CHARLES & COLVARD LTD
Form 10-Q
November 04, 2016

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 September 30, 2016

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

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 October 31, 2016, there were 21,444,885 shares of the registrant's common stock, no par value per share, outstanding.

CHARLES & COLVARD, LTD.

FORM 10-Q
For the Quarterly Period Ended September 30, 2016

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2016 (unaudited)	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 9,678,329	$ 5,274,305
Accounts receivable, net	1,946,026	3,852,651
Inventory, net	10,070,966	10,739,798
Prepaid expenses and other assets	839,100	701,105
Assets related to discontinued operations	-	83,000
Total current assets	22,534,421	20,650,859
Long-term assets:		
Inventory, net	17,111,073	21,588,622
Property and equipment, net	1,493,287	1,615,683
Intangible assets, net	5,989	71,086
Other assets	163,664	214,588
Total long-term assets	18,774,013	23,489,979
TOTAL ASSETS	$ 41,308,434	$ 44,140,838
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,604,625	$ 3,323,148
Accrued cooperative advertising	9,000	58,000
Accrued expenses and other liabilities	824,948	891,187
Liabilities related to discontinued operations	2,100	349,000
Total current liabilities	4,440,673	4,621,335
Long-term liabilities:		
Accrued expenses and other liabilities	625,391	710,223
Accrued income taxes	430,571	420,503
Total long-term liabilities	1,055,962	1,130,726
Total liabilities	5,496,635	5,752,061
Commitments and contingencies (Note 7)		
Shareholders' equity:		
Common stock, no par value; 50,000,000 shares authorized; 21,444,885 and 21,111,585 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	54,243,816	54,240,247
Additional paid-in capital	14,153,203	13,280,920
Accumulated deficit	(32,585,220)	(29,132,390)
Total shareholders' equity	35,811,799	38,388,777
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 41,308,434	$ 44,140,838

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net sales	$ 5,212,973	$ 5,100,152	$ 23,133,248	$ 18,299,773
Costs and expenses:				
Cost of goods sold	3,221,007	3,349,062	16,278,989	13,870,543
Sales and marketing	1,891,162	1,166,707	5,222,757	4,312,581
General and administrative	1,244,400	1,162,015	4,380,218	4,219,257
Research and development	-	6,352	2,848	15,456
Total costs and expenses	6,356,569	5,684,136	25,884,812	22,417,837
Loss from operations	(1,143,596)	(583,984)	(2,751,564)	(4,118,064)
Other income (expense):				
Interest income	-	-	-	11
Interest expense	(36)	(17)	(1,548)	(801)
Loss on abandonment of property and equipment	(473)	-	(116,021)	-
Gain on sale of long-term assets	-	-	-	125
Total other expense, net	(509)	(17)	(117,569)	(665)
Loss before income taxes from continuing operations	(1,144,105)	(584,001)	(2,869,133)	(4,118,729)
Income tax net expense from continuing operations	(3,325)	(3,243)	(10,068)	(9,579)
Net loss from continuing operations	(1,147,430)	(587,244)	(2,879,201)	(4,128,308)
Discontinued operations:				
Loss from discontinued operations	(6,949)	(1,378,837)	(586,027)	(3,564,760)
(Loss) gain on sale of assets from discontinued operations	(3,065)	-	12,398	-
Net loss from discontinued operations	(10,014)	(1,378,837)	(573,629)	(3,564,760)
Net loss	$ (1,157,444)	$ (1,966,081)	$ (3,452,830)	$ (7,693,068)
Net loss per common share:				
Basic – continuing operations	$ (0.06)	$ (0.03)	$ (0.14)	$ (0.20)
Basic – discontinued operations	(0.00)	(0.07)	(0.03)	(0.18)
Basic – total	$ (0.06)	$ (0.10)	$ (0.17)	$ (0.38)
Diluted – continuing operations	$ (0.06)	$ (0.03)	$ (0.14)	$ (0.20)
Diluted – discontinued operations	(0.00)	(0.07)	(0.03)	(0.18)
Diluted – total	$ (0.06)	$ (0.10)	$ (0.17)	$ (0.38)
Weighted average number of shares used in computing net loss per common share:				
Basic	20,997,686	20,571,340	20,898,484	20,336,839
Diluted	20,997,686	20,571,340	20,898,484	20,336,839

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Nine Months Ended September 30, 2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (2,879,201)	$ (4,128,308)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	445,576	582,291
Stock-based compensation	829,381	1,090,779
Provision for uncollectible accounts	(60,300)	29,000
Provision for sales returns	(430,000)	(505,000)
Provision for inventory reserves	54,000	213,000
Loss on abandonment of property and equipment	116,021	-
Gain on sale of long-term assets	-	(125)
Changes in operating assets and liabilities:		
Accounts receivable	2,396,925	3,126,654
Inventory	5,092,381	4,732,476
Prepaid expenses and other assets, net	(87,071)	(424,879)
Accounts payable	281,477	26,869
Accrued cooperative advertising	(49,000)	(192,000)
Accrued income taxes	10,068	9,579
Accrued expenses and other liabilities	(151,071)	186,931
Net cash provided by operating activities of continuing operations	5,569,186	4,747,267
Net cash used in operating activities of discontinued operations	(1,123,381)	(3,074,095)
Net cash provided by operating activities	4,445,805	1,673,172
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(410,306)	(188,410)
Patent, license rights, and trademark costs	(2,446)	(45,742)
Proceeds from sale of long-term assets	-	175
Net cash used in investing activities of continuing operations	(412,752)	(233,977)
Net cash provided by (used in) investing activities of discontinued operations	368,671	(17,041)
Net cash used in investing activities	(44,081)	(251,018)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	2,300	172,766
Net cash provided by financing activities of continuing operations	2,300	172,766
NET INCREASE IN CASH AND CASH EQUIVALENTS	4,404,024	1,594,920
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,274,305	4,007,341
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 9,678,329	$ 5,602,261
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 1,548	$ 801
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® (hereinafter referred to as moissanite or moissanite jewels) and finished jewelry featuring moissanite for sale in the worldwide jewelry market. Moissanite, also known by its chemical name 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 ethically-sourced, affordable, and 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, retailers, TV shopping networks, and designers and at retail to end consumers through its wholly owned operating subsidiaries, charlesandcolvard.com, LLC (formerly Moissanite.com, LLC) and Charles & Colvard Direct, LLC (until March 2016), and through third-party marketplaces.

As of September 30, 2016, the Company changed the name of its wholly owned subsidiary Moissanite.com, LLC to charlesandcolvard.com, LLC.

In February 2016, the Company made the strategic decision to explore a potential divestiture of its direct-to-consumer home party business previously operated through its Charles & Colvard Direct, LLC (dba Lulu Avenue®) subsidiary. After careful analysis of the Company's core competencies, go-to-market strategies, and intent to advance toward profitability, the management team and Board of Directors determined a divestiture of this distribution channel to be in the best interest of the Company and its shareholders. On March 4, 2016, the Company and Charles & Colvard Direct, LLC entered into an asset purchase agreement with Yanbal USA, Inc. ("Yanbal"), under which Yanbal purchased certain assets related to the Company's direct-to-consumer home party business for $500,000 and assumed certain liabilities related to such assets. A more detailed description of this transaction is included in Note 12, "Discontinued Operations."

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 nine months ended September 30, 2016 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2016.

The condensed consolidated financial statements as of and for the three and nine months ended September 30, 2016 and 2015 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2015 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, 2015 filed with the SEC on March 8, 2016 (the “2015 Annual Report”).

The accompanying condensed consolidated financial statements as of and for the three and nine months ended September 30, 2016 and 2015 include the accounts of the Company and its wholly owned subsidiaries charlesandcolvard.com, LLC (formerly 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.

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Significant Accounting Policies - In the opinion of the Company’s management, the significant accounting policies used for the three and nine months ended September 30, 2016 are consistent with those used for the year ended December 31, 2015. Accordingly, please refer to Note 2 to the consolidated financial statements in the 2015 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” and Note 12, “Discontinued Operations” related to changes in the Company’s reportable segments.

Recently Adopted/Issued Accounting Pronouncements - In May 2014, the Financial Accounting Standards Board (the “FASB”) 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, 2017, 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 2018.

In July 2015, the FASB issued new accounting guidance that will require an entity to measure inventory valued under the average cost method from the lower of cost or market to the lower of cost or net realizable value, with net realizable value defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. No other changes were made to the current guidance on inventory measurement. This guidance is effective on a prospective basis for public entities for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early application is permitted as of the beginning of an interim or annual reporting period. The Company does not anticipate early adoption at this time and does not anticipate a material impact on its consolidated financial statements.

In November 2015, the FASB issued new accounting guidance that requires that deferred tax assets and liabilities be classified as noncurrent in a classified statement of financial position. The guidance is effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods. Earlier application is permitted for all entities as of the beginning of an interim or annual report period. The amendments in this guidance may be applied either prospectively to all deferred tax assets and liabilities or retrospectively to all periods presented. The Company adopted this standard as of December 31, 2015 with prospective application. As a result, the Company reclassified its deferred tax assets classified as current to noncurrent and its deferred tax liabilities classified as current to noncurrent in its December 31, 2015 consolidated balance sheet.

In February 2016, the FASB issued new guidance that establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either financing or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of its pending adoption of the new standard on its consolidated financial statements.

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In March 2016, the FASB issued updated guidance that changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as the classification of related matters in the statement of cash flows. The update is effective for the Company in the first quarter of 2017. The Company is currently evaluating this guidance and the impact it will have 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.

As of September 30, 2016, the Company changed the name of its wholly owned subsidiary Moissanite.com, LLC to charlesandcolvard.com, LLC.

Previously, the Company managed its business primarily through the three distribution channels that it used to sell its product lines, loose jewels and finished jewelry, which included Charles and Colvard Direct, LLC. 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, charlesandcolvard.com, LLC and Charles & Colvard Direct, LLC. On March 4, 2016, the Company divested its direct-to-consumer home party business previously operated through its Charles & Colvard Direct, LLC (dba Lulu Avenue®) subsidiary. As a result, during the three months ended March 31, 2016, the Company began managing its business primarily through its two continuing distribution channels. Accordingly, the Company is presenting segment results for the two continuing operating and reportable segments within this footnote and the segment results for Charles & Colvard Direct, LLC within Note 12, "Discontinued Operations" of this Quarterly Report on Form 10-Q. The accounting policies of these 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 2015 Annual Report.

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