

CHARLES & COLVARD LTD
Form 10-Q
August 07, 2015

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from _____ to _____

Commission File Number: 000-23329

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

North Carolina 56-1928817
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

170 Southport Drive
Morrisville, North Carolina 27560
(Address of principal executive offices) (Zip Code)

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

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of August 4, 2015, there were 21,111,585 shares of the registrant's common stock, no par value per share, outstanding.

CHARLES & COLVARD, LTD.

FORM 10-Q

For the Quarterly Period Ended June 30, 2015

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2015 (unaudited)	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$5,254,242	\$4,007,341
Accounts receivable, net	4,462,286	5,510,253
Inventory, net	13,404,996	13,320,639
Prepaid expenses and other assets	905,306	602,850
Total current assets	24,026,830	23,441,083
Long-term assets:		
Inventory, net	21,124,138	25,617,990
Property and equipment, net	1,663,608	1,859,355
Intangible assets, net	172,895	216,947
Other assets	252,805	291,022
Total long-term assets	23,213,446	27,985,314
TOTAL ASSETS	\$47,240,276	\$51,426,397
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$3,314,133	\$3,286,086
Accrued cooperative advertising	36,000	220,000
Accrued expenses and other liabilities	1,475,571	684,577
Total current liabilities	4,825,704	4,190,663
Long-term liabilities:		
Accrued expenses and other liabilities	763,260	809,879
Accrued income taxes	414,018	407,682
Total long-term liabilities	1,177,278	1,217,561
Total liabilities	6,002,982	5,408,224
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value	54,240,247	53,949,001
Additional paid-in capital – stock-based compensation	12,283,365	11,628,503
Accumulated deficit	(25,286,318)	(19,559,331)
Total shareholders' equity	41,237,294	46,018,173
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$47,240,276	\$51,426,397

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net sales	\$7,476,872	\$7,841,647	\$15,853,936	\$13,909,200
Costs and expenses:				
Cost of goods sold	6,461,537	5,324,981	11,305,440	8,988,023
Sales and marketing	3,517,870	2,171,614	6,491,234	4,366,225
General and administrative	1,533,948	2,376,466	3,768,161	3,752,681
Research and development	7,043	9,514	9,104	11,501
Loss on abandonment of assets	-	-	-	2,201
Total costs and expenses	11,520,398	9,882,575	21,573,939	17,120,631
Loss from operations	(4,043,526)	(2,040,928)	(5,720,003)	(3,211,431)
Other income (expense):				
Interest income	-	20	11	49
Interest expense	(767)	(188)	(784)	(318)
Gain on sale of long-term assets	-	-	125	-
Total other expense, net	(767)	(168)	(648)	(269)
Loss before income taxes	(4,044,293)	(2,041,096)	(5,720,651)	(3,211,700)
Income tax net expense	(3,243)	(4,152,987)	(6,336)	(4,045,777)
Net loss	\$(4,047,536)	\$(6,194,083)	\$(5,726,987)	\$(7,257,477)
Net loss per common share:				
Basic	\$(0.20)	\$(0.31)	\$(0.28)	\$(0.36)
Diluted	\$(0.20)	\$(0.31)	\$(0.28)	\$(0.36)
Weighted average number of shares used in computing net loss per common share:				
Basic	20,326,577	20,262,299	20,217,646	20,229,979
Diluted	20,326,577	20,262,299	20,217,646	20,229,979

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Six Months Ended June 30,	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(5,726,987)	\$(7,257,477)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	440,676	588,745
Stock-based compensation	773,342	810,490
Provision for uncollectible accounts	19,000	682,725
Provision for sales returns	(581,000)	(845,000)
Provision for inventory reserves	615,000	69,000
Provision for deferred income taxes	-	4,039,723
Loss on abandonment of assets	-	2,201
Gain on sale of long-term assets	(125)	-
Changes in assets and liabilities:		
Accounts receivable	1,609,967	2,590,297
Inventory	3,794,495	868,994
Prepaid expenses and other assets, net	(264,239)	(394,745)
Accounts payable	28,047	(10,651)
Accrued cooperative advertising	(184,000)	8,000
Accrued income taxes	6,336	6,054
Other accrued liabilities	744,375	647,581
Net cash provided by operating activities	1,274,887	1,805,937
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(155,185)	(956,666)
Patent, license rights, and trademark costs	(45,742)	(59,863)
Proceeds from sale of assets	175	-
Net cash used in investing activities	(200,752)	(1,016,529)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	172,766	-
Net cash provided by financing activities	172,766	-
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,246,901	789,408
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	4,007,341	2,573,405
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$5,254,242	\$3,362,813
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$784	\$318
Cash paid during the period for income taxes	\$-	\$-

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. DESCRIPTION OF BUSINESS

Charles & Colvard, Ltd. (the “Company”), a North Carolina corporation founded in 1995, manufactures, markets, and distributes Charles & Colvard Created Moissanite® jewels (hereinafter referred to as moissanite or moissanite jewels), finished jewelry featuring moissanite, and fashion finished jewelry for sale in the worldwide jewelry market.

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

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q have been prepared in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information. However, certain information or footnote disclosures normally included in complete financial statements prepared in accordance with U.S. GAAP have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of the Company’s management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair statement of the results for the interim periods presented. The results for the three and six months ended June 30, 2015 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2015.

The condensed consolidated financial statements as of and for the three and six months ended June 30, 2015 and 2014 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2014 is derived from the audited financial statements as of that date. The accompanying statements should be read in conjunction with the audited financial statements and related notes, together with Management’s Discussion and Analysis of Financial Condition and Results of Operations, contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014 filed with the SEC on March 13, 2015 (the “2014 Annual Report”).

The accompanying condensed consolidated financial statements as of and for the three and six months ended June 30, 2015 and 2014 include the accounts of the Company and its wholly owned subsidiaries Moissanite.com, LLC, formed in 2011; Charles & Colvard Direct, LLC, formed in 2011; and Charles & Colvard (HK) Ltd., the Company’s Hong Kong subsidiary that became a dormant entity in the second quarter of 2009 and the operations of which ceased in 2008. All intercompany accounts have been eliminated.

Significant Accounting Policies - In the opinion of the Company’s management, the significant accounting policies used for the three and six months ended June 30, 2015 are consistent with those used for the year ended December 31, 2014. Accordingly, please refer to the 2014 Annual Report for the Company’s significant accounting policies.

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

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

Reclassifications - Certain amounts in the prior year's condensed consolidated financial statements have been reclassified to conform to the current year presentation, primarily amounts described in Note 3, "Segment Information and Geographic Data" related to changes in the Company's reportable segments.

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Recently Adopted/Issued Accounting Pronouncements - In May 2014, the Financial Accounting Standards Board issued a new accounting standard that supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of the new standard is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. The new standard defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting the standard recognized at the date of adoption (which includes additional footnote disclosures). The Company is currently evaluating the impact of the pending adoption of the standard on its consolidated financial statements and has not yet determined the method by which the Company will adopt the standard in 2017.

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

All other new and recently issued, but not yet effective, accounting pronouncements have been deemed to be not relevant to the Company and therefore are not expected to have any impact once adopted.

3. SEGMENT INFORMATION AND GEOGRAPHIC DATA

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

During 2014, the Company began managing its business primarily through the three distribution channels that it uses to sell its product lines, loose jewels and finished jewelry. Accordingly, the Company determined its three operating and reportable segments to be wholesale distribution transacted through the parent entity, and the two direct-to-consumer distribution channels transacted through the Company's wholly owned operating subsidiaries, Moissanite.com, LLC and Charles & Colvard Direct, LLC. The accounting policies of these three segments are the same as those described in Note 2, "Basis of Presentation and Significant Accounting Policies" of this Quarterly Report on Form 10-Q and in the Notes to the Consolidated Financial Statements in the 2014 Annual Report.

Previously, the Company determined it managed its business through two distribution channels, wholesale distribution and direct-to-consumer. While the Company has always managed its businesses as three separate operating segments, it previously aggregated the Moissanite.com, LLC and Charles & Colvard Direct, LLC operating segments into a single reportable segment for reporting purposes. The two wholly owned operating subsidiaries that previously were

aggregated under the direct-to-consumer segment are now each being presented as a separate reportable segment. The Company believes aggregation of the two subsidiaries into one reportable segment for reporting purposes is no longer warranted due to changes in how it sources product and sells directly to consumers, including changes in the management structure, strategic initiatives, and changes in sales models made during the year ended December 31, 2014 for each of the two wholly owned subsidiaries. Certain amounts for the three and six months ended June 30, 2014 have been reclassified to conform to the current period presentation as a result of this change in reportable segments.

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The Company evaluates the financial performance of its segments based on net sales; product line gross profit, or the excess of product line sales over product line cost of goods sold; and operating income (loss). Product line cost of goods sold is defined as product cost of goods sold in each of the Company's wholesale distribution and two direct-to-consumer distribution operating segments excluding non-capitalized expenses from the Company's manufacturing and production control departments, comprising personnel costs, depreciation, rent, utilities, and corporate overhead allocations; freight out; inventory valuation allowance adjustments; and other inventory adjustments, comprising costs of quality issues, damaged goods, and inventory write-offs.

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

Summary financial information by reportable segment is as follows:

	Three Months Ended June 30, 2015			
	Wholesale	Moissanite.com	Charles & Colvard Direct	Total
Net sales				
Loose jewels	\$3,628,160	\$138,148	\$-	\$3,766,308
Finished jewelry	1,294,494	1,122,732	1,293,338	3,710,564
Total	\$4,922,654	\$1,260,880	\$1,293,338	\$7,476,872
Product line cost of goods sold				
Loose jewels	\$3,040,470	\$21,748	\$65	\$3,062,283
Finished jewelry	1,204,174	533,659	259,089	1,996,922
Total	\$4,244,644	\$555,407	\$259,154	\$5,059,205
Product line gross profit				
Loose jewels	\$587,690	\$116,400	\$(65)	\$704,025
Finished jewelry	90,320	589,073	1,034,249	1,713,642
Total	\$678,010	\$705,473		