,780	2,439,734
Accumulated deficit	(12,617,110)	(13,660,485)
Total shareholders' equity	44,123,957	43,751,551
Total liabilities and shareholders' equity	\$ 46,447,288	\$ 45,948,762

See notes to consolidated financial statements.

[Table of Contents](#)CHARLES & COLVARD, LTD. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock		Additional Paid-in Capital - Stock Options	Accumulated Deficit	Total Shareholders' Equity
	Number Of Shares	Amount			
Balance at January 1, 2001	7,200,979	\$49,226,697	\$1,926,744	\$ (24,293,657)	\$26,859,784
Compensation expense related to stock options	—	—	37,262	—	37,262
Proceeds from right offering, net of offering costs of \$214,740	6,246,735	6,031,995	—	—	6,031,995
Shares repurchased	(76,000)	(76,000)	—	—	(76,000)
Net Income	—	—	—	1,224,735	1,224,735
Balance at December 31, 2001	13,371,714	55,182,692	1,964,006	(23,068,922)	34,077,776
Compensation expense related to stock options	—	—	92,497	—	92,497
Stock options exercised	10,641	13,631	(2,792)	—	10,839
Tax effect of stock options	—	—	386,023	—	386,023
Shares repurchased	(57,800)	(224,021)	—	—	(224,021)
Net Income	—	—	—	9,408,437	9,408,437
Balance at December 31, 2002	13,324,555	54,972,302	2,439,734	(13,660,485)	43,751,551
Compensation expense related to stock options	—	—	34,283	—	34,283
Stock options exercised	53,026	108,988	(6,959)	—	102,029
Tax effect of stock options	—	—	(59,278)	—	(59,278)
Shares repurchased	(163,300)	(748,003)	—	—	(748,003)
Net Income	—	—	—	1,043,375	1,043,375
Balance at December 31, 2003	13,214,281	\$54,333,287	\$2,407,780	\$ (12,617,110)	\$44,123,957

See notes to consolidated financial statements.

[Table of Contents](#)CHARLES & COLVARD, LTD. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2003	2002	2001
<b>Operating Activities</b>			
Net income	\$ 1,043,375	\$ 9,408,437	\$ 1,224,735
Adjustments:			
Depreciation and amortization	161,899	128,604	150,935
Stock option compensation	34,283	92,497	37,262
Loss on disposal of long term assets	—	—	119,460
Change in provision for uncollectible accounts	(10,000)	(135,000)	(45,000)
Deferred income taxes	1,099,501	(6,657,874)	—
Changes in assets and liabilities:			
Accounts receivable	(1,496,143)	742,165	(1,290,076)
Interest receivable	5,134	1,898	5,066
Inventory	(1,700,667)	(1,024,254)	1,730,345
Prepaid expenses and other assets	(172,263)	(112,430)	86,518
Accounts payable	414,499	343,109	(1,435,295)
Accrued payroll	(558,524)	521,455	91,386
Accrued expenses and other liabilities	5,242	114,927	(256,952)
Deferred gross profit	264,903	53,566	16,805
Net cash provided (used) in operating activities	(908,761)	3,477,100	435,189
<b>Investing Activities</b>			
Purchases of equipment	(144,284)	(215,825)	(37,362)
Patent and license rights costs	(24,103)	(33,252)	(15,305)
Proceeds from sale of long term assets	—	31,085	71,400
Net cash provided (used) in investing activities	(168,387)	(217,992)	18,733
<b>Financing Activities</b>			
Stock options exercised	102,029	10,839	—
Purchase of common stock	(748,003)	(224,021)	(76,000)
Proceeds from stock rights offering	—	—	6,031,995
Net cash provided (used) in financing activities	(645,974)	(213,182)	5,955,995
Net change in cash and equivalents	(1,723,122)	3,045,926	6,409,917
Cash and equivalents at beginning of year	13,282,245	10,236,319	3,826,402
Cash and equivalents at end of year	11,559,123	\$ 13,282,245	\$ 10,236,319

See notes to consolidated financial statements.

CHARLES & COLVARD, LTD. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
YEARS ENDED DECEMBER 31, 2003, 2002 AND 2001

**1. Organization and Basis of Presentation**

Charles & Colvard, Ltd. (formerly C3, Inc.) (“the Company”), was incorporated in North Carolina on June 28, 1995 and manufactures, markets and distributes Charles & Colvard created moissanite jewels (hereinafter referred to as moissanite or moissanite jewels) 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. Moissanite is being positioned as a jewel in its own right, distinct from all other jewels based on its fire, brilliance, luster, durability and rarity. From its inception in June 1995 through June 30, 1998, the Company was a development stage enterprise that devoted its resources to fund research and development of colorless, scientifically made moissanite jewels. The Company began shipping moissanite to domestic retail jewelers and international distributors during the second quarter of 1998. During the second quarter of 2000, the Company changed its domestic distribution model to sell through jewel distributors and jewelry manufacturers rather than direct to retail stores.

All of the Company’s activities are within a single business segment. Export sales aggregated approximately \$2.6 million, \$2.3 million, and \$2.1 million in 2003, 2002, and 2001 respectively.

**2. Summary of Significant Accounting Policies**

*Principles of Consolidation*

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

*Cash and Equivalents*

The Company considers all money market accounts and investments purchased with an original maturity of three months or less to be cash equivalents.

*Inventory*

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, which is greater than a year. 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 influence of customer demand, there may be a market for a portion of this unvalued inventory that management may pursue in the future.

*Equipment*

Equipment is recorded at cost and depreciated on the straight-line method based on estimated useful lives of three to 12 years. Leasehold improvements are amortized on the straight-line method over the life of the related lease.

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### *Patents and License Rights*

The Company capitalizes costs associated with obtaining patents issued or pending for inventions and license rights related to the manufacture of moissanite jewels. Such costs are amortized over 17 years.

### *Accounting for Long-Lived Assets*

The Company accounts for long-lived assets in accordance with Statement of Financial Accounting Standards (“FAS”) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Company evaluates the recoverability of its long-lived assets for financial impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be fully recoverable. Based on these evaluations, there were no significant adjustments to the carrying value of long-lived assets in 2003, 2002 or 2001.

### *Concentrations of Credit Risk*

Financial instruments which potentially subject the Company to concentrations of credit risk are primarily cash equivalents and trade receivables. The Company maintains cash and cash equivalents with high quality financial institutions and invests in low risk securities including U.S. Treasury bills, money market funds, and government agency notes.

Trade receivables potentially subject the Company to credit risk. The Company extends credit to its customers based upon an evaluation of the customer’s financial condition and credit history and does not require collateral. During 2003, two customers accounted for approximately 44% and 23% of the Company’s sales. At December 31, 2003, these customers accounted for 55% and 6% of receivables, respectively. During 2002, three customers accounted for approximately 42%, 23% and 14% of the Company’s sales. At December 31, 2002, these customers accounted for 59%, 2%, and 16% of receivables, respectively. During 2001, two customers accounted for approximately 38% and 26% of the Company’s sales.

### *Revenue Recognition*

Revenue is generally recognized when products are shipped. From time to time, the Company ships certain items on “memo” terms. For goods shipped on memo terms, the customer receives title to the goods and assumes the risk of loss, however they have an absolute right of return during the specified memo period. The Company recognizes revenue on these transactions upon the earlier of (1) the customer informing the Company that it will keep the product or (2) the expiration of the memo period.

### *Advertising Costs*

Advertising production costs are expensed as incurred. Media placement costs are expensed over the period the advertising appears. Advertising expenses for the years ended December 31, 2003, 2002, and 2001 amounted to approximately \$3,400,000, \$2,800,000, and \$1,600,000, respectively.

### *Research and Development*

All research and development costs are expensed as incurred.

### *Stock Compensation*

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

In accordance with APB 25, and the provision of FAS 123 as applicable to consultants, the Company recorded compensation expense of approximately \$34,000, \$ 92,000, and \$37,000 during 2003, 2002, and 2001, respectively, relating to stock options granted with exercise prices less than market value or granted to consultants. This compensation expense is recorded as part of general and administrative expenses in the Statement of Operations. Had compensation expense for all stock options been determined consistent with FAS 123, rather than APB 25, the Company’s net income and income per



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share for the years ended December 31, 2003, 2002, and 2001 would have been recorded to the pro forma amounts indicated below:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>Net income:</b>			
As reported	\$ 1,043,375	\$ 9,408,437	\$ 1,224,735
Deduct – total stock based compensation expense under fair value method for all awards, net of tax	693,468	436,766	87,700
<b>Pro forma net income</b>	<b>\$ 349,907</b>	<b>\$ 8,971,671</b>	<b>\$ 1,137,035</b>
<b>Basic net income per share:</b>			
As reported	\$ 0.08	\$ 0.70	\$ 0.10
Pro forma	0.03	0.67	0.09
<b>Diluted net income per share:</b>			
As reported	\$ 0.08	\$ 0.69	\$ 0.10
Pro forma	0.03	0.66	0.09

The fair value of each option grant is estimated on the grant date using a Black-Scholes option pricing model. The valuations for the years ended December 31, 2003, 2002, and 2001 were based on the following assumptions:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Weighted-average grant date fair value	\$3.70	\$ 2.99	\$ 0.91
Weighted-average expected lives (in years)	7.00	7.00	7.00
Risk-free interest rate	3.50%	3.425%	3.12-5.32%
Dividend yield	0%	0%	0%
Volatility factor	.975	.985	.977-1.006

### *Use of 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, 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.

### *Income Taxes*

The Company accounts for income taxes under the provisions of FAS No. 109, *Accounting for Income Taxes*. Under FAS 109, deferred income taxes are recognized for the tax consequences of “temporary” differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to the amount that is likely to be realized. As of December 31, 2001, the net deferred tax assets were fully reserved. During 2002, the valuation allowance was eliminated as it became more likely than not that the deferred tax assets would be realized due to sustained profitability.

### *Net Income Per Share*

The Company reports its net income per share in accordance with the Statement of FAS No. 128, *Earnings Per Share*. FAS 128 requires the presentation of both basic and diluted earnings per share, regardless of materiality, unless per share amounts are equal. Basic net income per share computations are based on the weighted-average common shares outstanding. Diluted net income per share computations include the dilutive effect, if any, of stock options and warrants using the treasury stock method.

For the years ended December 31, 2002, and 2001, warrants to purchase 300,000 shares of common stock at \$18 per share were excluded from the computation of diluted net income per share because the

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exercise price was greater than the average market price of the common shares. These warrants expired unexercised in November of 2002. In addition, for the years ended December 31, 2003, 2002, and 2001 stock options to purchase approximately 850,000, 950,000, and 1,200,000 shares, respectively, were also excluded from the computation of diluted net income per share because the options' exercise price was greater than the average market price of the common shares. During 2003, approximately 810,000 common stock options with an exercise price less than the average market price were included in the computation of diluted earnings per share. The weighted-average dilutive impact of these options, net of 470,000 treasury shares assumed to be repurchased, was 315,858 shares. During 2002, approximately 640,000 common stock options with an exercise price less than the average market price were included in the computation of diluted earnings per share. The weighted-average dilutive impact of these options, net of 340,000 treasury shares assumed to be repurchased, was 289,150 shares. During 2001, approximately 180,000 common stock options with an exercise price less than the average market price were included in the computation of diluted earnings per share. The weighted-average dilutive impact of these options, net of 170,000 treasury shares assumed to be repurchased, was 9,522 shares.

### *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. FAS 143 was 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 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 was effective for the Company's 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 an effect on the Company's 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 an effect on the Company's consolidated financial statements.

In December 2002, FAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure*, was issued. FAS No. 148 presents additional alternatives for transitioning to the fair value method of accounting for stock-based compensation, prescribes the format to be used for pro forma disclosures and requires the inclusion of similar pro forma disclosures in interim financial statements. The Company has not adopted the fair value based method of accounting for employee stock options; however, the disclosure requirements of this statement have been adopted.

In April 2003, FAS No. 149, *Amendments of Statement No. 133 on Derivative Instruments and Hedging Activities*, was issued. FAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This Statement was effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of this statement did not have an effect on the Company's consolidated financial statements.

In May 2003, FAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, was issued. FAS 150 established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement

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was generally effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective on July 1, 2003. The Company does not have any financial instruments with characteristics of both liabilities and equity within the scope of this statement and the adoption of this statement did not have an effect on the Company's consolidated financial statements.

In January 2003, FAS Interpretation ("FIN") No. 46, *Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51*, was issued (revised December 2003, FIN 46R). 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, however certain provisions of the interpretation were deferred until the period ending after March 15, 2004. The Company does not have any variable interest entities, and the adoption of this interpretation did not have an effect on the Company's consolidated financial statements.

### *Reclassification*

Certain 2002 and 2001 amounts have been reclassified to conform with the 2003 presentation.

### **3. Inventories**

Inventories consisted of the following:

	December 31,	
	2003	2002
Raw materials	\$ 1,133,805	\$ 217,815
Work-in-process	4,140,703	4,625,425
Finished goods	18,791,484	17,522,085
<b>Total Inventory</b>	<b>\$ 24,065,992</b>	<b>\$ 22,365,325</b>

Finished goods are shown net of a reserve for excess jewelry inventory of \$130,000 and \$230,000 at December 31, 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 December 31, 2003 and December 31, 2002, respectively. 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 may 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.

### **4. Equipment and Patent and License Rights**

Equipment balances are summarized as follows:

	December 31,	
	2003	2002
Machinery and equipment	\$ 333,517	\$ 311,517
Computer equipment	481,016	448,337
Furniture and fixtures	231,331	130,108
Leasehold improvements	103,073	103,073
Construction in progress	26,611	38,229
<b>Total</b>	<b>1,175,548</b>	<b>1,031,264</b>
Accumulated depreciation	(721,712)	(581,317)
<b>Total equipment, net</b>	<b>\$ 453,836</b>	<b>\$ 449,947</b>

Depreciation expense for 2003, 2002, and 2001 was \$140,395, \$108,159, and \$128,523, respectively.

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Patent and license rights balances are summarized as follows:

	December 31,	
	2003	2002
Patent and license rights	\$ 379,017	\$354,914
Accumulated amortization	(104,127)	(82,623)
Patent and license rights, net	\$ 274,890	\$272,291

Amortization expense for 2003, 2002, and 2001 was \$21,504, \$20,445, and \$22,412, respectively. Amortization expense is estimated to be approximately \$21,000 for each of the next five years.

### **5. Common Stock**

On February 21, 2001, the Company completed a Rights Offering to its shareholders. The Company issued an aggregate of 6,246,735 shares of common stock at \$1 per share. Net proceeds from the offering, after expenses, were \$6,031,995.

In September 2001, the Board of Directors authorized a common stock repurchase program. The program authorized management, in its discretion, to repurchase up to 1,300,000 shares of the Company's common stock through open market or privately negotiated transactions at prices at or below prevailing prices. This program expired in September 2002. During 2001, the Company repurchased 76,000 shares at a cost of \$1 per share from an affiliate of Chester L.F. Paulson. 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. During 2002, the Company repurchased 57,800 shares at an average price of \$3.88.

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. This program expired in September 2003. No shares were repurchased during 2002 under this program. During 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.

In December 2003, the Board of Directors authorized a follow-on repurchase program for up to 900,000 shares of the Company's common stock. As of December 31, 2003, there were no shares repurchased since the adoption of the follow-on program. Management will determine the time and extent of any future repurchases based on its evaluation of market conditions and other factors.

### **6. Preferred Stock**

The Company has authorized 10 million shares of preferred stock, no par value. The preferred stock may be issued from time to time in one or more series.

On February 21, 1999 the Company adopted a Shareholder Rights Plan under which all shareholders of record as of March 8, 1999 received rights to purchase shares of a new series of Preferred Stock. The adoption of this plan is intended as a means to guard against abusive takeover tactics. The rights will be exercisable only if a person or group acquires or announces a tender offer to acquire 20% or more of the Company's common stock. Under the plan all shareholders except the purchaser will be entitled to acquire the Company's common stock at a 50% discount. The rights will trade with the Company's common stock, unless and until they are separated upon the occurrence of certain future events.

### **7. Compensation**

#### *Stock Option Plans*

In 1996, the Company adopted the 1996 Stock Option Plan of C3, Inc. ("1996 Option Plan") under which options to acquire 777,450 common shares, reduced by the number of options granted outside the 1996 Option Plan, may be granted to key employees, directors and independent consultants. Under the 1996 Option Plan, both incentive and non-qualified options may be granted under terms and conditions

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established by the Compensation Committee of the Board of Directors. The exercise price for incentive options will be the fair market value of the related common stock on the date the option is granted. Options granted under the 1996 Option Plan generally vest equally over a three-year period and have terms of 10 years. The Company currently has no plans to award additional options under the 1996 Option Plan.

In 1997, the Company adopted the 1997 Omnibus Stock Plan of C3, Inc. (the “1997 Omnibus Plan”). The 1997 Omnibus Plan authorizes the Company to grant stock options, stock appreciation rights and restricted 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. The maximum number of shares of common stock for which awards may be granted under the 1997 Omnibus Plan may be increased from time to time to a number of shares equal to (i) 20% of the shares of common stock outstanding as of that time less (ii) the number of shares of common stock subject to outstanding options under the 1996 Option Plan. The number of shares reserved for issuance under the 1997 Omnibus Plan may also be adjusted upon certain events affecting the Company’s capitalization. Options granted under the 1997 Omnibus Plan generally vest over three- to five-year periods and have terms of 10 years, with the exception of options granted under the Executive Compensation Plan that vest immediately. The Board of Directors has reserved 1,730,912 shares for issuance under the 1997 Omnibus Plan.

The following is a summary of activity for the Company’s two stock option plans:

	1996 Option Plan		1997 Omnibus Plan	
	Number Of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise Price
<b>2001</b>				
Outstanding at beginning of year	360,177	\$ 4.10	838,866	10.88
Granted	—	—	257,600	1.16
Exercised	—	—	—	—
Canceled	(5,745)	4.04	(79,266)	11.49
Outstanding at end of year	354,432	4.10	1,017,200	8.31
<b>2002</b>				
Granted	—	—	233,066	3.64
Exercised	—	—	(10,641)	1.02
Canceled	—	—	(16,700)	5.96
Outstanding at end of year	354,432	4.10	1,222,925	\$ 7.52
<b>2003</b>				
Granted	—	—	193,115	4.48
Exercised	(13,520)	3.30	(39,506)	1.45
Canceled	(10,650)	4.81	(120,933)	11.24
Outstanding at end of year	330,262	\$ 4.11	1,255,601	\$ 6.88

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The following summarizes information about stock options outstanding at December 31, 2003:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Outstanding as of 12/31/2003	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Exercisable as of 12/31/2003	Weighted-Average Exercise Price
\$ 0.00-\$ 1.64	231,285	5.9	\$ 1.1919	186,348	\$ 1.1950
\$ 1.65-\$ 3.28	199,176	4.8	\$ 2.5531	187,428	\$ 2.5578
\$ 3.29-\$ 4.93	526,102	5.2	\$ 4.4372	411,705	\$ 4.4670
\$ 4.94-\$ 6.57	150,100	3.7	\$ 5.4397	138,718	\$ 5.4327
\$ 6.58-\$ 8.22	55,000	3.4	\$ 7.8020	55,000	\$ 7.8020
\$ 8.23-\$ 9.86	77,600	2.1	\$ 8.7446	77,233	\$ 8.7417
\$ 9.87-\$11.51	11,800	3.9	\$ 10.8100	11,800	\$ 10.8100
\$11.52-\$13.15	0	0.0	\$ 0.0000	0	\$ 0.0000
\$13.16-\$14.79	168,300	1.5	\$ 13.8667	156,706	\$ 13.8664
\$14.80-\$16.44	166,500	2.9	\$ 15.0000	72,150	\$ 15.0000
	<u>1,585,863</u>	<u>4.3</u>	<u>\$ 6.3067</u>	<u>1,297,088</u>	<u>\$ 6.0023</u>

*Other*

In February 2003 and May 2002, the Company amended the 2001 Executive Compensation Plan to remain in effect during 2003 and 2002. This plan offers key employees of the Company incentive awards in the form of cash payments, and/or stock option grants based upon the Company's attainment of certain performance goals. For 2003, no payments or stock options were issued under the plan. For 2002, \$450,000 in cash payments were recorded as operating expenses and 124,000 stock options were granted under the plan. No compensation was recorded for the stock options granted under the plan. For 2001, \$42,000 in cash payments were recorded as operating expenses and 91,000 stock options were granted under the plan. No compensation was recorded for the stock options granted under the plan.

**8. Income Taxes**

The Company accounts for income taxes under the liability method in accordance with FAS 109. Under the liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities.

The components of income tax expense are the following.

	Year Ended December 31,		
	2003	2002	2001
<b>Current</b>			
Federal	\$ 64,000	\$ —	\$—
State	—	—	—
	<u>\$ 64,000</u>	<u>\$ —</u>	<u>\$—</u>
<b>Deferred</b>			
Federal	\$ 891,954	\$(5,459,457)	\$—
State	207,547	(1,198,417)	—
	<u>1,099,501</u>	<u>(6,657,874)</u>	
	<u>\$ 1,163,501</u>	<u>\$(6,657,874)</u>	<u>\$—</u>

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

	December 31,	
	2003	2002
<b>Current</b>		
Reserves and accruals	\$ 235,179	\$ 250,601
<b>Long-Term</b>		
Federal and state loss carryforwards	5,039,000	6,167,000
Hong Kong loss carryforwards	258,000	142,000
Benefit of research tax credits	416,000	416,000
Alternative minimum tax credit	64,000	—
Stock option compensation	168,000	247,000
Depreciation	(37,061)	(36,704)
<b>Total long term</b>	<b>5,907,939</b>	<b>6,935,296</b>
<b>Total deferred tax assets</b>	<b>6,143,118</b>	<b>7,185,897</b>
Less valuation allowance	(258,000)	(142,000)
<b>Net deferred tax assets</b>	<b>5,885,118</b>	<b>7,043,897</b>

A reconciliation between expected income taxes, computed at the statutory federal income tax rate (34%) applied to pretax accounting income, and the income taxes included in the statements of operations for the years ended December 31, 2003, 2002 and 2001 follows:

	2003	2002	2001
Anticipated income tax expense at the statutory federal rate	\$ 750,000	\$ 935,000	\$ 416,000
State income tax expense, net of federal tax effect	101,000	125,000	56,000
Effect of Foreign operations	294,000	219,000	128,000
Other	18,501	168,126	125,000
Increase (decrease) in valuation allowance	—	(8,105,000)	(725,000)
<b>Income tax (benefit) expense</b>	<b>\$ 1,163,501</b>	<b>\$(6,657,874)</b>	<b>\$ —</b>

At December 31, 2003, the Company has operating and economic loss carryforwards of approximately \$13,070,000 expiring through 2020 for Federal Tax and 2015 for State Tax purposes, which can be offset against future federal and state taxable income. In accordance with Section 382 of the Internal Revenue Code of 1986, as amended, a change in equity ownership of greater than 50% of the Company within a three-year period results in an annual limitation on the Company's ability to utilize its NOL carryforwards that were created during tax periods prior to the change in ownership. As a result of various equity offerings and certain shareholder transactions, the utilization of a portion of the Company's NOL carryforwards has become limited, however, the Company does not believe this limitation will have a material effect on the Company's ability to utilize the NOL carryforward.

At December 31, 2001, the Company's assessment of the future net realizable value of deferred tax assets resulted in a valuation allowance. At that point in time, the Company had recorded one profitable year following years of significant losses and it was not clear if sufficient taxable income would be generated to realize the temporary differences and tax credit carryforwards. At December 31, 2002, the valuation allowance was eliminated as it became more likely than not that the deferred tax assets would be realized due to sustained profitability.

The Company also has approximately \$1.6 million in NOL 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. Due to the uncertainty of sufficient future taxable income in Hong Kong to utilize this NOL, we have established a valuation allowance against this deferred tax asset.

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### 9. Commitments

#### *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 Company also has 5 leases in Hong Kong and China with a total monthly commitment of approximately \$10,000 per month. These leases expire at various dates from December 31, 2004 to August 15, 2006.

The future minimum lease payments of the Company are as follows: \$220,000 in 2004, \$84,000 in 2005, and \$26,000 in 2006 totaling \$330,000. Rental expense incurred for operating leases and leases whose terms are less than one year in duration for 2003, 2002, and 2001 was approximately \$238,000, \$215,000, and \$190,000, respectively.

#### *Purchase Commitment*

On June 6, 1997, the Company entered into an Amended and Restated Exclusive Supply Agreement ("Exclusive Supply Agreement") and a Development 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 December 2003, the Company agreed with Cree on a framework for purchases for 2004. The Company is obligated to purchase a minimum quantity of usable material on a quarterly basis if Cree meets certain minimum quality levels. For each quarter during 2004, the Company has committed to purchase between \$400,000 and \$1,600,000 of raw material depending upon the quality of material received. If Cree's material quality is consistent with that received in 2003, future purchases are expected to be at the high end of this range.

During 2003, 2002, and 2001, the Company made purchases from Cree of approximately \$6.0 million, \$5.5 million, and \$1.2 million, respectively, for SiC materials.

### 10. Selected Quarterly Data (Unaudited)

	Quarters Ended			
	March 31	June 30	September 30	December 31
<b>Year Ended December 31, 2003</b>				
Net sales	\$ 4,373,143	\$ 4,311,706	\$ 3,776,592	\$ 4,778,942
Gross profit	2,674,702	2,919,130	2,226,768	2,843,852
Net income	532,451	502,231	4,206	4,487
Basic net income per share	0.04	0.04	0.00	0.00
Diluted net income per share	0.04	0.04	0.00	0.00
<b>Year Ended December 31, 2002</b>				
Net sales	\$ 4,150,146	\$ 4,075,602	\$ 3,180,043	\$ 5,107,724
Gross profit	2,111,192	2,442,701	2,209,767	3,162,930
Net income (1)	500,210	637,787	572,304	7,698,136
Basic net income per share <sup>(2)</sup>	0.04	0.05	0.04	0.58
Diluted net income per share	0.04	0.05	0.04	0.56

(1) During the quarter ended December 31, 2002, the Company recorded a one-time \$6.7 million non-operating and non-cash addition to earnings due to the expected realization of deferred tax assets.

(2) The sum of the quarterly numbers do not equal the amount reported on the Statement of Operations due to rounding.



**Schedule II**  
**Charles & Colvard, Ltd. And Subsidiary**  
**Valuation and Qualifying Accounts**

Year ended December 31	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Collections of Accounts Previously Written Off	Deductions/ Write Offs	Balance at End of Period
<b>Allowance for Doubtful Accounts</b>					
2003	\$ 140,000	\$ 67,188 <sup>(1)</sup>	\$ —	\$ 77,188	\$ 130,000
2002	\$ 275,000	\$ —	\$ 1,611	\$ 136,611 <sup>(2)</sup>	\$ 140,000
2001	\$ 320,000	\$ —	\$ 5,914	\$ 50,914 <sup>(2)</sup>	\$ 275,000
<b>Reserve for Excess Jewelry Inventory</b>					
2003	\$ 230,000	\$ —	\$ —	\$ 100,000 <sup>(3)</sup>	\$ 130,000
2002	\$ 635,000	\$ —	\$ —	\$ 405,000 <sup>(3)</sup>	\$ 230,000
2001	\$ 770,000	\$ —	\$ —	\$ 135,000 <sup>(3)</sup>	\$ 635,000
<b>Allowance for Returns</b>					
2003	\$ 110,000	\$ —	\$ —	\$ 30,000 <sup>(5)</sup>	\$ 80,000
2002	\$ 105,000	\$ 5,000 <sup>(4)</sup>	\$ —	\$ —	\$ 110,000
2001	\$ 150,000	\$ —	\$ —	\$ 45,000 <sup>(5)</sup>	\$ 105,000
<b>Lower of Cost or Market Inventory Reserve</b>					
2003	\$ 400,000	\$ —	\$ —	\$ —	\$ 400,000
2002	\$ —	\$ 400,000 <sup>(6)</sup>	\$ —	\$ —	\$ 400,000

- (1) Charged against General and Administrative expenses.
- (2) During 2001, there was \$15,685 of accounts written off as uncollectible and a \$35,229 decrease to the allowance to reflect the estimated collectibility of receivables. During 2002, there was \$71,611 of accounts written off as uncollectible and a \$65,000 decrease to the allowance to reflect the estimated collectibility of receivables.
- (3) Adjustments to reserve to reflect estimated net realizable value of remaining jewelry inventory.
- (4) Charged against sales.
- (5) Adjustments to allowance; credit to sales.
- (6) Charged against Cost of Goods Sold.

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

None.

**Item 9A. Controls and Procedures**

*(a) Evaluation of disclosure controls and procedures*

As of December 31, 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 III**

**Item 10. Directors and Executive Officers of the Registrant**

**Item 11. Executive Compensation**

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

**Item 13. Certain Relationships and Related Transactions**

**Item 14. Auditor Fees**

The information called for in items 10 through 14 is incorporated by reference from our definitive proxy statement relating to our annual meeting of shareholders, which will be filed with the Securities and Exchange Commission within 120 days after the end of fiscal 2003.

**Part IV**

**Item 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K**

(a) (1) and (2) Financial statements and financial statement schedule—the financial statements, financial statement schedule, and report of independent accountants are filed as part of this report (see Index to Financial Statements at Part II Item 8 on page 30 of this Form 10-K).

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

<b>Exhibit Number</b>	<b>Description</b>
3.1	Amended and Restated Articles of Incorporation of C3, Inc. which is hereby incorporated by reference to Exhibit 3.1 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).
3.2	Articles of Amendment of C3, Inc., as filed with the Secretary of State of North Carolina on February 23, 1999 which hereby is incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998.
3.3	Amended and Restated Bylaws of C3, Inc. which is hereby incorporated by reference to Exhibit 3.2 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333- 36809).
3.4	Articles of Amendment to the Company's Articles of Incorporation, as filed May 17, 2000 which is hereby incorporated by reference to Exhibit 3.4 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended June 30, 2000.
4.1	Specimen Certificate of common stock which is hereby incorporated by reference to Exhibit 4.1 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998.
4.2	Form of Representative's Warrant which is hereby incorporated by reference to Exhibit 4.2 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333- 36809).
4.3	Rights Agreement dated as of February 22, 1999 between C3, Inc. and First Union National Bank as Rights Agent, including the Form of Rights Certificate as Exhibit A which is hereby incorporated by reference to Exhibit 4.3 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998.
10.11	Amended and Restated Exclusive Supply Agreement, dated June 6, 1997, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.11 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).*
10.12	Development Agreement, dated as of June 6, 1997, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.12 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).*
10.13	Letter Agreement, dated July 14, 1997, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.13 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).*

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- 10.14 Letter Agreement, dated January 31, 1996, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.14 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).\*
- 10.15 1996 Stock Option Plan of C3, Inc. (as amended October 27, 1997) which is hereby incorporated by reference to Exhibit 10.15 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).+
- 10.16 1997 Omnibus Stock Plan of C3, Inc. which is hereby incorporated by reference to Exhibit 10.16 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).+
- 10.20 Agreement, dated September 24, 1997, between John M. Bachman, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.20 to the Registration Statement on Form S-1 of C3, Inc. (File No. 333-36809).\*
- 10.22 1997 Declaration of Amendment to 1997 Omnibus Stock Plan of C3, Inc. which is hereby incorporated by reference to Exhibit 99.3 to the Registration Statement on Form S-8 of C3, Inc. (File No. 333-43613).+
- 10.23 Supplemental Development Agreement, dated January 8, 1998, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.23 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1997.\*
- 10.24 Letter Agreement, dated January 8, 1998, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.24 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1997.\*
- 10.25 Amended and Restated Development Agreement, dated July 1, 1998 between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.25 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended June 30, 1998.\*
- 10.26 Letter Agreement dated, July 14, 1998, between Cree Research, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.26 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended June 30, 1998.\*
- 10.28 First Amendment to Agreement, dated March 23, 1998 between John M. Bachman, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.28 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended September 30, 1998.\*
- 10.29 Second Amendment to Agreement, dated September 28, 1998 between John M. Bachman, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.29 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended September 30, 1998.\*
- 10.30 1998 Declaration of Amendment to 1996 Stock Option Plan of C3, Inc. which is hereby incorporated by reference to Exhibit 10.30 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998. +
- 10.31 1998 Declaration of Amendment to 1997 Omnibus Stock Plan of C3, Inc., which is hereby incorporated by reference to Exhibit 10.31 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998. +
- 10.32 Employment Agreement, dated March 1, 1999, between Robert Thomas and C3, Inc., which is hereby incorporated by reference to Exhibit 10.32 to the Annual Report on Form 10-K of C3, Inc. for the fiscal year ended December 31, 1998. +

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- 10.34 Letter Agreement, dated May 3, 1999 between Cree Research, Inc. and C3, Inc., which is hereby incorporated by reference to Exhibit 10.34 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended March 31, 1999. \*
- 10.35 Licensing Agreement, dated October 10, 1998, between C. Eric Hunter and C3, Inc., which is hereby incorporated by reference to Exhibit 10.35 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended March 31, 1999. \*
- 10.36 Third Amendment to Agreement, dated June 16, 1999, between John M. Bachman, Inc. and C3, Inc., which is hereby incorporated by reference to Exhibit 10.36 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended June 30, 1999. \*
- 10.37 Fourth Amendment to Agreement, dated October 5, 1999, between John M. Bachman, Inc. and C3, Inc., which is hereby incorporated by reference to Exhibit 10.37 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended September 30, 1999. \*
- 10.39 Letter Agreement dated December 22, 1999 between Cree, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.39 to the Annual Report on Form 10-K of C3, Inc. for the year ended December 31, 1999.\*
- 10.40 Letter Agreement dated March 16, 2000 between Stuller Settings, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.40 to the Annual Report on Form 10-K of C3, Inc. for the year ended December 31, 1999.\*
- 10.41 Letter Agreement dated March 15, 2000 between The Bell Group, d/b/a Rio Grande and C3, Inc. which is hereby incorporated by reference to Exhibit 10.41 to the Annual Report on Form 10-K of C3, Inc. for the year ended December 31, 1999.\*
- 10.42 Letter Agreement dated May 14, 2000 between Cree, Inc. and C3, Inc. which is hereby incorporated by reference to Exhibit 10.42 to the Quarterly Report on Form 10-Q of C3, Inc. for the quarter ended March 31, 2000.\*
- 10.43 2000 Declaration of Amendment to 1996 Omnibus Stock Plan of C3, Inc. which is hereby incorporated by reference to Exhibit 10.43 to the Annual Report on Form 10-K of Charles & Colvard, Ltd. for the year ended December 31, 2000.+
- 10.44 2000 Declaration of Amendment to 1997 Omnibus Stock Plan of C3, Inc. which is hereby incorporated by reference to Exhibit 10.44 to the Annual Report on Form 10-K of Charles & Colvard, Ltd. for the year ended December 31, 2000.+
- 10.45 Letter Agreement dated December 7, 2000 between Cree, Inc. and Charles & Colvard, Ltd. which is hereby incorporated by reference to the Exhibit 99.2 of the Company's Current Report on Form 8-K dated January 9, 2001.\*
- 10.46 Fifth Amendment to Agreement, dated December 29, 2000 between John M. Bachman, Inc. and Charles & Colvard, Ltd., which is hereby incorporated by reference to Exhibit 10.46 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended March 31, 2001.\*
- 10.47 Charles & Colvard, Ltd. Fiscal Year 2001 Executive Compensation Plan which is hereby incorporated by reference to Exhibit 10.47 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended June 30, 2001.+

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- 10.48 Employment Agreement between James R. Braun, CFO and Charles & Colvard, Ltd. which is hereby incorporated by reference to Exhibit 10.48 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended June 30, 2001.+
- 10.49 Letter Agreement dated July 2, 2001 between Cree, Inc. and Charles & Colvard, Ltd. which is hereby incorporated by reference to Exhibit 10.49 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended September 30, 2001.\*
- 10.50 Letter Agreement dated March 8, 2002 between Cree, Inc. and Charles & Colvard, Ltd., which is hereby incorporated by reference to Exhibit 10.50 to the Annual Report on Form 10-K of Charles & Colvard, Ltd. for the year ended December 31, 2001.\*
- 10.51 Letter Agreement dated April 2, 2002 between JewelNet Corporation d/b/a K&G Creations and Charles & Colvard, Ltd. which is hereby incorporated by reference to Exhibit 10.51 to Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended March 31, 2002.\*
- 10.52 Sixth Amendment to Agreement, dated April 9, 2002 between John M. Bachman, Inc. and Charles & Colvard, Ltd., which is hereby incorporated by reference to Exhibit 10.52 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended March 31, 2002.\*
- 10.53 Executive Compensation Plan for Fiscal Year 2001 as Amended on May 20, 2002, which is hereby incorporated by reference to Exhibit 10.53 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended June 30, 2002.+
- 10.54 Letter Agreement dated August 5, 2002 between Cree, Inc. and Charles & Colvard, Ltd., which is hereby incorporated by reference to Exhibit 10.50 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended September 30, 2002.\*
- 10.55 Salary Continuation Agreement, dated July 15, 2002 between Barbara L. Mooty, Vice President of Brand Identity and Industry Relations, and Charles & Colvard, Ltd. which is hereby incorporated by reference to Exhibit 10.51 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended September 30, 2002.+
- 10.56 Salary Continuation Agreement dated October 1, 2002 between Dennis Reed, Vice President of Sales, and Charles & Colvard, Ltd., which is hereby incorporated by reference to Exhibit 10.56 to the Annual Report on Form 10-K of Charles & Colvard for the year ended December 31, 2002.+
- 10.57 Executive Compensation Plan for Fiscal Year 2001, as Amended on February 13, 2003., which is hereby incorporated by reference to Exhibit 10.57 to the Annual Report on Form 10-K of Charles & Colvard for the year ended December 31, 2002.+
- 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, which is hereby incorporated by reference to Exhibit 10.58 to the Quarterly Report on Form 10-Q of Charles & Colvard, Ltd. for the quarter ended June 30, 2003.+
- 10.59 Executive Compensation Plan for Fiscal Year 2001, as amended on February 16, 2004.++
- 10.60 Letter Agreement, dated December 18, 2003, between Stuller, Inc. and Charles & Colvard, Ltd.\*++

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14.1	Code of Business Conduct and Ethics.++
14.2	Code of Ethics for Senior Financial Officers.++
21.1	Schedules of Subsidiaries
23.1	Consent of Deloitte & Touche LLP
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.

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

+ Denotes a management contract or compensatory plan or arrangement.

++ Denotes filed herewith

(b) Reports on Form 8-K of Charles & Colvard for the fourth quarter of 2003

1. During the quarter ended December 31, 2003, we filed a Current Report on Form 8-K on October 22, 2003. Item 12 was reported and no financial statements were filed.
2. During the quarter ended December 31, 2003, we filed a Current Report on Form 8-K on October 23, 2003. Item 12 was reported and no financial statements were filed.
3. During the quarter ended December 31, 2003, we filed a Current Report on Form 8-K on December 16, 2003. Item 9 was reported and no financial statements were filed.

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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.

By: /s/ Robert S. Thomas Date: 3/15/04

Robert S. Thomas, President & CEO

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.

By: /s/ Robert S. Thomas Date: 3/15/04

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

By: /s/ James R. Braun Date: 3/15/04

James R. Braun  
Vice President of Finance &  
Chief Financial Officer  
(Principal financial and accounting officer)

By: /s/ Laura C. Kendall Date: 3/13/04

Laura C. Kendall  
Director

By: /s/ Walter J. O'Brien Date: 3/14/04

Walter J. O'Brien  
Director

By: /s/ Frederick A. Russ Date: 3/15/04

Frederick A. Russ  
Director

By: /s/ George A. Thornton, III Date: 3/13/04

George A. Thornton, III  
Director



**CHARLES & COLVARD, LTD.  
2001 EXECUTIVE COMPENSATION PLAN,  
AS AMENDED AND RESTATED EFFECTIVE FEBRUARY 16, 2004  
PLAN SUMMARY**

1. Purpose. The purpose of the 2001 Executive Compensation Plan, as amended and restated effective May 20, 2002, February 13, 2003 and February 16, 2004 (the "Plan"), is to provide selected key employees of Charles & Colvard, Ltd. (the "Company") with incentive awards in the form of cash payments and/or bonus option grants (each, an "award" and collectively, "awards") based upon attainment of performance goals, thereby promoting a closer identification of the participants' interests with the interests of the Company and its shareholders, and further stimulating such participants' efforts to enhance the efficiency, profitability, growth and value of the Company. The Plan was first adopted in fiscal year 2001 and may continue in effect for future years, as modified by the Compensation Committee (the "Committee") of the Board of Directors (the "Board") or by the Board in its or their discretion. (For the purposes herein, the "Committee" shall be interpreted to mean the Board if in fact the Board takes the indicated action.)
2. Eligibility. Key employees of the Company selected by the Committee shall be eligible to participate (each, a "participant"). Eligible participants shall be selected to participate on an annual or other periodic basis as determined by the Committee. For the 2004 plan year, the key employees eligible to participate in the Plan shall be the Chief Executive Officer, Chief Financial Officer, Vice President of Sales, Vice President of Manufacturing, Vice President of Brand Development and Industry Relations, Director of Domestic Sales, Director of International Sales, Director of Information Technology and such other key employees as may be selected by the Committee to participate in the Plan; provided, however, that the Committee shall have sole discretion to determine eligibility for Plan participation and participation in the Plan for any single plan year shall not guarantee eligibility to participate in any other plan year. Nothing contained in the Plan or the terms of any award will be construed as conferring upon any participant the right to continue in the employment of the Company or as imposing upon the Company the obligation to continue to employ a participant. Awards granted under the Plan may not be assigned or transferred by a participant to any other person or entity. (For the purposes of the Plan, a "plan year" shall coincide with the particular fiscal year of the Company.) A participant must be employed by the Company at December 31 of the applicable plan year to be eligible for a bonus for that plan year.
3. Administration of the Plan. The Plan will be administered by the Committee. The Committee is vested with the authority to determine eligibility, grant awards and establish and modify performance criteria. In addition, without limiting the foregoing, the Committee has full authority in its discretion to take any action with respect to the Plan including, without limitation, the authority (i) to determine all matters relating to

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- awards, including selection of individuals to be granted awards, the types of awards, the number of shares of the Company's common stock (the "Common Stock"), if any, subject to an award, and all terms, conditions, restrictions and limitations of an award; and (ii) to construe and interpret the Plan and any instruments evidencing awards granted under the Plan, to establish and interpret rules and regulations for administering the Plan and to make all other determinations deemed necessary or advisable for administering the Plan. All determinations of the Committee with respect to the Plan will be final and binding on the Company and all persons having or claiming an interest in any award granted under the Plan. No member of the Committee shall be liable while acting as administrator for any action or determination made in good faith with respect to the Plan or any award.
4. Nature of Awards. Awards granted under the Plan may consist of cash bonuses and/or bonuses in the form of option grants ("option bonuses"). The terms of option bonuses will be governed by the terms of the 1997 Omnibus Stock Plan of C3, Inc., as amended (the "1997 Plan"), or any other stock incentive plan which may apply to such option bonuses and shall be subject to the terms and conditions of such plan and the respective award agreement.
  5. Determination of Awards. The Committee will establish those performance goals (each, a "goal") which shall apply to the determination of awards, if any, to be made with respect to a participant for any plan year. A participant's ability to earn an award for a particular plan year will be based on the Company's attainment of the goals for that plan year. The goals and any other factors which may apply with respect to the grant of awards during a plan year shall be determined by the Committee and may differ from the goals applicable in other plan years; provided, however, that, unless the Committee determines otherwise, all awards which may be earned by Plan participants during any particular plan year will be determined based on the same goals.
  6. Determination of Cash Bonuses.
    - (a) General. The Company shall establish a cash bonus pool (the "cash bonus pool"), which will be used to fund cash awards earned under the Plan. The cash bonus pool will be funded in the event that the Company achieves its annual operating goals for the particular plan year, which for 2004 shall consist of the operating income goal ("income goal") and carat shipments goal ("shipment goal") as set out in the Company's annual business plan, as approved by the Board. The maximum cash bonus to be earned in any plan year by a participant is \$500,000 per year during the first three years of employment with the Company, \$1,000,000 per year during the next succeeding three years of employment with the Company and \$2,500,000 per year thereafter.
    - (b) 2004 Plan Year. For the 2004 plan year, the provisions which follow shall apply with respect to the award of cash bonuses; provided, however, that the Committee shall have full discretion to modify the goals and any other performance or other factors applicable to the determination of Plan awards for any subsequent plan year and shall not be bound by the provisions applicable for the 2004 plan year.

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- (i) Following the 2004 plan year, if the Committee determines that the income goal has been met, five percent (5%) of the Company's operating income will be contributed to the cash bonus pool from which cash bonuses for the 2004 plan year may be distributed.
  - (ii) If both the income goal and the shipments goal have been met at the end of the 2004 plan year, an additional five percent (5%) of the Company's operating income will be added to the cash bonus pool.
  - (iii) If both the income goal and the shipments goal have been met at the end of the 2004 plan year, fifteen percent (15%) of all pre-bonus, operating income in excess of the income goal will be added to the cash bonus pool for the 2004 plan year.
  - (iv) If the income goal is not met at the end of the 2004 plan year, the Committee (based on recommendations by the CEO) may in its discretion determine what amount, if any, will be contributed to the cash bonus pool and be payable to any eligible participant.
  - (v) The cash bonus pool if earned and payable will be paid 35% to the CEO and 16.25% to each of the CFO, Vice President of Manufacturing, Vice President of Sales and Vice President of Brand Development and Industry Relations.
  - (vi) The Sales and Marketing Directors, who are eligible for cash commission payments, and the Director of Information Technology, who participates in the quarterly bonus pool for non-officer employees, will not participate in cash bonuses, if any, in 2004.

7. Determination of Option Bonuses.

- (a) General. The Company shall establish an option bonus pool (the "option pool") which will be used to fund option awards earned under the Plan. Options from the option pool shall be awarded in the event the Company achieves its income goal for the particular year. Nothing in the terms of the Plan shall limit the authority of the Company to grant stock options or other stock-based awards under the 1997 Plan or other applicable plan.
- (b) 2004 Plan Year. For the 2004 plan year, the provisions which follow shall apply with respect to the award of option bonuses; provided, however, that the Committee shall have full discretion to modify the goals and any other performance or other factors applicable to the determination of Plan awards for any subsequent plan year and shall not be bound by the provisions applicable for the 2004 plan year.

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- (i) For the 2004 plan year, the option bonus pool shall consist of options for 143,000 shares of the Common Stock.
  - (ii) If the income goal has been met at the end of the 2004, the option pool will be distributed as follows: 40,000 options to the CEO, 20,000 options to each of the CFO, Vice President of Manufacturing, Vice President of Sales and Vice President of Brand Development and Industry Relations, 9,000 options to the Director of Information Technology and 7,000 options to each of the Director of Domestic Sales and Director of International Sales. Any options granted will have an option price equal to the closing sales price on the last trading day immediately prior to the Company's public announcement of the 2004 financial results, will vest immediately and will be exercisable over ten years.
  - (iii) If the income goal is not met at the end of the 2004 plan year, the Committee (based on recommendations by the CEO) may in its discretion determine the option grants, if any, that will be awarded to any eligible participant.
8. Timing of Awards. Unless the Committee determines otherwise, cash bonuses will be distributed as soon as practical following the completion of the annual audit for the respective preceding fiscal year by the Company's independent accountants. Except to the extent that the terms of the 1997 Plan (or other applicable plan) provide otherwise, and unless the Committee determines otherwise, option bonuses will be granted as of the last trading day immediately preceding the public announcement of the Company's financial performance for the respective preceding fiscal year.
9. Option Bonus Adjustments. Option bonuses will be adjusted proportionately in the event of any stock splits or similar adjustments occurring after the adoption of the Plan and prior to the end of fiscal year 2004 and may be subject to further adjustment in the event of any stock splits or other capital adjustments which occur after the end of the fiscal year, subject to the terms of the 1997 Plan or other applicable plan and the Committee's discretion thereunder.
10. Proration of Awards. To the extent a participant is employed by the Company for less than the full fiscal year, the bonus to which the participant is otherwise entitled shall be prorated to reflect the percentage of the fiscal year that the participant was employed by the Company.
11. Amendment. The Plan and any award granted under the Plan may be amended or terminated at any time by the Committee; provided, however, that (i) amendment or termination of an outstanding award may not, without the consent of the participant, adversely affect the rights of the participant with respect to such award; and (ii) approval of an amendment to the Plan by the shareholders of the Company shall be required in the event shareholder approval of such amendment is required by applicable law.

REDACTED - OMITTED MATERIAL HAS BEEN FILED SEPARATELY WITH THE COMMISSION AND IS DENOTED HEREIN BY \*\*\*\*\*

**CHARLES & COLVARD®**  
*Created*  
**M O I S S A N I T E**

**SENT VIA PRIORITY MAIL**

**Confidential**

December 18, 2003

Mr. Linus Cortez  
 Chief Financial Officer  
 Stuller, Inc.  
 302 Rue Louis XIV  
 Lafayette, Louisiana 70508

Dear Mr. Cortez:

This letter, when accepted by Stuller Inc., will amend and replace our existing letter agreement dated, March 16, 2000, including all extensions and amendments.

For the Term, Charles & Colvard, Ltd., (C&C), hereby:

1. Appoints Stuller Inc., (Stuller) the rights to sell Charles & Colvard created moissanite (either as a loose jewel or in manufactured jewelry) in the territory comprised of the North American Continent from the present date until December 31, 2004, (The Appointment Term).
2. Warrants that C&C shall appoint no additional distributors for the loose moissanite jewel in the territory during the term.
3. Warrants that Stuller will be charged no more than the lowest price charged to any jewelry industry customer worldwide. (Current price attached as Schedule A). Further, if at any time the pricing of moissanite is decreased, C&C shall provide Stuller with a credit toward additional purchases of moissanite equal to the amount of such price decrease on the lesser of (a) Stuller's net purchases of moissanite during the prior 90 days or (b) Stuller's actual inventory at such time.
4. Agrees to provide funding for the joint marketing of moissanite jewels as outlined on Schedule B attached, during 2004. Such funding shall be provided either as a credit to Stuller against future purchases, or as cash payments to vendors other than Stuller or C&C. Additionally, C&C Agrees to provide the funds for the marketing of moissanite equal to \*\*\*\*\* % of Stuller's purchases from C&C paid quarterly, in arrears, in the form of credits against future purchases of moissanite from C&C. It is agreed that the use of funds described on Schedule B, by mutual consent, may be used for purposes other than those detailed on the Schedule.
5. Agrees to maintain a backup inventory of 100% of the previous quarters purchases by Stuller.
6. Agrees to provide stock rebalancing quarterly on a dollar value per dollar value basis.
7. Agrees to provide the Stuller staff with any required training concerning the product, the marketing strategy, and the product positioning being implemented by C&C.

Stuller hereby recognizes and agrees to cooperate with C&C in the protection of all C&C trademarks, copyrights and intellectual property. Further, Stuller agrees to include Charles & Colvard created moissanite in its catalog and trade show presentations for the term of the agreement, and to make commercially reasonable efforts to market moissanite to its' customers consistent with the brand identity guidelines supplied by C&C, and, Stuller specifically agrees to sell Charles & Colvard, Ltd. created moissanite as loose stones only to retailers and manufacturers for use in jewelry mountings and not for resale as loose stones.

*3800 Gateway Boulevard, Suite 310 Morrisville, NC 27560 Telephone 919.468.0399  
 Facsimile 919.468.0486 www.moissanite.com*

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If the forgoing meets with your understanding of our agreement, please sign and return one copy of this letter for my files.

Agreed and accepted:

**Charles & Colvard, Ltd.**

/s/ Robert S. Thomas

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Robert S. Thomas  
President & CEO

**Stuller, Inc.**

/s/ Linus Cortez

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Linus Cortez  
Chief Financial Officer







**CHARLES & COLVARD®**  
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**M O I S S A N I T E**

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**M O I S S A N I T E**

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**M O I S S A N I T E**

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**CHARLES & COLVARD, LTD.**  
**CODE OF BUSINESS CONDUCT AND ETHICS**  
**(Adopted by the Board of Directors on February 16, 2004)**

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## **Fundamental Principles**

Charles & Colvard, Ltd. expects all of our officers, directors, employees, agents and representatives to meet the highest ethical standards in all of our business activities.

Our Board of Directors has adopted this Code of Business Conduct and Ethics as a guide to help us live up to our Company's high ethical standards. This Code does not cover every issue or "gray area" dilemma that may arise, but it establishes principles that should guide you in a wide range of business settings. Ethical conduct is not always easy to define, but we expect all employees to conduct themselves with fairness, honesty, integrity, respect and trust at all times. Every employee is required to be familiar with the Code and comply with it, since any one person's misconduct can damage the Company's hard-earned reputation and compromise the public's trust.

If you have any question about how this Code might apply to you, you should contact your supervisor or our Compliance Officer. The Compliance Officer is:

James R. Braun  
Chief Financial Officer  
Charles & Colvard, Ltd.  
3800 Gateway Boulevard  
Suite 310  
Morrisville, NC 27560  
Telephone: (919) 468-0399 x224

## **Scope and Application of this Code**

When this Code refers to "employees," the term includes the employees, officers, directors, agents and representatives (including consultants, advisors and independent contractors) of the Company. Likewise, references in this Code to our Company or Charles & Colvard includes Charles & Colvard, Ltd. and any and all of its subsidiaries.

This Code governs your conduct as an employee and requires you to avoid even the appearance of improper behavior. Even well-intentioned actions that violate the law or our standards of conduct may result in appropriate disciplinary action, including termination. If you are in a situation which you believe may violate or lead to a violation of this Code, follow the guidelines described below under the heading "Reporting of Code Violations." It is also your responsibility to report violations of this Code by others. Any person who we determine has violated this Code may be subject to discipline, up to and including termination.

We will ask our employees to read this Code and agree in writing to comply with it, and we will remind all employees periodically about their obligations under this Code.

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## **Compliance with Laws and Regulations**

The foundation of our ethical standards is obedience to the letter and spirit of the law. All employees must respect and obey all local, state and federal statutes and regulations and the statutes and regulations of any countries in which we do business. You should seek advice from your supervisor or the Compliance Officer if you have questions about such laws, especially when dealing with governments of countries or territories outside of the U. S.

### Insider Trading Laws

It is the policy of the Company that you must comply with our Policy Statement on the Prevention of Insider Trading, which, among other things, provides that you may not seek to benefit personally by buying or selling securities while in possession of material, nonpublic information that you have learned in connection with your employment with, or service to, the Company. Every new employee is required to acknowledge our Policy Statement, and you may obtain a copy of it from the Compliance Officer.

### Bribery, Kickbacks and Other Improper Payments

Bribery of public officials in the conduct of Company business in the United States or abroad is strictly prohibited. All employees are required to comply strictly with the United States Foreign Corrupt Practices Act which, in essence, prohibits the bribery of foreign government officials (including officials of designated public international organizations), political party candidates or officials or political parties. Bribery can take many forms, including the payment of money or anything else of value (such as “in-kind” items or services).

In addition, the U.S. government has a number of laws and regulations regarding business gratuities which may be accepted by U.S. government personnel. The promise, offer or delivery to an official or employee of the U.S. government of a gift, favor or other gratuity in violation of these rules would not only violate Company policy but may also be a criminal offense. State and local governments, as well as foreign governments, may have similar rules.

### Competition and Fair Dealing

We are committed to conducting our business in an open, vigorous and competitive fashion and seek to outperform our competition fairly and honestly, through superior performance and not through unethical or illegal business practices. Any activity that undermines this commitment is unacceptable and may be illegal.

Stealing proprietary information, possessing trade secret information that was obtained without the owner’s consent, or inducing such disclosures by past or present employees of other companies is prohibited. Each employee should respect the rights of and deal fairly with our customers, distributors, suppliers, competitors and employees. No employee may take unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts or any other intentional unfair-dealing practice.

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We support fair trade and free enterprise and laws that prohibit unlawful “restraints on trade” and seek to comply with them.

No employee may engage in any discussion with representatives of other companies or agencies regarding possible restraints of trade. Employees must notify the Company’s Compliance Officer of any such discussion initiated by any customer or competitor or potential customer or competitor. In addition, any and all discussions with competitors, regardless of their subject matter, should be reported promptly to the Company’s Compliance Officer so that they can be appropriately documented. Violations of Federal or state antitrust laws or regulations by any employee can subject both the Company and the employee to severe criminal and civil penalties and fines.

### **Conflicts of Interest**

A “conflict of interest” exists any time you face a choice between what is in your personal interest (financial or otherwise) and the interest of the Company. Such situations are not always easy to avoid. When a conflict of interest arises, it is important that you be careful to avoid even the appearance that your actions are not in our best interest. If you are in a position where your objectivity may be questioned because of an actual or apparent conflict between the interests of the Company and your individual interests or family or personal relationships, notify your supervisor or the Compliance Officer immediately.

It is not possible to list every activity that might present an actual or apparent conflict of interest. However, the following are examples of conduct or activities that would violate this Code unless approved in advance by the Compliance Officer or, if the conduct or activity concerns a director or executive officer, by the Audit Committee of the Board of Directors, or both, if required by the rules of The Nasdaq Stock Market and the Securities and Exchange Commission (the “SEC”) and by the Audit Committee Charter:

- Participation by an employee or a family member in a business transaction involving the Company and another entity or an individual with whom the employee (or his family) has a financial relationship;
- The use for personal gain by employees (or their family members) of any confidential or proprietary information obtained as a result of their relationship with the Company (patents, trade secrets or other confidential business information);
- Supervising an employee who is a family member where the supervisor has authority with regard to such matters as work assignments, compensation or promotions;
- Owning a direct or indirect financial interest in any company that is a competitor, customer, supplier or business partner where the employee can influence our decision whether to do business with such company;

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- Having an outside business or other interest which would impair the employee's ability to perform his duties;
  - Receipt by an employee or family member of improper personal benefits as a result of the employee's position in the Company (loans to or guarantees for the benefit of such persons are of particular concern);
  - Serving as an employee, consultant or member of the board of directors (or of a technical, scientific or similar advisory board) of a competitor, customer, supplier or business partner unless directed to do so by our Board of Directors (employees should avoid any direct or indirect business connection with our competitors, customers, suppliers or business partners, except on behalf of the Company);
  - Accepting cash compensation or stock, stock options or other stock-based compensation from another company where the employee is serving, at our request, on the board of directors of the company or in another advisory capacity, unless our Board of Directors approved such compensation in connection with our requesting the employee to serve;
  - Conducting personal business or affairs on company time or using our facilities and equipment for personal business, except where meeting with a third party on our premises serves the convenience of an officer of the Company or promotes an officer's charitable or civic cause and in any event does not interfere with the performance of the officer's duties;
  - Accepting employment outside of the Company that interferes with the proper performance of the employee's job at the Company or puts the employee in a situation where confidential information of the Company could be used; or
  - Accepting directed shares in a stock offering by a competitor, customer, supplier or business partner pursuant to a "friends and family" program or arrangement.

These are just a few examples. The key to the successful handling of any actual or potential conflict of interest is to disclose it as soon as you discover it. If you have any doubt about whether you have a conflict of interest, you should discuss it with your supervisor or the Compliance Officer.

We may periodically ask you to sign a formal statement about whether you are aware of possible conflicts of interest. You are required to respond to these requests promptly and candidly. We will treat your responses as confidential unless we are required to disclose the information by law or court order or the best interests of the Company require disclosure.

#### **Service on Other Boards**

From time to time you might be asked to serve as a member of the board of directors or as a member of a technical, scientific or similar advisory board of another company. This Code prohibits you from serving in such capacity with a competitor, customer, supplier or business

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partner. In addition, our policy prohibits you from serving in such capacity for any other for-profit enterprise without first obtaining the approval of the Chairman of the Board and the Chief Executive Officer. (Members of the Board of Directors are required only to notify the Chairman of the Board and the Chief Executive Officer if they are asked to serve on a board described in the preceding sentence.) This prohibition does not apply to service on the board of charitable, educational or other non-profit organizations.

#### **Entertainment, Favors and Gifts**

Business gifts and entertainment are customary courtesies designed to build goodwill among business partners. These courtesies include such things as gift items, meals and beverages, tickets to sporting or cultural events, discounts not available to the general public, travel, accommodations and other services. A problem may arise when such courtesies compromise – or appear to compromise – our ability to make objective and fair business decisions. The same concerns apply to employees offering gifts and entertainment to our business associates.

Accordingly, it is our policy to prohibit the giving or accepting of gifts and courtesies for business purposes having greater than a nominal value, other than reasonable hospitality given in the ordinary course of business, without the approval of your supervisor. Courtesies that are repetitive (no matter how small) may be perceived as an attempt to make the recipient obligated to the giver and are therefore inappropriate. Likewise, business entertainment should be moderately scaled and intended only to facilitate business goals. This prohibition applies at all times and does not change during traditional gift-giving seasons. Use good judgment in all gift and entertainment situations.

#### **Corporate Opportunities**

You are prohibited from taking personal advantage of business opportunities that you discover through your position with the Company. You are also prohibited from competing with the company, directly or indirectly, and from using corporate property or corporate information for improper personal gain.

#### **Confidential and Proprietary Information**

Employees must maintain the confidentiality of confidential information entrusted to them by the Company or our customers, suppliers, distributors or business partners, except to the extent disclosure is specifically authorized or required by laws or regulations. For purposes of the Code, “confidential information” includes all non-public information and, as such, may include information that customers, suppliers, distributors or business partners have entrusted to us. The obligation to preserve confidential information continues even after employment ends.

Employees also have an obligation to protect the Company’s proprietary information, including, but not limited to, our intellectual property, such as trade secrets, inventions, patents, trademarks, and copyrights, as well as business, marketing and service plans, technical expertise, production ideas, designs, databases, records, salary information and any unpublished financial data and reports. Unauthorized use or distribution of this information violates Company policy and could also be illegal and result in civil or even criminal penalties.



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When you joined the Company you signed a Confidential Nondisclosure Agreement requiring you to protect the confidentiality of the information referred to above. This agreement remains in effect for as long as you work for the Company and after you leave our employ.

### **Financial Integrity and Disclosure**

We require honest and accurate recording and reporting of information in order to make responsible business decisions. Business records must always be prepared accurately and reliably and stored properly. Our books, records and accounts must reflect all of our transactions and all other events that are the subject of a specific regulatory record-keeping requirement.

In addition, full, fair, accurate and timely disclosure in our periodic SEC reports is required and essential to the success of our business. Our employees must exercise the highest standard of care in preparing such reports in accordance with the following guidelines:

- All accounting records, as well as reports produced from those records, must be in accordance with the laws of each applicable jurisdiction;
- All records must fairly and accurately reflect the transactions or occurrences to which they relate;
- All records must fairly and accurately reflect, in reasonable detail, our assets, liabilities, revenues and expenses;
- Our accounting records must not contain any false or intentionally misleading entries;
- No transactions should be intentionally misclassified as to accounts, departments or accounting periods;
- All transactions must be supported by accurate documentation in reasonable detail and recorded in the proper account and in the proper accounting period;
- No information should be concealed from the internal auditors or the independent auditor; and
- Compliance with our system of internal accounting controls is required.

The persons holding the offices of Chief Executive Officer, Chief Financial Officer, Controller and Treasurer (the “Senior Financial Officers”) of the Company have overall responsibility for assuring full, fair, accurate, timely and understandable disclosure of relevant financial information to shareholders and investors. In particular they are responsible for assuring that we comply with rules of the SEC governing disclosure of financial information and for assuring that press releases and communications with investors and securities analysts are fair and accurate. Among other things, the Senior Financial Officers shall:

- Establish and maintain internal controls and procedures and disclosure controls and procedures designed to assure that financial information is recorded, processed and transmitted to those responsible for preparing periodic reports and other public communications and to assure our reports and communications are complete, accurate and timely.

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- Oversee the appropriate personnel to help ensure that the internal controls and procedures and disclosure controls and procedures are being followed.
  - Carefully review each periodic report for accuracy and completeness before it is filed with the SEC and carefully review each public communication containing financial information before it is released.
  - Promptly disclose to their superiors, and if necessary to the Audit Committee of the Board of Directors and our independent auditors, any material weaknesses in, or concerns regarding, our disclosure controls or internal controls.
  - Never create or maintain secret or unrecorded funds, assets, or accounts, or intentionally make a payment or approve an invoice, expense report or other document that is incorrect, misleading or inaccurate.

### **Employment Practices**

To recruit and retain high-caliber employees, our employment practices are designed to provide an environment that encourages you to comply with this Code, be respectful of our employees, customers and other business partners and perform your duties with fairness, honesty, integrity and professionalism.

It is our policy to hire, evaluate and promote employees on the basis of their ability, achievements, experience and performance. Accordingly, we will provide equal opportunity for all in recruitment, career development, promotion and compensation without regard to age, color, non-disqualifying disability, gender, national origin, race, marital status, veteran status, religion or any other basis that is protected under applicable law.

Ethnic, racial, religious, sexual or any other type of unlawful harassment is unacceptable. Inappropriate or unwelcome sexual behavior, either physical or verbal in nature, that interferes with and obstructs performance in the workplace violates our policy. To provide an environment that is conducive to productivity and personal growth, we prohibit illegal workplace harassment of any kind, whether the harasser or the victim is a co-worker, supervisor, agent, customer, guest or supplier. Our policy also prohibits retaliation against anyone who has made a harassment complaint.

If you believe you or another employee has experienced harassment, immediately report the incident by following the procedures provided below under the heading "Reporting of Code Violations." We will promptly investigate an alleged harassment complaint and remedy the situation when a violation of our policy can be substantiated.

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The laws affecting employment practices are complex and constantly evolving. It is critical that each supervisor maintain awareness of current legal developments and our employment policies by seeking appropriate advice of those within the Company who are responsible for keeping abreast of such legal developments or employment policies.

### **Health and Safety**

Our employees constitute our most indispensable asset. Our policy is to maintain a drug-free, secure workplace where all employees are attentive to hazard prevention and the avoidance of accidents and injuries. We are committed to protecting your health and safety and that of our customers, suppliers and visitors.

Safety protection is a condition of employment for all employees. You are accountable for your own safety and the safety of those around you. No deviations from our safety practices or procedures are permitted without the approval of the appropriate company personnel. You should report to work in a condition to properly perform your duties, free from the influence of drugs or alcohol. Violence and threatening behavior will not be tolerated.

You are responsible for reporting accidents, injuries and unsafe equipment, practices or conditions. If you violate applicable legal requirements or our policy related to health and safety, or if you intentionally fail to prevent violations or take reasonable corrective action, you will be subject to appropriate disciplinary action, including termination.

### **Communications**

We are committed to conducting business honestly. All communications, whether internal or external, should be accurate, complete and forthright. These communications may include, for example, general internal reports, media releases, marketing and sales brochures, regular reports and government filings.

We will provide accurate information when promoting our products. False or misleading claims concerning our products or those of our competitors are unacceptable. These same principles must be adhered to when responding to inquiries from customers, fellow employees, the media, governmental regulatory agencies and shareholders. Responses to such inquiries must be made in accordance with our policies and procedures (for instance, through a designated corporate communications officer).

Our policy prohibits employees from making any malicious or defamatory statement about any other person or company.

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## **Protection and Proper Use of Company Assets**

Each employee is a steward of our assets. As such, you are obligated to protect and preserve our assets and resources and assist us in our efforts to control costs and ensure the efficient use of our assets for our business purposes. Theft, carelessness and waste hurt our profitability.

Company assets include such things as documents, equipment, facilities, information, our logo and name, materials and supplies. You should not use our assets except for legitimate business purposes, though incidental personal use of the telephone and desk material and supplies is permitted. If you have a question whether it is permissible to use an asset for a specific purpose, you should consult with your supervisor or the Compliance Officer. The use of our assets and resources for personal financial gain is strictly prohibited.

You should immediately report to your supervisor or the Compliance Officer any suspected incident of fraud or theft.

### Electronic Information

Our computer resources, including electronic mail, should be used to support and advance our business purposes. Any personal use of these technologies should not create additional costs for the Company, interfere with work duties or violate any of our policies.

Electronic messages (including voicemail), to or from the Company equipment or accounts, and computer information are considered our property, and you should not have any expectation of privacy related to the use of such electronic information. Unless prohibited by law, we reserve the right to access and disclose this information as necessary for business purposes. You should use good judgment and not send a message or access or store any information that you would not want to be seen or heard by others.

### Personal Computer Software

You must understand and adhere to the license agreements that govern the use, and restrict the reproduction, of personal computer software. Generally, when we purchase software, we only acquire a license to use the software. We do not become the owner of the software package and programs. Many software licenses limit the use of the software to a specific computer unit. Multi-user licenses also exist, but further complicate the issue by requiring detailed administrative controls.

Computer software packages and programs that we purchase are also covered by copyright laws. You must not make additional copies of the purchased software, or its documentation, unless the license agreement specifically allows it and your supervisor or the Compliance Officer approves it. You must strictly abide by all license requirements.

## **Corporate Citizenship**

We are committed to being a good corporate citizen. We recognize the importance of making a positive contribution to society and the communities in which we operate. We meet these goals

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by contributing to the economy of the communities in which we operate, encouraging volunteerism and support of local community needs and activities, complying with environmental laws and regulations and supporting and encouraging public policies that promote good corporate citizenship and take into account legitimate employee and community interests.

#### **Political Contributions**

We respect and support your right to participate in political activities. However, it is not appropriate to conduct these activities during business hours or on our property or use any of our resources, such as telephones, computers or supplies, in your political activities. The Company will not reimburse you for personal political contributions.

We may sometimes express our views on local and national issues that affect our business. When we do, we may use our funds and resources when permitted by law. We may also make limited contributions to political parties or candidates in jurisdictions where it is legal and customary to do so. No employee may make or commit to political contributions on our behalf without approval from the Compliance Officer.

#### **Reporting of Code Violations**

You are required to report actual or suspected violations of this Code. You should initially report violations to your supervisor. You should also seek his or her advice if you have a question or concern about compliance with this Code, other policies and procedures or applicable laws, or if you have a question about the right thing to do in a particular situation. In many cases, the supervisor will be more knowledgeable about the question and will appreciate being brought into the decision-making process. You should remember that it is your supervisor's responsibility to help solve problems.

In cases where it might be inappropriate or uncomfortable for you to discuss an issue or question with your supervisor, or if the supervisor does not address the issue or question to your satisfaction, you should discuss the matter with the Compliance Officer. If you do not feel comfortable discussing the matter with the Compliance Officer, you should contact the Chairman of our Audit Committee, whose name appears on our website. You may identify yourself or choose to remain anonymous.

Supervisors are required to report alleged violations of this Code to the Compliance Officer promptly after receipt.

The Compliance Officer will make quarterly reports to the Audit Committee of the Board concerning alleged violations of this Code reported to the Compliance Officer by employees or their supervisors since the most recent quarterly report. The Compliance Officer's report will also describe the status of the investigation and how the alleged violation was resolved. In addition, upon the request of the Chairman of the Audit Committee, the Compliance Officer will report to the Committee regarding the effectiveness and administration of this Code.

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**Enforcement of this Code**

If you violate this Code you will be subject to disciplinary action, including up to termination where appropriate.

We will investigate alleged violations of this Code and provide any person who is alleged to have violated this Code a fair opportunity to be heard regarding the alleged conduct. All employees are expected to cooperate in internal investigations of misconduct.

Disciplinary measures will depend on the circumstances of the violation. Consideration will be given to whether or not a violation was intentional, as well as whether an employee acted in good faith in reporting the violation and cooperated with any resulting investigation or corrective action.

**No Retaliation**

Our policy prohibits retaliation in any form against an employee who in good faith reports a suspected violation of this Code. This policy applies even where the good faith allegation proves ultimately groundless. Any employee who violates our non-retaliation policy will be subject to disciplinary action. Any employee, however, who knowingly makes a false or misleading report will be subject to disciplinary action.

Except as required by law, we will take reasonable steps to safeguard the confidentiality of statements and other information that you report under this Code, unless it is not practicable to do so or the interests of the Company require disclosure.

**Waivers**

Any waiver of any provision of this Code for executive officers and directors may be made only by our Board of Directors and will be promptly disclosed, along with the reasons for the waiver, as required by the rules of The Nasdaq Stock Market or by law. Our “executive officers” for this purpose are those officers who are required to file reports of their stock transactions under Section 16 of the Securities Exchange Act of 1934.

If the Compliance Officer receives a request for consent or approval from an executive officer or director in accordance with any provision of this Code, the Compliance Officer will consult with the Chairman of the Board to determine whether the granting of such consent or approval constitutes a waiver for the purpose of the Board approval requirement.

**CHARLES & COLVARD, LTD.  
CODE OF ETHICS  
FOR  
SENIOR FINANCIAL OFFICERS  
(Adopted February 16, 2004)**

Charles & Colvard, Ltd. (together with its subsidiaries, the "Company") is committed to conducting its business in compliance with the law and the highest ethical standards. This Code of Ethics applies to the persons holding the offices of Chief Executive Officer, Chief Financial Officer, Treasurer and the principle accounting officer (individually, a "Senior Financial Officer" and collectively, the "Senior Financial Officers") of the Company. Its purpose is to promote honest and ethical conduct and compliance with the law, particularly as related to the maintenance of the Company's financial records and the preparation of financial statements filed with the Securities and Exchange Commission (the "SEC"). While covering a wide range of business practices and procedures, this Code cannot and does not cover every issue that may arise, or every situation in which ethical decisions must be made, but rather sets forth key guiding principles of business conduct that the Company expects of its Senior Financial Officers. The obligations of this Code of Ethics supplement, but do not replace, the Company's Code of Business Conduct and Ethics applicable to all employees, officers and directors.

This Code is intended to be our Code of Ethics for Senior Financial Officers pursuant to the provisions of Section 406 of the Sarbanes-Oxley Act of 2002 and related rules of the SEC.

1. Senior Financial Officers are expected to carry out their responsibilities honestly and with integrity, exercising at all times their best independent judgment.

2. Senior Financial Officers shall comply with the Company's Code of Business Conduct and Ethics, including but not limited to its provisions relating to:

- (a) the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (b) the full, fair, accurate, timely and understandable disclosure in reports and documents the Company files with or submits to the Securities and Exchange Commission and in other public communications;
- (c) compliance with applicable governmental laws, rules and regulations;
- (d) the prompt internal reporting of violations of the Code of Business Conduct and Ethics to the person or persons designated in the Code; and
- (e) accountability for adherence to the Code of Business Conduct and Ethics.

3. The Senior Financial Officers are responsible for promptly bringing to the attention of the Chairman of the Audit Committee or the full Board of Directors:

- (a) Any matters that could compromise the integrity of the Company's financial reports;

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(b) Any disagreement with respect to any material accounting matter; and

(c) Any violation of this Code of Ethics or of any law or regulation related to the Company's accounting or financial affairs.

4. No Senior Financial Officer may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against any employee in the terms and conditions of employment based upon any lawful act done by the employee (i) to provide information, cause information to be provided or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of law, including any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders; (ii) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of law, including any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders; or (iii) to make any report pursuant to the Company's Employee Complaint Policies and Procedures for Accounting and Auditing Matters.

5. Any waiver of this Code of Ethics may be made only by our Board of Directors and will be promptly disclosed as required by law or The Nasdaq Stock Market.

6. The Board of Directors will investigate or cause to be investigated alleged violations of this Code of Ethics. The Board will provide any Senior Financial Officer who is alleged to have violated this Code of Ethics a fair opportunity to be heard regarding his or her alleged conduct. The Board will take appropriate action if the Board determines as a result of its investigation that a violation of this Code of Ethics occurred.

7. A failure by any Senior Financial Officer to comply with the laws or regulations governing the Company's business, this Code of Ethics, the Code of Business Conduct and Ethics or any other Company policy or requirement may result in disciplinary action, including termination and, if warranted, legal proceedings.



SCHEDULE OF SUBSIDIARIES

Charles & Colvard, Ltd. (Registrant), a North Carolina Corporation

Wholly-owned Subsidiary:

Charles & Colvard (HK) Ltd., a Hong Kong Corporation

Controlled Company:

Guangzhou Charles & Colvard Trading Limited, a Chinese Corporation

INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statement No. 333-43613 of C3, Inc. on Form S-8 and in Registration Statement No. 333-100883 of Charles & Colvard, Ltd. on Form S-8 of our report dated March 2, 2004, appearing in this Annual Report on Form 10-K of Charles & Colvard, Ltd. for the year ended December 31, 2003.

/s/ DELOITTE & TOUCHE LLP  
Raleigh, North Carolina  
March 16, 2004

I, Robert S. Thomas, certify that:

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

March 15, 2004

*/s/ Robert S. Thomas*

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Robert S. Thomas  
President & Chief Executive Officer

I, James R. Braun, certify that:

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

March 15, 2004

*/s/ James R. Braun*

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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 Annual Report of Charles & Colvard, Ltd. (the "Company") on Form 10-K for the period ending December 31, 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*

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Robert S. Thomas  
President and Chief Executive Officer  
March 15, 2004

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

In connection with the Annual Report of Charles & Colvard, Ltd. (the "Company") on Form 10-K for the period ending December 31, 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*

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James R. Braun  
Vice President of Finance and Chief Financial Officer  
March 15, 2004

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