CHARLES & COLVARD LTD
Form 10-Q
November 14, 2011

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from ______ to ______

Commission File Number: 000-23329

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

North Carolina (State or other jurisdiction of incorporation or organization)	56-1928817 (I.R.S. Employer Identification No.)
300 Perimeter Park Drive, Suite A Morrisville, North Carolina (Address of principal executive offices)	27560 (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 x No o
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 x 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	x

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

As of November 8, 2011, there were approximately 19,461,402 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, 2011

TABLE OF CONTENTS

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1.Financial Statements

CHARLES & COLVARD, LTD.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

	September 30, 2011	December 31, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$4,389,667	$7,736,044
Accounts receivable, net	3,461,515	3,679,141
Interest receivable	17,309	6,163
Income tax receivable	-	113,030
Inventory, net	5,448,380	6,306,875
Prepaid expenses and other assets	258,663	343,137
Total current assets	13,575,534	18,184,390
Long-term assets:		
Held-to-maturity investments	5,007,928	1,018,551
Inventory, net	31,139,308	31,075,626
Property and equipment, net	985,965	377,352
Patent and license rights, net	249,075	252,542
Other assets	13,746	1,990
Total long-term assets	37,396,022	32,726,061
TOTAL ASSETS	$50,971,556	$50,910,451
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$710,990	$542,084
Accrued cooperative advertising	348,000	314,000
Accrued expenses and other liabilities	206,552	308,653
Total current liabilities	1,265,542	1,164,737
Long-term liabilities:		
Accrued income taxes	729,141	937,414
Total liabilities	1,994,683	2,102,151
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value	52,852,340	53,113,608
Additional paid-in capital – stock-based compensation	7,471,576	6,811,688
Accumulated deficit	(11,347,043)	(11,116,996)
Total shareholders' equity	48,976,873	48,808,300
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$50,971,556	$50,910,451

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net sales	$2,891,109	$3,002,608	$8,862,945	$9,184,912
Costs and expenses:				
Cost of goods sold	819,309	1,089,600	3,444,465	3,547,845
Sales and marketing	1,005,600	504,305	2,238,866	1,665,918
General and administrative	1,191,857	1,130,070	3,510,232	3,175,537
Research and development	28,476	12,979	71,982	63,829
Total costs and expenses	3,045,242	2,736,954	9,265,545	8,453,129
(Loss) income from operations	(154,133)	265,654	(402,600)	731,783
Other income (expense):				
Interest income	21,062	28,715	62,320	87,033
Interest expense	(456)	(880)	(718)	(2,645)
Loss on disposal of assets	-	-	(94,408)	-
Loss on call of long-term investments	-	-	(2,913)	-
Total other income (expense)	20,606	27,835	(35,719)	84,388
(Loss) income before income taxes	(133,527)	293,489	(438,319)	816,171
Income tax net benefit	243,182	218,463	208,272	330,481
Net income (loss)	$109,655	$511,952	$(230,047)	$1,146,652
Net income (loss) per common share:				
Basic	$0.01	$0.03	$(0.01)	$0.06
Fully diluted	$0.01	$0.03	$(0.01)	$0.06
Weighted average number of shares used in computing net income (loss) per common share:				
Basic	19,540,214	19,261,941	19,437,360	19,144,036
Fully diluted	19,791,217	19,515,550	19,437,360	19,392,644

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

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

	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$(230,047)	$1,146,652
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	201,340	99,130
Amortization of bond premium	3,335	10,390
Stock-based compensation	686,945	273,357
Provision for uncollectible accounts	300,985	410,000
Provision for sales returns	(45,000)	(88,000)
Provision for inventory reserves	(138,000)	(694,000)
Benefit for deferred income taxes	-	(102,443)
Loss on disposal of assets	94,408	-
Loss on call of long-term investments	2,913	-
Changes in assets and liabilities:		
Accounts receivable	(38,359)	(2,501,285)
Interest receivable	(11,146)	(37,756)
Income tax receivable	113,030	(113,030)
Note receivable	-	54,627
Inventory	932,813	2,152,504
Prepaid expenses and other assets, net	72,718	(98,243)
Accounts payable	168,906	30,427
Accrued cooperative advertising	34,000	373,000
Accrued income taxes	(208,273)	(115,008)
Other accrued liabilities	(102,101)	51,120
Net cash provided by operating activities	1,838,467	851,442
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(865,942)	(92,643)
Purchases of long-term investments	(6,245,625)	(5,056,990)
Proceeds from call of long-term investments	2,250,000	750,000
Patent and license rights costs	(34,952)	(33,638)
Net cash used in investing activities	(4,896,519)	(4,433,271)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	46,872	178,135
Share repurchases	(335,197)	-
Net cash (used in) provided by financing activities	(288,325)	178,135
NET DECREASE IN CASH AND CASH EQUIVALENTS	(3,346,377)	(3,403,694)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,736,044	7,405,685
CASH AND CASH EQUIVALENTS, END OF PERIOD	$4,389,667	$4,001,991

Supplemental disclosure of cash flow information:

Cash paid during the year for interest	$718	$2,645

See Notes to Condensed Consolidated Financial Statements.

Table of Contents

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) and finished jewelry featuring moissanite 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 sole source worldwide 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, luster, 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, through its wholly owned operating subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC, at retail to end consumers.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying 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, 2011 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2011.

The condensed consolidated financial statements as of and for the three and nine months ended September 30, 2011 and 2010 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2010 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, 2010 filed with the SEC on March 31, 2011 (the “2010 Annual Report”).

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries Moissanite.com, LLC; Charles & Colvard Direct, LLC; 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 nine months ended September 30, 2011 are consistent with those used for the year ended December 31, 2010. Accordingly, please refer to the 2010 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 consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets and valuation allowances, uncertain tax positions, stock-based compensation, 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.

Table of Contents

Recently Adopted/Issued Accounting Pronouncements - All 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 decisions and assessing performance as the source of the Company's operating and reportable segments.

The Company manages its business primarily by its product lines. Accordingly, the Company determined its two operating and reporting segments to be loose jewels and finished jewelry. 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 Consolidated Financial Statements in the 2010 Annual Report.

The Company evaluates the performance of its segments based on net sales and segment gross profit, or the excess of product sales over segment cost of goods sold. Segment cost of goods sold is defined as product cost of goods sold 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; manufacturing and physical inventory variances; inventory valuation allowance adjustments; and costs of quality issues and damaged goods. Accordingly, also excluded from the Company's segment performance measures are operating expenses, comprising sales and marketing, general and administrative, and research and development expenses; interest; and taxes.

Summary information by segment is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Loose jewels				
Net sales	$2,209,049	$2,833,170	$7,249,173	$8,227,342
Segment cost of goods sold	562,476	935,246	2,224,390	2,973,975
Segment gross profit	$1,646,573	$1,897,924	$5,024,783	$5,253,367
Finished jewelry				
Net sales	$682,060	$169,438	$1,613,772	$957,570
Segment cost of goods sold	222,684	107,416	742,287	944,537
Segment gross profit	$459,376	$62,022	$871,485	$13,033

A reconciliation of the Company's segment cost of goods sold to cost of goods sold as reported in the condensed consolidated financial statements is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Segment cost of goods sold	$785,160	$1,042,662	$2,966,677	$3,918,512
Non-capitalized manufacturing and production control expenses	235,252	112,600	573,380	238,194
Freight out	14,255	10,280	47,413	33,009

Inventory variances and valuation adjustments	(220,834)	(127,000)	(161,982)	(696,747)
Costs of quality issues and damaged goods	5,476	51,058	18,977	54,877
Cost of goods sold	$819,309	$1,089,600	$3,444,465	$3,547,845

7

Table of Contents

The Company's net inventories by segment are as follows:

	September 30, 2011	December 31, 2010
Loose jewels		
Raw materials	$6,466,973	$6,700,628
Work-in-process	2,157,707	2,132,910
Finished goods	22,831,736	25,384,397
Finished goods on consignment	643,639	558,149
Totals	$32,100,055	$34,776,084
Finished jewelry		
Raw materials	$217,022	$292,611
Work-in-process	179,061	69,276
Finished goods	3,112,022	1,483,787
Finished goods on consignment	851,530	635,117
Totals	$4,359,635	$2,480,791

Supplies inventories of approximately $128,000 and $126,000 at September 30, 2011 and December 31, 2010, respectively, included in finished goods inventories in the consolidated financial statements are omitted from inventories by segment because they are used in both product lines and are not maintained separately.

The Company recognizes sales by geographic area based on the country in which the customer is based. A portion of the Company's international sales represents products sold internationally that may be re-imported to United States ("U.S.") retailers. The following presents certain data by geographic area:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net sales				
United States	$1,808,602	$1,904,846	$5,162,913	$5,375,593
International	1,082,507	1,097,762	3,700,032	3,809,319
Totals	$2,891,109	$3,002,608	$8,862,945	$9,184,912

	September 30, 2011	December 31, 2010
Property and equipment, net		
United States	$985,965	$377,352
International	-	-
Totals	$985,965	$377,352

	September 30, 2011	December 31, 2010
Patent and license rights, net		
United States	$72,773	$80,864
International	176,302	171,678
Totals	$249,075	$252,542

4. INVESTMENTS

Investments consist of long-term U.S. government agency securities carried at amortized cost using the effective interest method. The Company classifies its marketable securities as held-to-maturity based upon management's positive intention and ability to hold these securities until their maturity dates.

Table of Contents

The following table summarizes information about held-to-maturity investments at September 30, 2011:

	Amortized Cost	Gross Unrealized Gains	Estimated Fair Value
U.S. government agency securities	$5,007,928	$38,149	$5,046,077

As of September 30, 2011, the estimated fair value of the investments was greater than the amortized cost. Because management intends to hold the investments until their maturity dates, this unrealized gain was not recorded in the consolidated financial statements.

The maturities of held-to-maturity investments at September 30, 2011 were as follows:

	After 2 Years through 3 Years	After 3 Years through 4 Years	After 4 Years through 5 Years	Total
U.S. government agency securities	$1,511,715	$2,250,000	$1,246,213	$5,007,928

5. FAIR VALUE MEASUREMENTS

Under U.S. GAAP, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. U.S. GAAP also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are obtained from independent sources and can be validated by a third party, whereas unobservable inputs reflect assumptions regarding what a third party would use in pricing an asset or liability. The fair value hierarchy consists of three levels based on the reliability of inputs, as follows:

- Level 1 - quoted prices in active markets for identical assets and liabilities
- Level 2 - inputs other than Level 1 quoted prices that are directly or indirectly observable
- Level 3 - unobservable inputs that are not corroborated by market data

The Company evaluates assets and liabilities subject to fair value measurements on a recurring and non-recurring basis to determine the appropriate level to classify them for each reporting period. This determination requires significant judgments to be made by the Company. The instruments identified as subject to fair value measurements on a recurring basis are cash and cash equivalents, trade accounts receivable, held-to-maturity investments, trade accounts payable, and accrued expenses. All instruments other than held-to-maturity investments are reflected in the consolidated balance sheets at carrying value, which approximates fair value due to the short-term nature of these instruments. The estimated fair value of the Company’s held-to-maturity investments as of September 30, 2011 utilized Level 2 inputs of similar investments traded on active securities exchanges.

Assets that are measured at fair value on a non-recurring basis include property and equipment and patent and license rights. These items are recognized at fair value when they are considered to be impaired. Level 3 inputs are primarily based on the estimated future cash flows of the asset determined by market inquiries to establish fair market value of used machinery or future revenue expected to be generated with the assistance of patent and license rights.

6. INVENTORIES

The Company’s total inventories, net of reserves, consisted of the following as of September 30, 2011 and December 31, 2010:

9

Table of Contents

	September 30, 2011	December 31, 2010
Raw materials	$6,683,995	$6,993,239
Work-in-process	2,336,768	2,202,186
Finished goods	26,469,756	27,489,810
Finished goods on consignment	1,506,169	1,193,266
Less inventory reserves	(409,000)	(496,000)
Totals	$36,587,688	$37,382,501
Short-term portion	$5,448,380	$6,306,875
Long-term portion	31,139,308	31,075,626
Totals	$36,587,688	$37,382,501

Inventories are stated at the lower of cost or market on an average cost basis. Inventory costs include direct material and labor, inbound freight, purchasing and receiving costs, inspection costs, and warehousing costs. Any inventory on hand at the measurement date in excess of the Company's current requirements based on historical and anticipated levels of sales is classified as long-term on the Company's consolidated balance sheets. The Company's classification of long-term inventory requires it to estimate the portion of on-hand inventory that can be realized over the next 12 months and does not include precious metal, labor, and other inventory purchases expected to be both purchased and realized over the next 12 months.

Obsolescence is not a factor in the Company's loose jewel inventory valuation. The Company's jewels do not degrade over time and inventory generally consists of the shapes and sizes most commonly used in the jewelry industry. In addition, the majority of jewel inventory is not mounted in finished jewelry settings and is therefore not subject to fashion trends. The Company has very small market penetration in the worldwide jewelry market, and the Company has the exclusive right in the U.S. through mid-2015 and in many other countries through mid-2016 to produce and sell created SiC for use in jewelry applications. In view of the foregoing factors, management has concluded that no excess or obsolete loose jewel inventory reserve requirements existed as of September 30, 2011. Finished jewelry is more fashion oriented and subject to styling trends that could render certain designs obsolete. In 2010, the Company began manufacturing finished jewelry featuring moissanite, the majority of which consists of such basic designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets that tend not to be subject to significant obsolescence risk due to their classic styling. In addition, the Company manufactures small individual quantities of designer-inspired fashion jewelry as part of its sample line that are used in the selling process to its wholesale customers. Typically in the jewelry industry, slow-moving or discontinued lines are sold as closeouts in alternative sales channels. The Company reviews the finished jewelry inventory on an ongoing basis for any lower of cost or market and obsolescence issues and has concluded that no such finished jewelry inventory reserve requirements relating to the Company's new line of finished jewelry products existed as of September 30, 2011.

Periodically, the Company ships finished goods inventory to customers on consignment terms. Under these terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Finished goods on consignment at September 30, 2011 and December 31, 2010 are net of a reserve of $11,000 and $15,000, respectively, to allow for certain loose jewels and finished jewelry on consignment with customers that may not be returned or may be returned in a condition that does not meet the Company's current grading standards.

Total net loose jewel inventories at September 30, 2011 and December 31, 2010, including inventory on consignment net of reserves, were $32.10 million and $34.78 million, respectively. The loose jewel inventories at September 30, 2011 include an inventory reserve for shrinkage, or jewels on review with prospective customers and vendors that may not be returned to the Company, of $14,000. Loose jewel inventories at September 30, 2011 and December 31, 2010 also include an inventory reserve for recuts, or the projected material loss resulting from the recutting of damaged jewels into smaller loose jewels to remove the damage, of $52,000 and $36,000, respectively.

Jewelry inventories consist primarily of finished goods, a portion of which the Company acquired as part of the January 2009 settlement agreement with a former manufacturer customer to reduce the outstanding receivable to the Company. Due to the lack of a plan to market this inventory at that time, a jewelry inventory reserve was established to reduce the majority of the jewelry inventory value to scrap value, or the amount the Company would expect to obtain by melting the gold in the jewelry and returning to loose-jewel finished goods inventory those jewels that meet grading standards. This scrap reserve has declined as the associated jewelry is sold down, with a balance of $299,000 and $496,000 at September 30, 2011 and December 31, 2010, respectively. Because the finished jewelry

Table of Contents

the Company began manufacturing in 2010 after it entered that business was made pursuant to an operational plan to market and sell the inventory, it is not subject to this reserve. The finished jewelry inventories at September 30, 2011 also include an inventory reserve for jewelry in need of repair of $33,000. Total net jewelry inventories at September 30, 2011 and December 31, 2010, including inventory on consignment net of reserves and including new jewelry manufactured by the Company since entering the finished jewelry business in 2010, were $4.36 million and $2.48 million, respectively.

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

7. INCOME TAXES

During 2008, the Company recorded a valuation allowance against certain deferred tax assets. Due to continued uncertainty over sufficient future taxable income to fully utilize these deferred tax assets, the Company did not record an income tax benefit for the pretax losses incurred during the three and nine months ended September 30, 2011. In addition, due to the full valuation allowance on operating loss carryforwards recorded in prior years, the Company also did not recognize an income tax expense associated with pretax income during the three and nine months ended September 30, 2010. Until such time that the uncertainty is overcome, the Company does not expect to recognize income tax expense or benefit for operating income or loss, respectively, in future periods.

The Company recognized an income tax net benefit of approximately $243,000 and $208,000 for the three and nine months ended September 30, 2011, respectively, compared to an income tax net benefit of approximately $218,000 and $330,000 for the three and nine months ended September 30, 2010, respectively.

During the three months ended September 30, 2011, the Company entered into a voluntary disclosure agreement with a taxing authority for which the Company had previously recorded a liability for an uncertain tax position. As a result of the agreement, the Company reduced its total recorded liabilities relating to uncertain tax positions by approximately $252,000 and recognized a corresponding income tax benefit. This benefit was offset by approximately $9,000 and $44,000 of income tax expense for estimated tax, penalties, and interest for other uncertain tax positions for the three and nine months ended September 30, 2011, respectively.

During the three and nine months ended September 30, 2010, the Company recognized approximately $18,000 and $49,000 of income tax expense, respectively, for estimated tax, penalties, and interest associated with uncertain tax positions.

During the three months ended September 30, 2010, the Company also recognized income tax benefits of approximately $102,000 from the reduction of a valuation allowance on operating loss carryforwards due to potential utilization of deferred tax assets, approximately $113,000 associated with federal tax refunds, and approximately $21,000 from the elimination of a deferred tax asset and associated uncertain tax position resulting from the carryback of operating losses to the 2004 and 2005 tax years. During the nine months ended September 30, 2010, the Company also recognized approximately $143,000 of additional income tax benefit, consisting of a $102,000 reduction of a deferred tax asset valuation allowance to offset liabilities associated with an uncertain tax position and a $41,000 reduction of the liability for the same uncertain tax position.

8. COMMITMENTS AND CONTINGENCIES

Lease Commitments

In March 2004, the Company entered into a seven-year lease, beginning in August 2004, for approximately 16,500 square feet of mixed-use space from an unaffiliated third party at a base cost with escalations throughout the lease term plus additional common-area expenses based on the Company's proportionate share of the lessor's operating costs. The lease provided for two rent holidays, during which no rent was payable, and a moving allowance. In January 2011, the Company amended the lease effective January 1, 2011 to extend the term through January 2017 in exchange for a reduced rental rate and 50% rent abatement in the first 12 months of the extended term. The amended lease includes 3% annual rent escalations and a one-time option to terminate the lease effective as of July 31, 2014. The Company recognizes rent expense on a straight-line basis, giving consideration to the rent holidays, the moving allowance paid to the Company, and the rent abatement. At the Company's option, the amended lease can be extended for one five-year period. As of September 30, 2011, the Company's future minimum payments under this operating lease were $748,000.

Table of Contents

Rent expense for the three months ended September 30, 2011 and 2010 was approximately $58,000 and $44,000, respectively. Rent expense for the nine months ended September 30, 2011 and 2010 was approximately $152,000 and $154,000, respectively.

Purchase Commitments

On June 6, 1997, the Company entered into an amended and restated exclusive supply agreement with Cree, Inc. (“Cree”). The exclusive supply agreement had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the amended and restated exclusive supply agreement, the Company has committed to purchase from Cree a minimum of 50%, by dollar volume, of its raw material SiC crystal requirements. If the Company’s orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. There exist no outstanding purchase commitments under the amended and restated exclusive supply agreement as of September 30, 2011.

9. STOCK-BASED COMPENSATION

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Employee stock options	$92,821	$16,164	$255,769	$63,519
Consultant stock options	23,083	-	79,635	-
Restricted stock awards	92,686	64,100	351,541	209,838
Income tax benefit	(41,973)	(23,168)	(156,327)	(75,842)
Totals	$166,617	$57,096	$530,618	$197,515

Due to the Company’s valuation allowance against deferred tax assets, all of the above income tax benefit was reserved as of September 30, 2011. No stock-based compensation was capitalized as a cost of inventory during the three and nine months ended September 30, 2011 and 2010.

Stock Options - The following is a summary of the stock option activity for the nine months ended September 30, 2011:

	Shares	Weighted Average Exercise Price
Outstanding, December 31, 2010	660,450	$1.97
Granted	278,440	$2.96
Exercised	(32,585)	$1.44
Forfeited	(15,310)	$1.61
Expired	(19,968)	$10.62
Outstanding, September 30, 2011	871,027	$2.12

The weighted average grant date fair value of stock options granted during the nine months ended September 30, 2011 was $2.07. The total fair value of stock options that vested during the nine months ended September 30, 2011 was approximately $239,000. The fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option pricing model with the following weighted average assumptions for stock options granted during the nine months ended September 30, 2011:

Dividend yield	0.0	%
Expected volatility	90.7	%
Risk-free interest rate	1.80	%
Expected lives (years)	5.0	

12

Table of Contents

Although the Company issued dividends in prior years, a dividend yield of zero was used due to the uncertainty of future dividend payments. Volatility is a measure of the amount by which a financial variable such as share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company estimates expected volatility giving primary consideration to the historical volatility of its common stock. The risk-free interest rate is based on the published yield available on U.S. Treasury issues with an equivalent term remaining equal to the expected life of the stock option. The expected lives of the stock options represent the estimated period of time until exercise or forfeiture and are based on historical experience of similar awards.

The following table summarizes information about stock options outstanding at September 30, 2011:

Options Outstanding			Options Exercisable			Options Vested or Expected to Vest		
Balance as of 9/30/2011	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 9/30/2011	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 9/30/2011	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
871,027	8.29	$2.12	409,818	7.52	$2.26	819,545	8.23	$2.11

As of September 30, 2011, the unrecognized stock-based compensation expense related to unvested stock options was approximately $522,000, which is expected to be recognized over a weighted average period of approximately 27 months.

The aggregate intrinsic value of stock options outstanding, exercisable, and vested or expected to vest at September 30, 2011 was approximately $579,000, $316,000, and $561,000, respectively. This amount is before applicable income taxes and represents the closing market price of the Company's common stock at September 30, 2011 less the grant price, multiplied by the number of stock options that have a grant price that is less than the closing market price. This amount represents the amount that would have been received by the optionees had these stock options been exercised on that date. During the three and nine months ended September 30, 2011, the aggregate intrinsic value of options exercised was approximately $26,000 and $46,000, respectively.

Restricted Stock - The following is a summary of the restricted stock activity for the nine months ended September 30, 2011:

	Shares	Weighted Average Grant Date Fair Value
Unvested, December 31, 2010	108,512	$2.35
Granted	278,866	$2.91
Vested	(147,989)	$2.49
Canceled	-	$-
Unvested, September 30, 2011	239,389	$2.92

As of September 30, 2011, the unrecognized stock-based compensation expense related to unvested restricted stock was approximately $545,000, which is expected to be recognized over a weighted average period of approximately 31 months.

Dividends - The Company has not paid any cash dividends in the current year through September 30, 2011.

10. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the periods. Fully diluted net income (loss) per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of stock options that are computed using the treasury stock method.

Table of Contents

The following table reconciles the differences between the basic and fully diluted earnings per share presentations:

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
Numerator:				
Net income (loss)	$109,655	$511,952	$(230,047)	$1,146,652
Denominator:				
Weighted average common shares outstanding:				
Basic	19,540,214	19,261,941	19,437,360	19,144,036
Stock options	251,003	253,609	-	248,608
Fully diluted	19,791,217	19,515,550	19,437,360	19,392,644
Net income (loss) per common share:				
Basic	$0.01	$0.03	$(0.01)	$0.06
Fully diluted	$0.01	$0.03	$(0.01)	$0.06

For the three months ended September 30, 2011 and 2010, stock options to purchase approximately 461,000 and 294,000 shares, respectively, were excluded from the computation of fully diluted net income (loss) per common share because the exercise price of the stock options was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net income (loss) per common share. For the nine months ended September 30, 2011 and 2010, stock options to purchase approximately 871,000 and 301,000 shares, respectively, were excluded from the computation of fully diluted net income (loss) per common share because the exercise price of the stock options was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net income (loss) per common share.

11. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, investments, and trade accounts receivable. The Company maintains cash, cash equivalents, and investments with high-quality financial institutions and invests in low-risk