CHARLES & COLVARD LTD
Form 10-K
March 09, 2018

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

FORM 10-K

(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, 2017

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)

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

Title of each class	Name of each exchange on which registered
Common Stock, no par value per share	The Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 Website, 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 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 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," "smaller reporting company" and "emerging growth 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
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 June 30, 2017, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates of the registrant was $17,068,461 based on the closing sales price as reported on The Nasdaq Capital Market.

As of March 2, 2018, there were 21,575,673 shares of the registrant's common stock, no par value per share, outstanding.

DOCUMENT INCORPORATED BY REFERENCE

None.

CHARLES & COLVARD, LTD.

FORM 10-K
For the Fiscal Year Ended December 31, 2017

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Statements expressing expectations regarding our future and projections relating to products, sales, revenues, and earnings are typical of such statements and are made under the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, but are not limited to, statements about our plans, objectives, representations, and contentions and are not historical facts and typically are identified by use of terms such as "may," "will," "should," "could," "expect," "plan," "anticipate," "believe," "estimate," "predict," "continue," and similar words, altho forward-looking statements are expressed differently.

All forward-looking statements are subject to the risks and uncertainties inherent in predicting the future. You should be aware that although the forward-looking statements included herein represent management's current judgment and expectations, our actual results may differ materially from those projected, stated, or implied in these forward-looking statements as a result of many factors including, but not limited to, our dependence on consumer awareness, acceptance, and growth of sales of our products resulting from our strategic initiatives; the impact of the execution of our business plans on our liquidity; our ability to fulfill orders on a timely basis; the financial condition of our major customers and their willingness and ability to market our products; dependence on a limited number of customers; dependence on our exclusive supply agreement with Cree, Inc., for the sole supply of the raw material; intense competition in the worldwide jewelry industry; our ability to maintain compliance with the continued listing requirements of The Nasdaq Stock Market LLC, or Nasdaq; our current customers' potential perception of us as a competitor in the finished jewelry business; quality control challenges from time to time that can result in lost revenue and harm to our brands and reputation; general economic and market conditions, including the current economic environment; the impact of natural disasters on our operations; the pricing of precious metals, which is beyond our control; the potential impact of seasonality on our business; the potential adverse effect of recent U.S. tax legislation; the impact of significant changes in e-commerce opportunities, technology, or models; our ability to protect our intellectual property; the risk of a failure of our information technology infrastructure to protect confidential information and prevent security breaches; risks of conducting business in foreign countries; the potential adverse impact of negative or inaccurate social media commentary; the failure to evaluate and integrate strategic opportunities; possible adverse effects of governmental regulation and oversight; and the impact of anti-takeover provisions included in our charter documents, in addition to the other risks and uncertainties described in more detail in "Risk Factors" in Part I, Item 1A of this Annual Report on Form 10-K. Forward-looking statements speak only as of the date they are made. We undertake no obligation to update or revise such statements to reflect new circumstances or unanticipated events as they occur except as required by the federal securities laws, and you are urged to review and consider disclosures that we make in the reports that we file with the Securities and Exchange Commission, or SEC, that discuss other factors relevant to our business.

PART I

Item 1. Business

Overview

Our Mission

At Charles & Colvard, we believe luxury can be both beautiful and conscientious. With innovative technology and sustainable practices, our goal is to lead a revolution in the jewelry industry – delivering a brilliant product at extraordinary value balanced with environmental and social responsibility.

Charles & Colvard, Ltd., a North Carolina corporation founded in 1995 (which may be referred to as Charles & Colvard, we, us, or our), manufactures, markets and distributes Charles & Colvard Created Moissanite® (which we refer to as moissanite or moissanite jewels) and finished jewelry featuring our proprietary moissanite gemstone for sale in the worldwide jewelry market. Our unique differentiator, moissanite – The World's Most Brilliant Gem® – is core to our ambition to create a movement around beautiful, environmentally and socially responsible fine jewelry. Charles & Colvard is the original creator of lab-created moissanite, and we believe that we are leading the way in delivering the most pure form of this gemstone through technological advances in gemstone manufacturing, cutting, polishing and setting.

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Our strategy is to build a globally revered brand of gemstones and jewelry that appeals to a wide consumer audience and leverages our advantage of being the original and leading worldwide source of created moissanite. We believe a direct relationship with consumers is important to this strategy, which entails delivering tailored educational content, engaging in dialogue with our audience, and positioning our brand to meet the discerning needs of today's consumer. We sell loose moissanite jewels and finished jewelry through two operating segments: our Online Channels segment, which comprises our charlesandcolvard.com website, e-commerce outlets, including marketplaces such as Amazon and eBay, and drop-ship customers, such as Overstock.com, and other pure-play, exclusively e-commerce customers, such as Gemvara; and our Traditional segment, which consists of wholesale, retail, and television customers. For more information about our operating segments, see Note 3, "Segment Information and Geographic Data", in the Notes to the Consolidated Financial Statements. We believe our expanding application of an omni-channel sales strategy across the jewelry trade and to the end consumer with branded finished jewelry featuring moissanite positions Charles & Colvard goods at the many touchpoints where consumers are when they are making their buying decisions – thereby creating greater exposure for our brand and increasing consumer demand.

In February 2016, we made the strategic decision to explore a potential divestiture of our direct-to-consumer home party business previously operated through our Charles & Colvard Direct, LLC (dba Lulu Avenue®) subsidiary. After careful analysis of our 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 our best interest and our shareholders' best interest. On March 4, 2016, we and Charles & Colvard Direct, LLC entered into an asset purchase agreement with Yanbal USA, Inc., or Yanbal, under which Yanbal purchased certain assets related to our 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 13, "Discontinued Operations", in the Notes to the Consolidated Financial Statements.

Our Market Opportunity

According to Forbes.com and McKinsey & Company, by 2020 the global online fashion jewelry market is expected to drive $45 billion in sales – representing 15% of the global jewelry market – and global online fine jewelry is projected to represent a staggering $30 billion of the global jewelry market. Concurrently, according to the Wall Street Journal, the lab-created gemstone opportunity is expected to reach an $8 billion market size. We believe this convergence of the online fine jewelry shopper and the emergence of lab-created gemstones as a solution to the underserved, ethically-minded value consumer shapes a bright and sizeable future opportunity for Charles & Colvard and jewelry designed with our exceptional gemstone.

Our Strategic Direction

As consumers have shifted to significant levels of online shopping and buying, in particular, the Millennial generation, we have had to transform our go-to-market strategy in a relatively short period. Our historical business was that of a gemstone manufacturer, and as such, we created gemstones, and leveraged our distributor networks as the primary method for delivering our goods to market. That meant relying on our network partners to generate interest and sales for our gemstone, while they were doing the same for other gemstones and jewelry across the industry. Consequently, we believe there was a substantial lack of market awareness for moissanite.

In order to address these issues, we began building a new leadership team in December 2015. This team increased the focus on the importance of a direct connection with the consumer, and over the course of the last two years began implementing new strategies to strike a dialogue with this audience.

In October 2016, we re-launched Charles & Colvard with the intent to position both Charles & Colvard and its innovative moissanite product – Forever One™ – as a premium gemstone and jewelry brand. During this pivotal time, we launched the charlesandcolvard.com web site as our primary storefront, established our brand across key social media properties, and began a significant digital marketing campaign to gain exposure, build brand awareness, and begin the journey of establishing a lifetime relationship with consumers that are seeking an alternative luxury brand that aligns with their buying preferences.

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2017 was a year of growth and optimization of our branding initiatives. We progressed the business from our 2016 re-launch, and focused on driving consumer awareness while making calculated marketing and sales investments as we engaged new channel partners and forged inroads into new markets. Over the course of the year, we executed our strategic plan with new innovations in our Forever One™ product line and finished jewelry offerings. We invested in key retail and wholesale partnerships, as evidenced by our brick-and-mortar expansion into nearly all Helzberg Diamonds stores. We explored new channels, applying our e-commerce expertise as we rolled-out our inaugural presence on Tmall® in China, and achieving authorized Seller-Fulfilled Prime status on Amazon.com. We believe that we have improved the customer experience with our brand by taking such actions as offering free shipping and introducing a 60-day free returns policy. We also believe that we were able to amplify our global marketing efforts as we advanced toward profitability. A more detailed description of our achievements in 2017 is included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Our strategy for 2018 is to focus on growth and market expansion across channels and geographies. As competitive moissanite makes its way to market, there is no more important time than now to confirm Charles & Colvard's leadership position as the premier worldwide moissanite provider and to further establish our presence in emerging markets. Our key strategies for 2018 are:

- Drive organic revenue growth in the U.S. and maintain attractive margins – We plan to continue engaging our target customers through creative and progressive marketing campaigns and leverage technology to ensure efficiencies in our marketing, sales and customer service functions.

- Expand our gemstone and jewelry offerings to serve a broad range of customers – We plan to continue innovating our moissanite gemstone offerings and further enhance our jewelry offerings to include unique, curated collections and new styles at multiple price points that will appeal to a broad audience.

- Target the global market opportunity through continued brand building, focused channel expansion and world-class customer service – We plan to diversify and expand our global customer base in a low-risk manner by introducing our brand in select markets via cross-border trade initiatives and through established marketplaces.

- Balance growth-oriented investments to generate sustainable earnings improvement – We plan to maintain financial flexibility and use data-driven business decisions to balance investments in future growth with consistent near-term financial performance.

Our Guiding Principles

One of the most critical factors in implementing our strategies and achieving success is our team of employees. We carefully develop, support and reward our team members, making sure they know our fundamental mission, which is to lead a revolution in the jewelry industry – delivering a brilliant product at an extraordinary value balanced with environmental and social responsibility. We have set forth Guiding Principles that set the tone for everything we do – from structuring our interactions with partners, customers and shareholders to the way we operate our business, and the products we bring to market. Following are the principles that guide our actions:

- Catalyze – Build positive momentum with customers and influencers by being thoughtful and trustworthy in every interaction.

- Innovate – Disrupt the jewelry industry through use of technology – in gemstone and jewelry design, business processes and engagement with our audience.

- Aspire – Be socially conscious, economically informed and environmentally responsible. Build a sustainable business and give back through community acts.

- Obsess – Think like a consumer, act like a friend. Constantly seek ways to reduce friction between the brand and our audience.
- Achieve – Focus attention on the interdependent successes of individual, brand and shareholder.
- Enrich – Promote personal growth and the ability to affect positive change in the business by cultivating a culture of critical thinking and creativity.

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Our Audience

Our consumer audience is in transition. Historically, our audience has been largely comprised of Baby Boomers and Generation X – which we consider an older set of consumers driven by a traditional style of jewelry. Today, our market research and buying habit analytics indicate that, regardless of demographic, our audience appears to be driven by three distinct motivating factors: (1) Beauty – the innate brilliance of our gemstone and jewelry selection; (2) Value – the “bang for the buck” possible with moissanite, and the ability to buy luxury items while saving money for the more important things in life; and (3) Conscientiousness – having a positive impact on the world by buying from brands that are environmentally and socially responsible.

Our marketing programs are driven by this understanding of our audience and their motivating factors. Their mindset drives the segmented messages we deliver, defines the partners and kindred brands we select and co-promote with, and determines the channels in which we engage with our audience.

While these common motivating factors transcend demographics, we believe that we are seeing distinct trends that lend themselves to highly targeted marketing programs. Most distinctly, we have discovered – what we refer to as the conscientiousness factor – emanating from the Millennial and burgeoning Generation Z demographics. We believe that today’s younger consumers are socially and ethically wired. They appear to proactively seek out goods and services that align with their core principles and become devoted and vocal advocates of brands that embody ‘green’ practices. This consumer group is our fastest growing online channels demographic.

In summary, we believe our beautiful, high value, ethically-sourced product aligns directly with the principles and purchasing requirements of our primary target – the Millennial audience. However, we believe that we also appeal to a broader range of demographics for whom we can deliver tailored promotional programs that speak to their distinct motivating factors.

Marketing to the Online Channels Segment

Driven by knowledge of our changing audience, we adjusted our strategy and marketing tactics throughout 2017 and proactively engaged the consumer through a multi-channel digital marketing strategy. Our goal is to continue growing our direct relationship with the consumer, which we believe will drive interest across all of our selling channels. Our approach for marketing directly to the consumer includes the following online programs:

- Social Media – To reinforce and support our position as the leading source of ethically-sourced, lab-created moissanite, our marketing team manages several social media initiatives that target current and future jewelry consumers to support the promotion and sale of Charles & Colvard Created Moissanite®. Our campaigns are focused on driving a consistent message emphasizing the environmentally and socially responsible aspects of our jewels, their everlasting beauty, and overall value. Our social media efforts include both owned posts and engagements (our own profiles and activities) as well as paid placement (ads presented to targeted audiences).

- Digital Marketing – According to a recent research study by Forrester Research, Inc., a global independent research, data, and advisory services firm, 71% of consumers begin their buying journeys by using a web search to discover new products and services. In short, the typical buyer’s journey is a digital one. Digital marketing encompasses the myriad ways we can be a part of that journey – from Search Engine Marketing (keyword buys and ads) to digital display (banner ads and product re-targeting ads) to video pre-roll (ads playing before third-party YouTube videos), and native advertising (long-form content produced in conjunction with editorial outlets such as Refinery29®). We are using, and continually optimizing, available digital marketing channels and will continue to monitor new forms of paid media as they arise, assessing whether they will be effective in helping us connect with our target audiences.

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Influencer Campaigns – According to Forbes Magazine and a study from MuseFind Technologies Inc., a leading U.S. influencer marketing authority, up to 92% of consumers trust an influencer more than an ad or traditional celebrity endorsement. This is a clear indicator of what marketers have already come to accept: that people trust other people more than they trust brands. However, we believe there is a caveat: the influencers that a brand partners with must truly be aligned in mindset. We do not believe that we can simply find someone with millions of followers, pay them to post about our brand and product, and expect to see results. Instead, we believe we must find influencers who embody the same mindset as our brand and believe in the products we bring to market. This takes time, and we plan to continue to build our influencer network throughout 2018.

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- Sweepstakes – We believe sweepstakes, especially leveraging social media platforms in partnership with kindred brands, are powerful in acquiring and engaging new audiences. Through the use of sweepstakes in 2017, we increased our email marketing subscribers and social media followers, generated a multitude of user-generated content about our brand and products, and converted new customers. Sweepstakes will be a marketing tactic we intend to expand upon throughout 2018.

- A Twist on the Traditional TV Channel – Throughout our history, we have utilized TV as a channel to reach our consumers. In 2017, we identified a shift in our audience and how they began to disengage from TV and shift to online and streaming video. We are combining our years of knowledge about video marketing, and the power of seeing our product in motion, with our growing expertise in digital marketing. These efforts are expected to culminate in extensive use of video marketing and livestream video in 2018.

- Consumer Education – Because we believe education of the consumer is so important to the sell-through of moissanite products, we continue to enhance our website and contribute to third party platforms such as social media sites to share extensive educational information about moissanite, in addition to general background information about our company. But we do not believe our value to the marketplace is only realized in our product. As our goal is to lead a revolution in the jewelry industry, we also have a commitment to providing value through education of the jewelry market by bringing to light the environmental and social impact of the trade as a whole. We plan to continue to create content of value on our own site and social channels and to contribute more to third party platforms, sharing extensive educational information about environmentally and socially responsible, lab-grown moissanite.

Distributing to the Online Channels Segment

Equally as important to us as marketing to our direct consumer audience is moving our customers through the process of engaging with our brand – and eventually converting into a lifetime customer. Throughout the above marketing tactics, we employ calls to action that drive the consumer to the many places where they can view our products and complete their purchase. We utilize a centralized distribution and fulfillment facility in Morrisville, North Carolina, to fulfill online channels orders. Following are our primary online transactional channels:

- charlesandcolvard.com – In 2017, we significantly enhanced our transactional web site to optimize for the mobile consumer and to reduce friction between our brand and the consumer. Programs such as free shipping, a 60-day return policy, and an enhanced and optimized shopping experience were rolled out in time for the 2017 holiday season. With data collected through web analytics, and through user surveys that reveal how consumers use the site, we are in a continual state of optimizing the buying experience – making it easier for shoppers to browse, sort and compare. Through the use of partners such as Affirm, Inc., and PayPal Holdings, Inc., or PayPal, for financing purchases, Braintree, a service of PayPal, for ease of transfer, and cross-border trade, or CBT, services, we are continually focused on improving our customers' experience.

- Marketplaces – As noted previously, a large majority of buyers start their online shopping experience with a web search. According to BloomReach, Inc., a global content management firm, as many as 55% of those searches begin on Amazon. That number skews even higher within the Millennial demographic – based on a finding by the Pew Research Center, a renowned nonpartisan fact think tank, Amazon is the brand Millennials identify as most relevant. Therefore, we have made a point to be prominent on Amazon, achieving Seller-Fulfilled Prime status in 2017, which means we have the option of fulfilling orders with the same benefits of Amazon Prime. This will enable us to be positioned more prominently in Amazon's search platform and to take advantage of their negotiated shipping rates and service levels that, in turn, will lower our shipping costs. This status is available by Amazon to only those sellers who have a history of fulfilling orders quickly and not running out of stock. We are also prominent on eBay and a multitude of other specialty marketplaces, allowing us to meet our customers where they want to buy.

- Pure-Play E-tailers – Bain & Company, a global management consulting firm, estimates that 28% of total retail sales will become e-commerce centric by 2030. As consumers become more digitally savvy, new businesses have gained traction by tailoring their product, services and experiences to specific consumer preferences. We believe that these pure-play e-tailers offer unique opportunities for Charles & Colvard to feature our gemstones and connect with their loyal audiences. As our 2018 strategy evolves, we plan to focus on expanding these relationships and forging new partnerships that enable us to reach differentiated audiences.

- Drop Ship Retail – Retailers are consistently seeking socially responsible brands to serve the growing demand for conscientious product selection from their audiences. In an effort to smartly expand their assortment, they utilize drop-ship as it enables them to offer a more robust assortment online without having to physically take ownership of the goods in their warehouse. As we have refined charlesandcolvard.com's post-purchase customer experience to deliver fast shipping and a streamlined return process, we are leveraging these enhanced processes to support the increasing opportunity among retailers that are incorporating drop-ship as core to their online assortment expansion strategy.

- Cross-Border Trade – According to statistics from Statista.com (based on data from Shopify Inc., a global cloud-based, multi-channel commerce platform), with 84% of global e-commerce sales predicted to take place outside of Europe and North America by 2020, we anticipate combining regionalized marketing efforts in new geographies with promotional campaigning to drive international consumers to our charlesandcolvard.com web property. Through the application of market-leading CBT technology, we believe CBT to be a significant opportunity in 2018 and beyond.

Marketing to the Traditional Channels Segment

The Traditional Channels segment is our legacy channel – representing such outlets as distributor partners, brick-and-mortar retail, and traditional television shopping. These channels remain important avenues for Charles & Colvard to drive product to market, and be present in the many places the consumer takes their shopping journey.

- Trade advertising – In 2017, we continued to target the trade with print advertisements featuring moissanite, with specific emphasis on our Forever One™ moissanite jewels and finished jewelry featuring the Forever One™ jewel in leading trade publications. We intend to continue to deliver meaningful promotion of Forever One™ as we further expand this product line into the wholesale distribution segment.

- Industry associations – We maintain relationships with major jewelry industry organizations and jewelry trade publications as an opportunity to communicate with our peers on a consistent basis through media coverage, trade shows, and charitable events, among others.

- Trade shows – Our attendance at leading jewelry trade shows as a sponsor, an exhibitor, or a participant has helped us extend our outreach to customers. In 2017, we attended major domestic and international jewelry industry trade shows including JCK, North America's largest annual jewelry trade event in Las Vegas, and the Hong Kong Gem and Jewellery Fair. We intend to continue investing in these important industry events in 2018.

- Cooperative advertising – We sometimes participate in the cooperative advertising programs of our distributor and retail partners, subject to the customer adhering to our branding guidelines and other conditions. In these programs, we subsidize a portion of their marketing costs in order to create awareness of and exposure for our gemstones and jewelry.

Distributing to the Traditional Channels Segment

We utilize a centralized distribution and fulfillment facility in Morrisville, North Carolina, to fill bulk orders to manufacturer, distributor, and retail customers.

- Retail – In order to create awareness and exposure for our gemstones, jewelry, and brands, we sell loose moissanite jewels and finished jewelry featuring moissanite at wholesale prices to nationally recognized and emerging retail customers through a broad range of channels including jewelry chains, television shopping networks, and department stores. Wholesale orders are received via purchase order and filled from our centralized distribution and fulfillment center. In addition, we have placed loose moissanite jewels and finished jewelry inventory in stores on a consignment basis. We continue to evolve our retail channel strategy as we optimize our historical methods and partners.

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- Domestic Manufacturers and Distributors – In order to service the vast number of independent jewelers, jewelry stores, and smaller jewelry chains, we sell our loose moissanite jewels to domestic wholesale distributors and finished jewelry manufacturers at distributor prices, that in turn set them in mountings and sell them to retailers, sell them through their own e-commerce sites, or resell the loose jewels at a markup to independent jewelers and jewelry stores – whether brick-and-mortar, online, or both. In addition, we have placed loose moissanite jewels and finished jewelry inventory with select domestic distributors on a consignment basis. We continue to evaluate our channel strategy for domestic distributors, which may result in a change to our historical domestic distributor methods and partners.

- International Manufacturers and Distributors – In order to create global awareness and exposure for our gemstones, jewelry, and brands, we sell loose moissanite jewels and finished jewelry featuring moissanite to international wholesale distributors and finished jewelry manufacturers at distributor prices, that in turn set them in mountings and sell them to retailers, sell them through their own e-commerce sites, or resell the loose jewels at a markup to independent jewelers and jewelry stores in their local markets. We currently have more than 15 international wholesale distributors covering portions of Canada, the UK, Western Europe, Australia and New Zealand, Southeast Asia, the Middle East, and China. In addition, we have placed loose moissanite jewels and finished jewelry inventory with select international distributors on a consignment basis. We continue to evaluate our channel strategy for international distributors, which may result in a change to our historical international distributor methods and partners. A portion of our international sales consists of finished jewels sold internationally that may be re-imported to U.S. retailers.

For a discussion of our largest customers for 2017 and 2016, see Note 14, “Major Customers and Concentration of Credit Risk”, in the Notes to the Consolidated Financial Statements.

Seasonality

Sales in the retail jewelry industry are typically seasonal due to increased consumer purchases during the holiday season. Because historically we have primarily sold our loose moissanite jewels and finished jewelry featuring moissanite at wholesale pricing to distributors, manufacturers, and retailers, our sales to support the holiday season have largely taken place during the third and beginning of the fourth calendar quarters, depending on the sales channel and the level of advanced planning and production our customers undertook. However, the effect of seasonality on our business is also impacted by the timing of orders we receive to support new or expanded distribution and the level of current inventory positions held by our customers. In recent years, excluding one-time sales events from time to time throughout the year, we have experienced a higher degree of seasonality in the fourth quarter than we have experienced in prior years primarily as a result of the holiday season sales to end consumers through our growing direct-to-consumer e-commerce website, charlesandcolvard.com and as a result of increased sales through our Online Channels segment. In future periods, as sales of our finished jewelry increase to retailers and directly to consumers, both in dollars and as a percentage of total sales, we anticipate a seasonality trend more typical with the retail jewelry industry, and these factors may significantly affect our results of operations in a given quarter.

Change in Fiscal Year-End

On January 30, 2018, our Board of Directors approved a change in our fiscal year from a fiscal year beginning on January 1 and ending on December 31 of each year to a fiscal year beginning on July 1 and ending on June 30 of each year. This change in our fiscal year-end enables management to shift its annual planning and budgeting process away from the holiday season, so that management’s focus during that time is on revenue-generating opportunities with customers. This change to the fiscal year reporting cycle will begin July 1, 2018. As a result of the change, we will have a six-month transition period from January 1, 2018 to June 30, 2018. During this period, we plan to file our results for the three-month period ending March 31, 2018 in our Quarterly Report on Form 10-Q for the quarter ending March 31, 2018 and to file a transition report with our results for the six-month period ending June 30, 2018 on

Form 10-KT with the SEC.

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Moissanite

Over 120 years ago, Nobel Prize-winning chemist, Henri Moissan, Ph.D., first discovered the extremely rare mineral, silicon carbide, or SiC, in a meteorite crater in Arizona. Over a century after the discovery of SiC, and after years of experimentation, researchers from the Research Triangle Park in North Carolina developed and patented a thermal growing process for creating pure SiC crystals in a controlled laboratory environment. This long-sought-after breakthrough made possible the world’s first lab-created moissanite gemstone – posthumously named after its discoverer. With hardness rivaling any mineral on earth, and optical properties exceeding all mined and created gemstones, we believe moissanite is a brilliant new type of jewel that is free from environmental and ethical issues, and capable of disrupting traditional definitions of fine jewelry.

Naturally-occurring moissanite is generally very small in size, dark green or black in color, and not a commercially viable source of gemstone material. Therefore, in order to create high quality moissanite material in desirable colors and across a range of carat sizes that will appeal to a consumer audience, we expect only lab-grown SiC crystals to provide a sustainable source of moissanite for gemstones. In addition to carat size, important characteristics of a gemstone are beauty, durability, and rarity. The beauty of a near-colorless and colorless gemstone is characterized by its color, brilliance, and fire. The brilliance of a gemstone is measured by its refractive index, or the extent to which, when coupled with the facet design, the gemstone reflects light. The fire of a gemstone, or the breaking of light rays into spectral colors, is measured by its dispersion. Durability is determined by a gemstone’s hardness, or resistance to scratching and toughness, or resistance to chipping or cleaving. Rarity is the availability or perceived availability of a gemstone.

Moissanite jewels have a unique combination of brilliance, fire, durability, and rarity. Moissanite’s beauty is objectively derived from its refractive index, which is higher than any other gemstone, including diamond. And its hardness is greater than all minerals, and all known gemstone materials with the exception of diamond. As a result, moissanite jewels, like diamond, can be cut with sharp, well-defined, and highly polished facets that accentuate their brilliance and fire. The cutting specifications (facet arrangement and proportions) for moissanite jewels are different than any other gemstone, and designed to maximize the brilliance and fire of the material. We evaluate the finished jewels to exacting standards with automated video-imaging equipment and specially trained quality control personnel. Due to the rare natural occurrence of moissanite and both the proprietary and technical limitations in producing mass quantities of gem-grade moissanite, we believe that moissanite is among the rarest of jewels.

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

Description	Refractive Index	Dispersion	Hardness (1)	Toughness
Charles & Colvard Created Moissanite®	2.65-2.69	0.104	9.25 – 9.5	Excellent
Diamond	2.42	0.044	10	Good to Excellent (2)
Ruby	1.77	0.018	9	Excellent (3)
Sapphire	1.77	0.018	9	Excellent (3)
Emerald	1.58	0.014	7.50	Poor to Good

(1) For purposes of this table, "hardness" is based on the Mohs Scale, which is a relative scale only. Quantitative comparisons of different gemstone materials cannot be made directly using the Mohs Scale. Moissanite jewels, while harder than all other known gemstones, are approximately one-half as hard as diamond.
(2) In cleavage direction, toughness is "good"
(3) Except twinned stones

Sources: Gemological Institute of America, Gem Reference Guide for 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 524-541 (5th Ed. 2004); Institution Of Electrical Engineers, Properties of Silicon Carbide (Gary L. Harris, Ed., 1995); Robert Webster, Gems: Their Sources, Descriptions and Identification 889-940 (5th Ed. 1994); W. von Muench, "Silicon Carbide" in Landolt-Börnstein 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, 425-438 (1999); Mindat.org, "Moissanite" (https://www.mindat.org/min-2743.html); and Wikipedia, "Moissanite" (https://en.wikipedia.org/wiki/Moissanite).

Products and Product Development

Moissanite jewels

Historically, Charles & Colvard primarily sold near-colorless moissanite jewels including Forever Classic™ and Forever Brilliant®. We continue to offer these products in a variety of shapes including round, square brilliant, princess, cushion, radiant, pear, marquise, heart, and oval, among others, in sizes ranging from approximately 1.3 to 12 millimeters (approximately 0.008 to 5.3 carats). In 2015, we announced availability of our premier product, the first colorless moissanite jewel, Forever One™, which grades from colorless (D-E-F) to near-colorless (G-H-I) using the Gemological Institute of America's color grading scale. Our limited launch was met with great enthusiasm from channel partners and consumers. In response to this demand, we continue to expand our Forever One™ product line with additional shapes and sizes. Today, we offer Forever One™ in 14 cuts, and a multitude of sizes ranging from melee accent stones as small as .005 carats to gemstones up to 6.13 carats, and our recently-released Exotics that are as large as 15.55 carats diamond equivalent weight ("DEW").

Moissanite finished jewelry

We began selling finished jewelry featuring moissanite in 2010. Our core designs include stud earrings, solitaire and three-stone rings, pendants, and bracelets. We are now selling an expanded selection of fashion-oriented, designer-inspired moissanite jewelry that we offer as an expansion to the core line of jewelry. The primary ingredients of our moissanite finished jewelry are loose moissanite jewels that we have on hand as part of our finished goods inventory, white, yellow, and rose gold settings, sterling silver settings, and labor to mount the jewels into the settings.

In addition, we historically purchased fashion finished jewelry comprising base metals and non-precious gemstones for sale through Lulu Avenue®. This finished jewelry was fashion oriented and subject to styling trends that could change with each catalog season. The majority of this finished jewelry was custom designed for us. We made limited purchases of fashion finished jewelry after the divestiture of our direct-to-consumer home party business on March 4, 2016.

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Source of Raw Material

Our moissanite jewels are made from gem-grade SiC crystals. Our sole supplier of SiC crystals is Cree, Inc., or Cree, with which we have certain exclusive supply rights for SiC crystals to be used for gemstone applications. We source the metals used for our finished jewelry, including white, yellow, and rose gold and sterling silver, from a number of domestic and international manufacturers located in the U.S, China, India, Mexico, or Hong Kong. In line with our goal of providing socially and ethically-sourced products, we require suppliers to adhere to our stringent supplier guidelines, as well as to certify that their gold is coming from conflict free sources and that all metals supplied to us are responsibly sourced.

Exclusive Supply Agreement with Cree

On December 12, 2014, we entered into a new exclusive supply agreement with Cree, or the Supply Agreement, which superseded and replaced our prior agreement with Cree. Under the Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the Supply Agreement will expire on June 24, 2018, unless extended by the parties. Accordingly, we are reviewing various alternatives with respect to our purchase of SiC material, including whether to exercise our unilateral option, subject to certain conditions, to renew the Supply Agreement for an additional two-year period. Our total purchase commitment under the Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately $29.60 million and approximately $31.50 million. As of December 31, 2017, our remaining purchase commitment through June 2018 under the Supply Agreement ranges from approximately $5.15 million to approximately $7.05 million.

Intellectual Property

We held U.S. product and method patents for moissanite jewels that expired during 2015, under which we had broad, exclusive rights to manufacture, use, and sell moissanite jewels in the U.S. We held these same patents in 25 foreign jurisdictions primarily across Asia and Europe that expired in the third quarter of 2016, and will expire in Mexico in 2021. In addition, we have certain trademarks and pending trademark applications that support our moissanite branding strategy. Since the expiration of our patents we have noted new providers of moissanite entering the market. We know how challenging it is to create high-quality moissanite and anticipate it will take emerging providers significant time and investment to bring meaningful and competitive products to market. As we experienced ourselves, we anticipate it will take these new providers significant time to evolve from producing low-end moissanite to delivering high-quality gemstones in the colorless or near-colorless range. Achieving the capacity to consistently produce a high-quality moissanite product at mass scale requires a careful balance of silicon carbide-specific faceting skills and a well-tuned global supply chain. Therefore, we do not anticipate direct moissanite competition in our superior quality gemstone ranges in the foreseeable future.

Our success and our ability to compete successfully depends in part upon our proprietary technology. In addition to our remaining international patents, we rely on trade secret laws and employee, consultant, and customer confidentiality agreements to protect certain aspects of our technology. We currently are not subject to any claims that our products or processes infringe on the proprietary rights of third parties. At the present time, we are also dependent on Cree’s technology for the production of SiC crystals.

Manufacturing and Quality Assurance

Moissanite jewels

The production of Charles & Colvard Created Moissanite® jewels is an elaborate process developed over a number of years of collaborative research and development, acquired and learned knowledge from scientists, and considerable investment expense.

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Following are the key manufacturing processes of our moissanite jewels:

- Growing gem-grade raw SiC crystals;
- Manufacturing rough preforms;
- Faceting and polishing jewels;
- Inspecting, sorting, and grading; and
- Engraving.

Growing gem-grade raw SiC crystals – SiC crystal growth suitable for gem-grade usage at commercial quantities is proprietary both in design and in operational methodology. Cree has grown the majority of our SiC crystals in accordance with the terms of the Supply Agreement. We routinely evaluate the yield and quality of saleable moissanite jewels from SiC crystals. The yield of saleable jewels from each crystal is one of the most significant factors affecting the volume and cost of moissanite jewels available for sale. Yield is dependent on the quality of the crystals, and variations in crystal quality can adversely affect our gross margin percentage.

Manufacturing rough preforms – We have made considerable investment in the design, development, and customization of a proprietary manufacturing process that includes equipment, software, and procedures to maximize raw material yield. The result is production of intermediary shapes, called “preforms,” that vary depending upon the size and shape of the desired finished jewel. We continue to invest research and development resources to improve raw material yield, including studying alternate preform shapes and cutting technologies, due to the dramatic effect such an improvement could have on our gross margin percentage.

Faceting and polishing jewels – Each preform is faceted and polished by our independent third-party gem-cutters based on master designs with multiple quality control measures built into the process. Gem-cutter training is a regimented program involving several months of progressive hands-on bench training. As we continue to expand the assortment of Forever One™, we will continue the process of certifying additional cutters to ensure sufficient scalability of our production capabilities to meet anticipated demand for this premium finished jewel.

Inspecting, sorting, and grading – Similar to other gemstones, each faceted moissanite jewel greater than 2.5 millimeters in size is individually graded against established master standards using our specially trained personnel. Additionally, as part of our overall quality assurance program, a representative sample from each batch of jewels is submitted to an image analyzer to ensure critical angles and other attributes designed to maximize moissanite’s optical properties are consistently maintained. 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 independent third parties that we will require to adhere to our rigorous quality control and monitoring standards.

Engraving – For moissanite gemstones over four millimeters in size, Charles & Colvard laser inscribes an identifying code on the girdle of each gemstone. This identifier matches a grading standard and is an important element in protecting the integrity of Charles & Colvard Created Moissanite® and ensuring the customer an authentic Charles & Colvard gemstone.

Finished jewelry

Our line of finished jewelry featuring moissanite is developed by a team of industry experts integrating our moissanite jewels into many forms of jewelry, generally made of precious metals, either designed or purchased by us utilizing a core group of suppliers, manufacturers, and finishers. In addition to our Limited Lifetime Warranty offered on our moissanite jewels, we provide a 12-month Limited Warranty on all finished jewelry featuring our moissanite.

Our prior line of fashion finished jewelry, comprised of base metals and non-precious gemstones for sale through Lulu Avenue®, was either designed exclusively for us and manufactured to our specifications or purchased from a core group of suppliers and manufacturers. We made limited purchases of fashion finished jewelry after the divestiture of our direct-to-consumer home party business on March 4, 2016.

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All procured finished jewelry components are sourced from our approved suppliers, and each finished jewelry item is jobbed and/or tracked by stock keeping unit ("SKU"), utilizing our enterprise resource planning system. The components of moissanite finished jewelry comprised in each job are then manufactured into finished jewelry by assemblers either in the U.S. or internationally in China, India, Mexico, or Hong Kong. We are continuously working with our existing manufacturing partners, as well as identifying new manufacturing partners, to expand our assortments and efficiencies.

All finished jewelry produced by Charles & Colvard undergoes a multi-point inspection process. A representative sampling of manufactured finished jewelry items undergoes stone and metals testing to ensure that the items for sale are of the quality that we strive to maintain. Also, in line with our goal of providing socially and ethically-sourced products, we require suppliers of our gold to certify that the gold is coming from conflict free sources and that all metals supplied to us are responsibly sourced. If required by government ordinance or requested by a customer, we facilitate the inspection of our finished jewelry by internationally recognized testing facilities to comply with legal requirements and to ensure consumer confidence.

Working Capital Practices

Our primary source of working capital is cash on hand and cash generated by operations. Because we have a quarterly minimum purchase commitment under the Supply Agreement, we may be required to purchase SiC materials in excess of our immediate needs from time to time, which may result in inventories that are higher than we might otherwise maintain.

Payment terms on trade receivables for our Traditional segment customers are generally between 30 and 120 days, though we may offer extended terms with specific customers and on significant orders from time to time. We extend credit to our customers based upon a number of factors, including an evaluation of the customer's financial condition and credit history that is verified through trade association reference services, the customer's payment history with us, the customer's reputation in the trade, and/or an evaluation of the customer's opportunity to introduce our moissanite jewels or finished jewelry featuring moissanite to new or expanded markets.

Our return policy for certain customers in our Online Channels segment provides for the return of purchases for any reason generally within 60 days of shipment in accordance with our warranty policy as disclosed on the charlesandcolvard.com website. Our return policy for customers in our Online Channels segment (excluding those of charlesandcolvard.com) and those in our Traditional segment allows for the return of jewels and finished jewelry for credit generally within 30 days of shipment if returned for a valid reason. We have established an allowance for returns based on our historical return rate, which takes into account any contractual return privileges granted to our customers. Periodically, we ship loose jewel goods, finished jewelry goods, and finished goods inventory to Traditional segment 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 that typically ranges from six months to one year.

Competition

As competitive moissanite makes its way to market, there is no more important time than now to confirm Charles & Colvard's leadership position as the premier worldwide moissanite provider and to further establish our presence in emerging markets. We believe our leadership position is a product of over 20 years of moissanite innovation, and is bolstered by the following strengths:

- Our exclusive SiC crystal supply agreement with Cree, which holds the U.S. patent for micropipe-free silicon carbide material and the related method of manufacture. We believe this core material empowers Charles & Colvard to rise above all other moissanite with an unrivaled level of gemstone clarity.

- Our mature supply chain, which we believe enables us to seamlessly manage the complex manufacturing process of both our moissanite gemstones and the varied jewelry options we deliver to a global audience.

- Our global distribution network, which we have optimized for timely delivery of everything from singular consumer orders to bulk distribution orders.

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- Our significant inventory supply, which we believe positions us to meet the just-in-time needs of our distribution partners. We believe having inventory on the shelf is paramount to delivering for our customers as their demand dictates.

- Over 20 years of innovation and continuous improvement of our moissanite gemstone. With Forever One™, we believe that we have achieved a level of perfection that is rarely seen in any gemstone – featuring colorless grades with an innovative cut that we believe reveals optical properties unrivaled by any other jewel. This pinnacle of production is the outcome of continual improvement and artisan craft.

With our above strengths outlined, it is also important to note that our future competitive success is reliant, in part, on the following:

- our ability to continue our relationship with Cree in order to sustain our supply of high-quality SiC crystals;

- our ability to differentiate Charles & Colvard Created Moissanite® from competing products making their way to market;

- our ability to understand the consumer market segment and effectively market to them a compelling value proposition that leads to converted customers;

- our continued success in developing and promoting brands for our moissanite jewels and finished jewelry featuring moissanite, resulting in increased interest and demand for moissanite jewelry at the consumer level;

- the continued willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote Charles & Colvard Created Moissanite® to the retail jewelry trade;

- the continued willingness of distributors, retailers, and others in our distribution channels to purchase loose Charles & Colvard Created Moissanite®, and the continued willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;

- our continued ability and the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our moissanite jewels and finished jewelry;

- our continued ability and the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in finished jewelry with high-quality workmanship;

- our continued ability and the ability of retail jewelers to effectively market and sell finished jewelry featuring moissanite, including finished jewelry to consumers; and

- our ability to operationally execute the strategy for our Online Channels segment.

Competitive Gemstones and Jewelry

Gemstone materials can be grouped into three types:

- natural gemstone, which is found in nature;

- synthetic gemstone, which has the same chemical composition and essentially the same physical and optical 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, physical properties, or optical characteristics.

Our moissanite jewels compete with fine gemstones such as ruby, sapphire, emerald, and tanzanite as well as with natural, synthetic, and treated diamonds as a synthetic gemstone. We may also face competition from synthetic diamonds, synthetic diamond films, and other sources of synthetic moissanite not presently available in qualities, sizes, and volumes suitable for use as gemstones. Some suppliers of diamonds and other fine gemstones, as well as the suppliers of synthetic and simulated gemstones, may have substantially greater financial, technical, manufacturing, and marketing resources and greater access to distribution channels than we do.

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We believe A Diamond Is Forever® (which is a registered trademark of the De Beers Group of Companies) is one of the greatest marketing achievements, ever. Not only did the campaign persuade nearly four full generations that a diamond was the only true way to express love, but apparently it even made it taboo to spend less than three months' salary to achieve what we believe is an artificially inflated value based on a throttled supply chain. Further, we believe it put marketing of any clear gemstone at a disadvantage due to people's natural tendency to compare. However, as Millennials have entered the jewelry market with a new mindset of economic awareness, environmental responsibility and social consciousness, we believe the market opportunity has evolved. We believe moissanite – and specifically, Charles & Colvard – is primed to take advantage of the market in which people are actively looking for an alternative to diamond.

Competing with diamond

The worldwide market for large, uncut, high-quality natural diamonds is significantly consolidated and controlled by De Beers (headquartered in South Africa), Alrosa (Russia), Rio Tinto (Australia), and BHP (Canada). These companies have a major impact on the worldwide supply and pricing of natural diamonds at both the wholesale and retail levels. 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. However, there are signs that the diamond industry is under pressure, with the De Beers Group of Companies recently reporting that the average price of goods sold to trade clients (consolidated sales) was $162 per carat. This is 13% lower than the average price achieved in 2016. We believe these indicators show a change in consumer confidence in the diamond trade.

We may also face competition from treated and synthetic diamonds. Treated diamonds, which are natural diamonds with imperfections or flaws that have been altered in some manner to enhance their appearance, have been available in the jewelry industry for the past several decades and are generally less expensive than diamonds of similar size, cut, and color that have not been altered. Synthetic diamonds are also available in the marketplace and are produced for jewelry applications available to consumers.

We have seen a recent emergence of new manufacturers of lab-grown diamonds that offer a product directly competitive with natural diamond; however, they are priced below that of natural diamond, and therefore compete with Charles & Colvard Created Moissanite®. Although we believe that colorless gemstone-quality synthetic and treated diamonds cannot presently be produced at prices competitive with those currently offered for our moissanite jewels, there can be no assurance that such competitive prices cannot be achieved in the future by the producers of any natural, synthetic or treated diamonds. The primary producers of synthetic diamonds used for industrial applications are Element Six (a member of the De Beers Group of Companies) and Sumitomo Electric Industries. There are also a number of Russian producers of synthetic diamonds for industrial uses. In addition, companies such as Diamonex (a Morgan Technical Ceramics Company) and Scio Diamond Technology Corporation are synthesizing diamonds in limited quantities, limited carat sizes, and in limited ranges of color. Synthetic diamond films can be grown at commercially viable prices in thicknesses that can be applied to various surfaces such as other synthetic materials.

Competing with other moissanite producers

Although we believe that our moissanite jewels have a leadership market position, we are beginning to face competition from other companies that develop competing SiC material. These products are emerging primarily from Eastern countries, and are making their way into the U.S. market. Our ongoing research of the competitive landscape has identified competing moissanite in the "E-F" and below color range according to the Gemological Institute of America's grading scale. However, we have not yet identified competing moissanite that exhibits a level of cut, clarity or polish that is competitive with Charles & Colvard Created Moissanite®. We also have not identified new sources that have exhibited the ability to supply a consistent and high volume of quality moissanite substantial enough to address the considerable consumption needs of distributors and retailers that serve the jewelry trade. Achieving the capacity to consistently produce a high-quality moissanite product at mass scale requires a careful balance of SiC-specific faceting skills and a well-tuned global supply chain. Therefore, we do not anticipate direct moissanite competition in our superior quality gemstone ranges for the foreseeable future.

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Competing with simulants and synthetics

We may also, to a lesser degree, face competition from existing diamond simulants and other synthetic gemstones, including cubic zirconia. Producers and sellers of these products may see the markets for these products being eroded by the market penetration of our moissanite jewels. We believe that the substantially lower price of these products is the primary basis upon which they will compete with our moissanite jewels; however, they are not considered fine jewelry products.

Competing in the finished jewelry space

The global fine jewelry market competition is fierce. Such well-known jewelry designers and manufacturers as David Yurman, Tacori, Harry Winston, Tiffany & Co., and Pandora, among others, have a variety of jewelry collections featuring diamond and other precious and semi-precious gemstones, and enjoy strong brand recognition and a loyal consumer following. These companies also have greater financial resources than we do to develop and market their products.

We intend to expand our market share and compete with these well-known brands primarily on the basis of the combination of quality, design, and value, as moissanite is the highest quality, affordable alternative available to more expensive gemstones such as diamond. We believe that focusing on the clear advantages in moissanite's retail price points, especially in the one-carat and larger sizes, will provide a key point of differentiation and value proposition to the end consumer who may not have had the opportunity to previously purchase fine jewelry due to limitations in discretionary spending income.

In addition, we believe that the Charles & Colvard Created Moissanite® brand, in addition to other brands for both moissanite jewels, including Forever One™, and moissanite finished jewelry that we are developing pursuant to our marketing programs, may create a long-term competitive advantage for our products as we build brand recognition. We endeavor to partner with recognized designers and jewelry companies, in addition to developing our own proprietary brands of finished jewelry. While our finished jewelry business is still developing, our goal is to build multiple strong brands sought after by the end consumer. We propose to focus our marketing efforts on emphasizing our attractive designs, coupled with moissanite's exceptional brilliance, fire, durability, and rarity, to establish moissanite as a primary consumer choice in fine jewelry.

Our design, manufacture and marketing of finished jewelry featuring moissanite under exclusive brands for sale at wholesale pricing to distributors and retailers and at retail to end consumers through our charlesandcolvard.com and other online channel outlets may result in some of our current wholesale customers perceiving us as a competitor, despite our efforts to use primarily non-conflicting sales channels. As we continue to develop our finished jewelry business, we intend to increase distribution through new and existing channels similarly to how many other companies have executed cross-channel marketing and distribution strategies. Due to the size of the finished jewelry market, we believe that such sales channels can co-exist, with the overall end result being increased consumer and brand awareness of moissanite products and a corresponding increased demand for not only our products, but those of our distributor and manufacturer customers as well.

Government Regulation

We are subject to governmental regulations in the manufacture and sale of moissanite jewels and finished jewelry. In particular, the Federal Trade Commission, or 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. In addition, the precious metal in our finished jewelry may be subject to requirements, which vary by country and by state, such as hallmarking and alloy content. While we have a policy to ensure compliance with applicable regulations, if our actions are found to be in violation of FTC or other governmental regulations, we may be required to suspend marketing of our products and could incur significant expenses in developing new marketing strategies and materials that would not violate FTC regulations.

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Research and Development

We invested approximately $3,700 in research and development during 2017 compared to $2,800 in 2016 primarily for the study of product enhancement and manufacturing process efficiencies.

Employees

As of March 5, 2018, we had a total of 76 employees, 69 of whom were full-time and seven of whom were part-time. None of our employees are represented by a labor union. We believe that our employee relations are good.

Directors and Executive Officers of Charles & Colvard, Ltd.

The members of our current Board of Directors are the following:

Neal I. Goldman
Chairman of the Board; President of Goldman Capital Management, Inc., an investment advisory firm.

Anne M. Butler
Chief Executive Officer of Butler Advisors, a consulting firm specializing in strategic and operational advising to private equity, venture capital, and institutional investors on direct selling acquisitions and management.

Benedetta Casamento
Retail Consultant.

Jaqui Lividini
Chief Executive Officer and Founding Partner of Lividini & Co., a brand strategy company that specializes in brand development and marketplace positioning, engagement marketing, and retail strategy.

Suzanne Miglucci
President and Chief Executive Officer of Charles & Colvard, Ltd.

Ollin B. Sykes
President of Sykes & Company, P.A., a regional accounting firm specializing in accounting, tax, and financial advisory services.

Our current executive officers are the following:

Suzanne Miglucci
President and Chief Executive Officer

Clint J. Pete
Chief Financial Officer

Don O'Connell
Chief Operating Officer and Senior Vice President, Supply Chain

Available Information

Our corporate information is accessible through our website at https://www.charlesandcolvard.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual

Report on Form 10-K. We make available, free of charge, access on our website to all reports we file with, or furnish to, the SEC, including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. A copy of this Annual Report on Form 10-K and our other reports are available without charge upon written request to Investor Relations, Charles & Colvard, Ltd., 170 Southport Drive, Morrisville, North Carolina 27560.

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Item 1A. Risk Factors

We operate in a dynamic and rapidly changing business environment that involves substantial risk and uncertainty, and these risks may change over time. The following discussion addresses some of the risks and uncertainties that could cause, or contribute to causing, actual results to differ materially from expectations. In evaluating our business, you should pay particular attention to the descriptions of risks and uncertainties described below. If any of these risks actually occur, our business, financial condition, or results of operations could be materially and adversely affected.

Our future financial performance depends upon increased consumer acceptance, growth of sales of our products, and operational execution of our strategic initiatives. We believe that most consumers are not generally aware of the existence and attributes of moissanite jewels and that the consumer market for moissanite jewels and finished jewelry featuring moissanite remains in the early stages of development. Total moissanite jewelry retail sales have historically been less than 1% of the total jewelry market. The degree of future market acceptance and demand is subject to a significant amount of uncertainty. Our future financial performance will depend, in part, upon greater consumer acceptance of moissanite jewels as an ethically-sourced, affordable, luxurious alternative to other gemstones, such as diamond, and our ability to develop brands and execute strategic initiatives, in particular, our Online Channels segment, to grow our sales and operating income. As we execute our strategy to build and reinvest in our business, significant expenses and investment of cash will be required ahead of the revenue streams we expect in the future, and this may adversely affect our operating income. If we are unable to execute and achieve desired revenue levels, we may adjust our strategic initiatives in response to the results of our investments.

In addition, consumer acceptance may be affected by retail jewelers’ and jewelry manufacturers’ acceptance of moissanite jewels and finished jewelry featuring moissanite. The quality, design, and workmanship of the jewelry settings, and the quality of the gemstones, whether manufactured by us or other manufacturers, could affect both consumers’ perception and acceptance of our jewels and costs incurred by returns and markdowns. Additionally, as other competitors enter the market, the lower quality of competitors’ gemstones could negatively impact consumer perception of moissanite, and in turn, acceptance of our jewels.

Thus, our future financial performance may be affected by:

- our ability to understand the consumer market segment and effectively market to them a compelling value proposition that leads to converted customers;
- our ability to reach consumers through traditional and digital channels in order to gain interest in moissanite jewels and jewelry;
- our continued success in developing and promoting brands for our moissanite jewels and finished jewelry featuring moissanite, resulting in increased interest and demand for moissanite jewelry at the consumer level;
- our ability to differentiate Charles & Colvard Created Moissanite® from competing products making their way to market;
- the continued willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote Charles & Colvard Created Moissanite® to the retail jewelry trade;
- the continued willingness of distributors, retailers, and others in the channel of distribution to purchase loose Charles & Colvard Created Moissanite®, and the continued willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;
- our continued ability and the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our moissanite jewels and finished jewelry;
- our continued ability and the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in finished jewelry with high-quality workmanship;
- our continued ability and the ability of retail jewelers to effectively market and sell finished jewelry featuring moissanite to consumers; and
- our ability to operationally execute our Online Channels segment.

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The execution of our business plans could significantly impact our liquidity. The execution of our business plans to expand our Online Channels segment and to create required inventory of our Forever One™ jewels requires significant investments, which may reduce our cash position. Should we fail to execute on our business plans, we could see delays in the return of cash from our investments, resulting in a liquidity shortfall. Under the $10.00 million asset-based revolving credit facility, or the Credit Facility, that we obtained from Wells Fargo Bank, National Association, or Wells Fargo, on June 25, 2014, failure to meet one or more of the following covenants could restrict our ability to draw or make further draws on the Credit Facility: (i) failure to conduct our business as conducted on the date we obtained the Credit Facility; (ii) failure to make required payments to third parties; and (iii) failure to comply with the other covenants and defaults contained in the Credit Facility, including a covenant to maintain at least $1.00 million in excess availability (as defined under the Credit Facility) and a covenant that required us to maintain a specified minimum monthly EBITDA through December 2017 if the cash position for our demand deposit account maintained at Wells Fargo falls below $3.00 million or we draw upon the Credit Facility. If we are not able to take advances against the Credit Facility, our cash and cash equivalents and other working capital may be insufficient to meet our working capital and capital expenditure needs. In addition, the Credit Facility matures on June 25, 2018, and there is no guarantee for extension or renewal.

Our business and our results of operations could be materially adversely affected as a result of our inability to fulfill orders on a timely basis. As sales of our loose moissanite jewels increase, including our Forever One™ jewel, availability of certain shapes and sizes may be at risk. In addition, finished jewelry has a large variety of styles of which we maintain on-hand stock for such core designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets; and made-to-order under strict deadlines for certain wholesale and direct-to-consumer e-commerce outlets. We must adequately maintain relationships, forecast demand, and operate within the lead times of third parties that facet and/or enhance the jewels and manufacture the finished jewelry setting to ensure adequate on-hand quantities and/or the shipment of customer orders in a timely manner as we transition certain customers from Forever Brilliant® to Forever One™. In addition, we are currently dependent upon certain vendors for all of the faceting of our loose jewels. If any or all of these vendors were to cancel their arrangements with us, we could experience a disruption in our operations and incur additional costs to procure faceting services from a replacement vendor. The inability to fulfill orders on a timely basis and within promised customer deadlines could result in a cancellation of the orders and loss of customer goodwill that could materially and adversely affect our business, results of operations, and financial condition.

The financial difficulties or insolvency of one or more of our major customers or their lack of willingness and ability to market our products could adversely affect results. We are subject to a concentration of credit risk amongst our major customers (some of whom are distributors), and a default by any of these customers on their debts to us could have a material adverse effect on our financial position. Future sales and our ability to collect accounts receivable depend, in part, on the financial strength of our customers and our distributors' willingness and ability to successfully market our products. We estimate an allowance for accounts for which collectability is at risk and this allowance adversely impacts profitability. In the event customers experience greater than anticipated financial difficulties, insolvency, or difficulty marketing products, we expect profitability to be adversely impacted by our failure to collect accounts receivable in excess of the estimated allowance. In these circumstances, we may demand the return of product sold to such customers, resulting in an increase in inventory and a reduction in accounts receivable. While general economic conditions have improved in recent periods, given uncertainty in the current economic environment, constrained access to capital, the impact of inflation on our currency, or general market contractions may heighten our exposure to customer default and generate lower than expected distributor sales.

We are currently substantially dependent on a limited number of distributors, jewelry manufacturers, and retailers for the sale of our products. A significant portion of the moissanite jewels and finished jewelry featuring moissanite that we sell are distributed through a limited number of distributors, manufacturers, and retailers and, therefore, we are substantially dependent upon these companies for distribution of our products. During 2017, our three largest customers, which are loose jewel and finished jewelry distributors, collectively accounted for approximately 38% of net sales. As we continue to build our finished jewelry business, we anticipate in the near term that a significant portion of the moissanite jewels and finished jewelry featuring moissanite that we sell will continue to be to a limited number of manufacturers, distributors, and retailers.

We expect to remain dependent upon the Supply Agreement with Cree for the sole supply of our SiC crystals for the foreseeable future. If we are unable to obtain sufficient, high-quality SiC crystals from Cree and we have a significant increase in demand for our moissanite jewels, then we may not be able to meet that demand. Cree has certain proprietary rights relating to its process for growing large single crystals of SiC and its process for growing colorless and near-colorless SiC crystals. Under the Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the Supply Agreement will expire on June 24, 2018, unless extended by the parties. Accordingly, we are reviewing various alternatives with respect to our purchase of SiC material, including whether to exercise our unilateral option, subject to certain conditions, to renew the Supply Agreement for an additional two-year period. Our total purchase commitment under the Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately $29.60 million and approximately $31.50 million. However, there can be no assurance that Cree will be able to continue to produce and supply us with SiC crystals of sufficient quality, sizes, and volumes that we desire or that we will successfully negotiate future purchase commitments at acceptable prices that enable us to manage our inventories and raw material costs effectively.

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We face intense competition in the worldwide jewelry industry. The jewelry industry is highly competitive and we compete with numerous other jewelry products. In addition, we face competition from treated diamonds, synthetic diamonds, lab-grown diamonds, other moissanite jewels, and companies developing other synthetic jewelry technologies. A substantial number of companies supply products to the jewelry industry, many of whom we believe have greater financial resources than we do. Competitors could develop new or improved technologies that may render the price point for moissanite noncompetitive, which could have an adverse effect on our business, results of operations, and financial condition.

In addition, we have previously relied on our patent rights and other intellectual property rights to maintain our competitive position. Our current U.S. product and method patents for moissanite jewels expired in 2015 and most of our patents in foreign jurisdictions expired in 2016 with only Mexico remaining (which expires in 2021). As a result, we anticipate new providers of moissanite will enter the market. However, because the process of creating high-quality moissanite is challenging, we believe it will take emerging providers significant time and investment to bring meaningful and competitive products to market. As we experienced ourselves, we anticipate it will take these new providers significant time to evolve from producing low-end moissanite to delivering high-quality gemstones in the colorless or near-colorless range. Achieving the capacity to consistently produce a high-quality moissanite product at mass scale requires a careful balance of SiC-specific faceting skills and a well-tuned global supply chain. Therefore, we do not anticipate direct moissanite competition in our superior quality gemstone ranges for the foreseeable future. If, however, we are unable to successfully build strong brands for our moissanite jewels and finished jewelry featuring moissanite or competition grows faster than expected, we may not have commercially meaningful protection for our products or a commercial advantage against our competitors or their competitive products or processes, which may have a material adverse effect on our business, results of operations, and financial condition.

Our failure to maintain compliance with Nasdaq’s continued listing requirements could result in the delisting of our common stock. Our common stock is currently listed on The Nasdaq Capital Market. In order to maintain this listing, we must satisfy minimum financial and other requirements. In the past, we have received a notification letter from Nasdaq indicating that we were not in compliance with listing requirements because the minimum bid price of our common stock closed below $1.00 per share for 30 consecutive business days. However, Nasdaq subsequently notified us that we had regained compliance with the minimum bid price requirement. If we fail to satisfy Nasdaq’s listing requirements in the future, we expect to take actions to regain compliance, but we can provide no assurance that any such action would prevent our common stock from dropping below the Nasdaq minimum bid price requirement or prevent future non-compliance with Nasdaq’s listing requirements. If our common stock is delisted from Nasdaq, the delisting could substantially decrease trading in our common stock and adversely affect the market liquidity of our common stock; adversely affect our ability to obtain financing on acceptable terms, if at all; and may result in the potential loss of confidence by investors, suppliers, customers, and employees and fewer business development opportunities. Additionally, the market price of our common stock may decline further and shareholders may lose some or all of their investment.

Our current customers may potentially perceive us as a competitor in the finished jewelry business. As described above, we are currently dependent on a limited number of customers, including distributors, jewelry manufacturers, and retailers for the sale of our products. Our design, manufacture, and marketing of finished jewelry featuring moissanite under exclusive brands for sale to distributors and retailers may result in some of these current customers perceiving us as a competitor, despite our efforts to use primarily non-conflicting sales channels. In response, these customers may choose to reduce their orders for our products. This reduction in orders could occur faster than our sales growth in this business, which could materially and adversely affect our business, results of operations, and financial condition.

We may experience quality control challenges from time to time that can result in lost revenue and harm to our brands and reputation. Part of our strategy for success is to establish Charles & Colvard with reputable, high-quality, and sophisticated brands. The achievement of this goal depends in large part on our ability to provide customers with high-quality moissanite and finished jewelry featuring moissanite. Although we take measures to ensure that we sell only the best quality products, we may face quality control challenges, which could impact our competitive advantage. There can be no assurance we will be able to detect and resolve all quality control issues prior to shipment of products to our distributors, manufacturers, retailers, and end consumers. Failure to do so could result in lost revenue, lost customers, significant warranty and other expenses, and harm to our reputation.

Our business and our results of operations could be materially adversely affected as a result of general economic and market conditions. Our business, including our sales volumes and overall profitability, could be adversely impacted by disruptions in global financial markets, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increased unemployment rates, and uncertainty about economic stability. We are unable to predict the likely duration and severity of the effects of these disruptions in the financial markets and the adverse global economic conditions, and if economic conditions deteriorate, our business and results of operations could be materially and adversely affected. The consequences of such adverse effects could include interruptions or delays in our suppliers' performance of our contracts, reductions and delays in customer purchases, delays in or the inability of customers to obtain financing to purchase our products, and bankruptcy of customers and/or suppliers.

Luxury products, such as fine jewelry, are discretionary purchases for consumers. Recessionary economic cycles, higher interest rates, higher fuel and energy costs, inflation, levels of unemployment, conditions in the residential real estate and mortgage markets, access to credit, consumer debt levels, unsettled financial markets, and other economic factors that may affect consumer spending or buying habits could materially and adversely affect demand for our products. In addition, volatility in the financial markets has had and may continue to have a negative impact on consumer spending patterns. A reduction in consumer spending or disposable income may affect us more significantly than companies in other industries and could have a material adverse effect on our business, results of operations, and financial condition.

Our operations could be disrupted by natural disasters. We conduct substantially all of our activities, including executive management, manufacturing, packaging, and distribution activities, at one North Carolina location. Although we have taken precautions to safeguard our facility, including obtaining business interruption insurance, any future natural disaster, such as a hurricane, flood or fire, could significantly disrupt our operations and delay or prevent product shipment during the time required to repair, rebuild or replace our facility, which could be lengthy and result in significant expenses. Furthermore, the insurance coverage we maintain may not be adequate to cover our losses in any particular case or continue to be available at commercially reasonable rates and terms. In addition, the vendors that perform all of the faceting of our loose moissanite jewels are located in regions that are susceptible to tsunamis, flooding, and other natural disasters that may cause a disruption in our vendors' operations for sustained periods and the loss or damage of our work-in-process inventories located at such vendors' facilities. Damage or destruction that interrupts our ability to deliver our products could impair our relationships with our customers. Prolonged disruption of our services as a result of a natural disaster may result in product delivery delays, order cancellations, and loss of substantial revenue, which could materially and adversely affect our business, results of operations, and financial condition.

Sales of moissanite jewelry could be dependent upon the pricing of precious metals, which is beyond our control. Any increases in the market price of precious metals (primarily gold) could affect the pricing and sales of jewelry incorporating moissanite jewels, including jewelry manufactured by us. The majority of price increases in precious metals are passed on to the end consumer in the form of higher prices for finished jewelry. These higher prices could have a negative impact on the sell-through of moissanite jewelry at the retail level. From the beginning of 2006 through 2017, the price of gold has increased significantly, resulting in higher retail price points for gold jewelry. This has had a negative impact on both sales of moissanite jewelry and the jewelry industry as a whole.

Seasonality of our business may adversely affect our net sales and operating income. Sales in the retail jewelry industry are typically seasonal due to increased consumer purchases during the holiday season. Because historically we have primarily sold our loose moissanite jewels and finished jewelry featuring moissanite at wholesale pricing to distributors, manufacturers, and retailers, our sales to support the holiday season have largely taken place during the third and beginning of the fourth calendar quarters, depending on the sales channel and the level of advance planning and production our customers undertook. As sales of our finished jewelry featuring moissanite to retailers and directly to consumers increase, both in dollars and as a percentage of total sales, our results for the three months ending December 31 may depend upon the general level of retail sales during the holiday season as well as general economic conditions and other factors beyond our control. In anticipation of increased sales activities during the three months ending December 31, we may incur significant additional expenses, including higher inventory of finished jewelry in the second half of the calendar year.

On January 30, 2018, our Board of Directors approved a change in our fiscal year from a fiscal year beginning on January 1 and ending on December 31 of each year to a fiscal year beginning on July 1 and ending on June 30 of each year. This change to the fiscal year reporting cycle will begin July 1, 2018. In recent years, excluding one-time sales events, we have experienced a higher degree of seasonality in the three months ending December 31 than we have experienced in prior years primarily as a result of the holiday season sales to end consumers through our Online Channels segment and as a result of increased sales through our Traditional segment. Our quarterly results of operations may continue to fluctuate as a result of a number of factors, including seasonal cycles, the timing of new product introductions, the timing of orders by our customers, and the mix of product sales demand, and these factors may significantly affect our results of operations in a given quarter.

Recent U.S. tax legislation may adversely affect our financial condition, results of operations, and cash flows. Recently enacted U.S. tax legislation has significantly changed the U.S. federal income taxation of U.S. corporations, including by reducing the U.S. corporate income tax rate, limiting interest deductions, permitting immediate expensing of certain capital expenditures, and revising the rules governing net operating losses (which may adversely impact the value of our net deferred tax assets) and foreign tax credits. Many of these changes are effective immediately, without any transition periods or grandfathering for existing transactions. The legislation is unclear in many respects and could be subject to potential amendments and technical corrections, as well as interpretations and implementation regulations by the U.S. Department of the Treasury and Internal Revenue Service, any of which could materially affect the impacts of the legislation. In addition, it is unclear how these U.S. federal income tax changes will affect state and local taxation, which often uses federal taxable income as a starting point for computing state and local tax liabilities.

While some of the changes made by the tax legislation may adversely affect us in one or more reporting periods and prospectively, other changes may be beneficial on a going forward basis. We continue to work with our tax advisors to determine the full impact of this legislation on us. See Note 12, “Income Taxes,” in the Notes to Consolidated Financial Statements included elsewhere in this Form 10-K for additional information about our deferred tax assets and our provisional analysis of the income tax effects of this new legislation.

If the e-commerce opportunity changes dramatically or if e-commerce technology or providers change their models, our results of operations may be adversely affected. As we adopt e-commerce as one of our primary selling channels, our business model becomes more reliant on third-party platforms to achieve success. Should our products, product listings, or business not meet the requirements of certain third-party transactional channels such as marketplaces, comparison shopping engines, or social commerce sites, it may affect our ability to meet our revenue targets. Additionally, Amazon, eBay, Jet, Walmart.com, Gemvara, or other desirable e-commerce platforms may decide to make significant changes to their respective business models, policies, systems, or plans, and those changes could impair or inhibit our ability to sell our products through those channels. Further, a significant change in consumer online behavior or introduction of new or disruptive technology could adversely affect overall e-commerce trends and diminish the value of investments we have made in select online channels. Any of these results could cause a significant reduction in our revenue and have a material adverse effect on our results of operations.

We may not be able to adequately protect our intellectual property, which could harm the value of our products and brands and adversely affect our business. We rely primarily on patent, copyright, trademark, and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. We had U.S. product and method patents for moissanite jewels, which expired in August 2015, under which we believed that we had broad, exclusive rights to manufacture, use, and sell moissanite jewels in the U.S. We had these same patents in 25 foreign jurisdictions primarily across Asia and Europe that expired in the third quarter of 2016, and will expire in Mexico in 2021. However, our patent expirations could enable competitors and other businesses to duplicate and market a similar product and enter the marketplace. Without patent protection, we must rely primarily on our branding strategy and the Supply Agreement under which Cree supplies SiC crystals exclusively to us, as well as confidentiality procedures, to protect our proprietary rights, which may or may not be sufficient. In addition, at the present time, we are dependent on Cree's technology for the production of SiC crystals. There can be no assurance that any patents issued to or licensed by or to us will provide any significant commercial protection, that we will have sufficient resources to protect our respective patents and proprietary rights, that any additional patents will be issued in the future, or that any existing or future patents will be upheld by a court should we seek to enforce our rights against an infringer. At this point, we cannot reasonably estimate the impact these patent expirations will have on our future results of operations.

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The existence of valid patents does not prevent other companies from independently developing competing technologies. Existing producers of SiC crystals 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 any patents issued to or licensed by or to us. Accordingly, 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, results of operations, and financial condition.

In addition, we have certain trademarks and pending trademark applications that support our moissanite branding strategy, and we use certain brand names for which we do not currently have proprietary rights. The success of our growth strategy may depend on our continued ability to use our existing brand names in order to increase consumer awareness and further develop strong brands around our moissanite jewels and finished jewelry collections. We cannot assure that any future trademark or other registrations will be issued for pending or future applications or that we will be able to obtain licenses or other contractual rights to use brand names that may infringe the proprietary rights of third parties. We also cannot assure that any registered or unregistered trademarks or other intellectual property or contractual rights will be enforceable or provide adequate protection of our proprietary rights. Our inability to secure proprietary protection with respect to our brands could have a material adverse effect on our business, results of operations, and financial condition.

We also cannot be certain that our products and brand names do not or will not infringe valid patents, trademarks, and other intellectual property rights held by third parties. We may be subject to legal proceedings and claims from time to time relating to the intellectual property of others in the ordinary course of our business. 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.

A failure of our information technology, or IT, infrastructure or a failure to protect confidential information of our customers and our network against security breaches could adversely impact our business and operations. We rely upon the capacity, reliability, and security of our IT infrastructure and our ability to expand and continually update this infrastructure in response to the changing needs of our business related to the deployment, integration, and management of new technology. For example, we implemented new IT systems and payment gateways that support our Online Channels segment. As we implement and integrate new systems, as well as retire and de-integrate existing systems, the IT operating environment following such changes may not perform as expected. We also face the challenge of supporting our older systems and implementing necessary upgrades. If we experience a problem with the functioning of an important IT system or a security breach of our IT systems, the resulting disruptions could have an adverse effect on our business.

In addition, we and certain of our third-party vendors receive and store personal information associated with our sales operations and other aspects of our business. In connection with our e-commerce business, we rely on encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Our disclosure controls and procedures address cybersecurity and include elements intended to ensure that there is an analysis of potential disclosure obligations arising from security breaches. We also maintain compliance programs to address the potential applicability of restrictions against trading while in possession of material, nonpublic information generally and in connection with a cybersecurity breach. The breakdown in existing controls and procedures around our cybersecurity environment may prevent us from detecting, reporting or responding to cyber incidents in a timely manner and could have a material adverse effect on our financial position and value of our Company's stock. Despite our implementation of security measures, our IT systems and e-commerce business are vulnerable to damages from computer viruses, natural disasters, unauthorized access, cyber-attack, and other similar disruptions. An increasing number of websites and Internet companies have reported breaches of their security. Any such compromise of our security could damage our reputation, business, and brand and expose us to a risk of loss or litigation and possible liability, which could substantially harm our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations, damage our computers or those of our customers, or otherwise damage our reputation and business. These issues are likely to become more difficult as we expand the number of countries in which our e-commerce website operates. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.

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For example, in 2016, the European Union, or EU, Parliament approved the new EU data protection legal framework known as the General Data Protection Regulation, or GDPR. The GDPR will replace existing regulations and will become effective in May 2018, thereby extending the scope of EU data protection law to all non-EU companies processing data of EU residents. The GDPR contains numerous requirements and changes from existing EU law, including more robust obligations on data processors, greater rights for data subjects, and heavier documentation requirements for data protection compliance programs. The costs of compliance with, and other burdens and any penalties imposed by, such laws, regulations and policies could have a material adverse impact on our results of operations.

We are subject to certain risks due to our international distribution channels and vendors. We currently have more than 15 international wholesale distributors covering portions of Canada, the UK, Western Europe, Australia and New Zealand, Southeast Asia, the Middle East, and China. In addition, we use certain companies based outside the U.S. to facet our moissanite jewels and to manufacture finished jewelry. 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 U.S. These risks include the following:

- the adverse effects on U.S.-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;
- the continuing adverse economic effects of any global financial crisis;
- 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;
- the burdens of complying with a variety of foreign laws and other factors beyond our control;
- the potential difficulty of enforcing agreements with foreign customers and suppliers; and
- the complications related to collecting receivables through a foreign country’s legal system.

Additionally, while all of our 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 our foreign 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.

Negative or inaccurate information on social media could adversely affect our brand and reputation. We are actively using various forms of digital and social media outreach to accomplish greater awareness of our brand and the value proposition we offer. These social media platforms and other forms of Internet-based communications allow access not only by us, but by any individual, to a broad audience of consumers and other interested persons. Consumers value readily available information concerning goods that they have or plan to purchase; however, they may act on such information without further investigation or authentication. Many social media platforms, including those relating to recruiting and placement activities, immediately publish the content of their participants’ posts, often without filters or checks on accuracy of the content posted. While we actively monitor social media sites, we may be unable to quickly and effectively respond to or correct inaccurate and/or unfavorable information posted on social media platforms. Any such information may harm our reputation or brand, which could in turn materially and adversely affect our business, results of operations, and financial condition.

If we fail to evaluate, implement, and integrate strategic acquisition or disposition opportunities successfully, our business may suffer. From time to time we evaluate strategic opportunities available to us for product, technology, or business acquisitions or dispositions. If we choose to make acquisitions or dispositions, we face certain risks, such as failure of an acquired business to meet our performance expectations, failure to recognize cost savings from a disposition, diversion of management attention, retention of management and existing customers of our current and any acquired business, and difficulty in integrating or separating a business’s operations, personnel, and financial and operating systems. We may not be able to successfully address these risks or any other problems that arise from future acquisitions or dispositions. Any failure to successfully evaluate strategic opportunities and address risks or other problems that arise related to any acquisition or disposition could adversely affect our business, results of operations, and financial condition.

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Governmental regulation and oversight might adversely impact our operations. We are subject to governmental regulations in the manufacture and sale of moissanite jewels and finished jewelry. In particular, 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. In addition, the precious metal in our finished jewelry may be subject to requirements, which vary by country and by state, such as hallmarking and alloy content. 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 jewels and finished jewelry products. While we have a policy to ensure compliance with applicable regulations, if our production or marketing of moissanite jewels and/or finished jewelry is challenged by governmental agencies or competitors, or if regulations are issued that restrict our ability to market our products, our business, results of operations, and financial condition could be materially adversely affected.

Some anti-takeover provisions of our charter documents 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 have an anti-takeover effect and may delay or prevent takeover attempts not first approved by our 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 the interests of all of our shareholders.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

We currently lease approximately 36,350 square feet of office, storage, and light manufacturing space in the Research Triangle Park area of North Carolina from an unaffiliated third-party that is used by both of our current operating and reportable segments.

The majority of all U.S. personnel, including our executive offices, sales offices, administrative personnel, and production facilities are housed in the current space.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which we are a party or to which any of our property is subject.

Item 4. Mine Safety Disclosures

Not applicable.

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PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market for Registrant's Common Equity

Our common stock is traded on the Nasdaq Capital Market under the symbol "CTHR." At the opening of business on November 3, 2017, shares of the Company's common stock were transferred, at the Company's request, from the Nasdaq Global Select Market to the Nasdaq Capital Market. The following table presents, for the periods indicated, the high and low sales prices of our common stock, as reported by the Nasdaq Global Select Market or Nasdaq Capital Market, as applicable. As of March 2, 2018, there were 243 shareholders of record of our common stock.

	High	Low
Year Ended December 31, 2016:		
First Quarter	$1.49	$0.75
Second Quarter	$1.26	$0.93
Third Quarter	$1.33	$0.85
Fourth Quarter	$1.23	$0.83
Year Ended December 31, 2017:		
First Quarter	$1.19	$0.90
Second Quarter	$1.01	$0.84
Third Quarter	$0.99	$0.81
Fourth Quarter	$1.55	$0.80

We did not pay any dividends on our common stock during 2017 or 2016. We will regularly review and consider the best policies and practices for our company, including the dividend policy. The payment of future dividends will be dependent on the facts and circumstances at the time of that review

Item 6. Selected Financial Data

Not applicable.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion is intended to provide a better understanding of our consolidated financial statements, including a brief discussion of our business and products, key factors that impacted our performance, and a summary of our operating results. This information should be read in conjunction with Item 1A, "Risk Factors" and our consolidated financial statements and the notes thereto included in Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K. Historical results and percentage relationships among any amounts in the consolidated financial statements are not necessarily indicative of trends in operating results for future periods.

Overview

At Charles & Colvard, we believe luxury can be both beautiful and conscientious. With innovative technology and sustainable practices, our goal is to lead a revolution in the jewelry industry – delivering a brilliant product at extraordinary value balanced with environmental and social responsibility.

Charles & Colvard, Ltd., a North Carolina corporation founded in 1995, manufactures, markets and distributes Charles & Colvard Created Moissanite® and finished jewelry featuring its proprietary moissanite gemstone for sale in the worldwide jewelry market. Our unique differentiator: moissanite – The World's Most Brilliant Gem® – is core to our ambition to create a movement around beautiful, environmentally and socially responsible fine jewelry. We are the original creator of lab-created moissanite, and we believe that we are leading the way in delivering the most pure form of this gemstone through technological advances in manufacturing, cutting, polishing and setting.

Our strategy is to build a globally revered brand of gemstones and jewelry that appeals to a wide consumer audience and leverage our advantage of being the original and leading worldwide source of created moissanite. We believe a direct relationship with consumers is important to this strategy, which entails delivering tailored educational content, engaging in dialogue with our audience, and positioning our brand to meet the discerning needs of today's consumer. We sell loose moissanite jewels and finished jewelry through two business operating segments: our Online Channels segment, which comprises our charlesandcolvard.com website, e-commerce outlets, including marketplaces such as Amazon and eBay, and drop-ship customers, such as Overstock.com, and other pure-play, exclusively e-commerce customers, such as Gemvara; and our Traditional segment, which consists of wholesale, retail, and television customers. We believe our expanding application of an omni-channel sales strategy across the jewelry trade and to the end consumer with branded finished jewelry featuring moissanite positions Charles & Colvard goods at the many touchpoints where consumers are when they are making their buying decisions – thereby creating greater exposure for our brand and increasing consumer demand.

In February 2016, we made the strategic decision to explore a potential divestiture of our direct-to-consumer home party business previously operated through our Charles & Colvard Direct, LLC (dba Lulu Avenue®) subsidiary. After careful analysis of our 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 our best interest and our shareholders' best interest. On March 4, 2016, we and Charles & Colvard Direct, LLC entered into an asset purchase agreement with Yanbal USA, Inc., or Yanbal, under which Yanbal purchased certain assets related to our 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 13, "Discontinued Operations," in the Notes to the Consolidated Financial Statements. We are now presenting the operating results of Charles and Colvard Direct, LLC as a discontinued operation.

2017 was a year of growth and optimization of our branding initiative. We progressed the business from our 2016 re-launch, and focused on driving consumer awareness while making calculated marketing and sales investments as we engaged new channel partners and forged inroads into new markets. Over the course of the year, we executed against our strategic plan to deliver the following outcomes:

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- Innovated the Forever One™ product line – In 2017, we invested resources into the continued expansion of the Forever One™ offering. We announced the availability of Exotic Gemstones – a selection of grand loose gemstones that range from six carats to 15.5 carats DEW. We also introduced new gemstones in coveted shapes including heart, marquis and trillion, bringing Charles & Colvard's breadth of Forever One™ to 14 cuts. In addition, we released Forever One™ melee accent gemstones that are used to enhance jewelry products such as rings, earrings and pendants. With Forever One™ representing 84% of our total net revenue, we believe we have achieved critical mass in the establishment of this gemstone as the industry's leading moissanite option.

- Expanded our finished jewelry line – We expanded our product line and introduced new jewelry options in fashion, fine, and bridal jewelry. This breadth is important as we expand our footprint beyond bridal and work toward building a relationship with our consumers that transcends a lifetime of commemorative moments.

- Invest in key retail and wholesale partnerships – We leveraged significant groundwork laid with existing partners whose brands and customers align with ours to amplify our reach into these established markets. A key accomplishment for 2017 was our expanded footprint with Helzberg Diamonds stores. Growing from our initial test of 50 stores in 2016, we celebrated a full year of brick-and-mortar success with Helzberg with an expansion into nearly all doors – a testament to the significant performance of our product in their stores. This is an important relationship for Charles & Colvard as we position ourselves in varied consumer-facing outlets to serve the consumer who wants to touch and see moissanite to validate their purchase.

- Explore new traditional and non-traditional sales channels – We secured new inroads in previously unexplored channels as green field opportunities that we believe will open new and innovative inroads to the consumer.

- Convey e-commerce learning to new channels – We leveraged our experience and significant underpinnings in e-commerce to expand our footprint into new channels and regions. We exemplified this goal with the launch of Charles & Colvard jewelry on Alibaba's Tmall® marketplace in China. We will continue to explore optimal audiences and outlets for our products as we evolve this strategy in 2018.

- Evolve our customer service function – We continually improved our customer service function throughout 2017, including a new 60-day return policy, and free shipping and returns. Coupled with substantial improvements in our charlesandcolvard.com shopping and mobile experiences, we made significant strides in our customer's experience.

- Amplify our global marketing efforts – We continue to carefully measure the return on our marketing investments, and focus our efforts on profitable endeavors that drive interest in the Charles & Colvard brand, pull consumers to our many sales and educational outlets, and drive conversions. Digital marketing is a complicated endeavor, and we believe it is imperative to leverage analytics and technology to support smart marketing investments. We will take our learnings and successes from 2017, and apply them to our 2018 organic and international growth plans.

- Advance toward profitability – In 2017, we made calculated investments in our growth while continually striving to reach profitability, which culminated in profitable financial results for the fourth quarter of 2017. These efforts solidified the management team's understanding of what it takes to make Charles & Colvard a profitable business, as well as set a baseline for the investments required to achieve sustainable top-line growth.

As we continue to execute our strategy to build and reinvest in our businesses, significant expenses and investment of cash will be required ahead of the revenue streams we expect in the future. While this has resulted in some unprofitable reporting periods during 2016 and 2017, we will continue to analyze each investment decision with the intent to grow our business while maintaining our goal of achieving positive financial results and cash flows. We believe that we will continue to generate or have access to sufficient working capital to fund operations as we execute our plans to expand and grow the business.

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Our total consolidated net sales for the year ended December 31, 2017 of $27.03 million were 7% lower than total consolidated net sales during the year ended December 31, 2016. The decrease in consolidated net sales for the year ended December 31, 2017, was due principally to the sale, in a single transaction, during the first quarter of 2016 of approximately $6.77 million of legacy gemstone inventory, or the Legacy Inventory Sale, as a result of our efforts to reduce inventories. This decrease in consolidated net sales for the year ended December 31, 2017, was offset partially by increased demand for our Forever One™ gemstones over the prior year and higher finished jewelry net sales during 2017. Traditional segment net sales for the year ended December 31, 2017 of $15.95 million were 21% lower than Traditional segment net sales during the year ended December 31, 2016, primarily due to the Legacy Inventory Sale in the prior year. This decrease compared with the prior year was offset somewhat by strong finished jewelry sales during 2017. Online Channels segment net sales for the year ended December 31, 2017 of $11.09 million were 25% greater than Online Channels segment net sales during the year ended December 31, 2016, primarily due to higher finished jewelry sales and increased demand for our Forever One™ gemstones during 2017 evidenced through our increased presence on e-commerce outlets, including charlesandcolvard.com.

Loose jewel sales comprised 61% of our total consolidated net sales for the year ended December 31, 2017 and decreased 23% to $16.58 million, compared with $21.45 million in the previous year. Finished jewelry sales comprised 39% of our total consolidated net sales and increased 35% to $10.45 million, compared with $7.72 million in the previous year.

Operating expenses from continuing operations decreased by $533,000, or 4%, to $12.17 million in 2017 from $12.70 million in 2016. Of this decrease, general and administrative expenses decreased $855,000, or 15%, to $4.69 million primarily as a result of decreased compensation-related expenses and professional services expenses, offset partially by increased bank fees associated with our Credit Facility and credit card transaction processing and bad debt expense. Loss on abandonment of property and equipment decreased $118,000, or 100%, for the year ended December 31, 2017, compared to the previous year. In 2016, we abandoned costs of construction in progress related to website branding and design for our direct-to-consumer e-commerce business, charlesandcolvard.com, due to a change in our corporate strategy to consolidate our web properties. We had no such abandonment of property and equipment in 2017. These decreases were offset partially by an increase in sales and marketing expenses of $439,000, or 6%, to $7.48 million, primarily as a result of increased compensation-related expenses, an increase in professional services expenses, and an increase in software-related expenses offset partially by a decrease in advertising expenses.

We recorded a net loss of $453,000, or $0.02 per diluted share, for the year ended December 31, 2017, compared to a net loss of $4.53 million in the previous year. The decreased net loss was due primarily to an increase in Forever One™ gemstone sales with a more favorable profit margin as we implement our new sales and marketing strategies and a gain on an insurance claim settlement related to excess recovery over costs previously written off associated with insured losses incurred in connection with a shipment of work-in-process materials. These improvements were partially offset by the increased sales and marketing expenses. We recorded a net loss from continuing operations of $453,000 for the year ended December 31, 2017, compared to a net loss from continuing operations of $3.95 million in the previous year.

The execution of our strategy to grow our company, with the ultimate goal of increasing consumer awareness and clearly communicating the value proposition of moissanite, is challenging and not without risk. As such, there can be no assurance that future results for each reporting period will exceed past results in sales, operating cash flow, and/or net income due to the challenging business environment in which we operate and our investment in various initiatives to support our growth strategies. In addition, sales in the retail jewelry industry are typically seasonal due to increased consumer purchasing patterns during the year-end holiday season. We can also see the effect of seasonality due to the timing of orders we receive to support new or expanded distribution and the level of current inventory positions held by our customers. Accordingly, we expect to continue seeing these types of seasonal trends impact future reporting period financial results. However, as we execute our growth strategy and messaging initiatives, we remain committed to our current priorities of generating positive cash flow and strengthening our financial position while both monetizing our existing inventory and manufacturing our created moissanite loose jewels and finished jewelry featuring moissanite to meet sales demand. We believe the results of these efforts will propel our revenue growth and profitability and further enhance shareholder value in coming years, but we fully recognize the business and economic challenges that we face.

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Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which we prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosures of contingent assets and liabilities. "Critical accounting policies and estimates" are defined as those most important to the financial statement presentation and that require the most difficult, subjective, or complex judgments. We base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Under different assumptions and/or conditions, actual results of operations may materially differ. The most significant estimates impacting our consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions, and revenue recognition. We also have other policies that we consider key accounting policies, but these policies typically do not require us to make estimates or judgments that are difficult or subjective.

Valuation and Classification of Inventories - Inventories are stated at the lower of cost or net realizable value 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 our current requirements based on historical and anticipated levels of sales is classified as long-term on our consolidated balance sheets. Our classification of our inventory as either short- or long-term inventory requires us 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 in cost of goods sold over the next 12 months.

Our work-in-process inventories include raw SiC crystals on which processing costs, such as labor and sawing, have been incurred and components, such as metal castings and finished good moissanite jewels, that have been issued to jobs in the manufacture of finished jewelry. Our moissanite jewel manufacturing process involves the production of intermediary shapes, called "preforms," that vary depending upon the size and shape of the finished jewel. To maximize manufacturing efficiencies, preforms may be made in advance of current finished inventory needs but remain in work-in-process inventories. As of December 31, 2017 and December 31, 2016, work-in-process inventories issued to active production jobs approximated $2.99 million and $7.18 million, respectively.

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

Accounts Receivable Reserves - Estimates are used to determine the amount of two reserves against trade accounts receivable. The first reserve is an allowance for sales returns. At the time revenue is recognized, we estimate future returns using a historical return rate that is reviewed quarterly with consideration of any contractual return privileges granted to customers, and we reduce sales and trade accounts receivable by this estimated amount. The allowance for sales returns was $537,000 and $415,000 at December 31, 2017 and 2016, respectively.

The second reserve is an allowance for doubtful accounts for estimated losses resulting from the failure of our customers to make required payments. This allowance reduces trade accounts receivable to an amount expected to be collected. Based on historical percentages of uncollectible accounts by aging category, changes in payment history, and facts and circumstances regarding specific accounts that become known to management when evaluating the adequacy of the allowance for doubtful accounts, we determine a percentage based on the age of the receivable that we deem uncollectible. The allowance is then calculated by applying the appropriate percentage to each of our accounts receivable aging categories, with consideration given to individual customer account activity subsequent to the current period, including cash receipts, in determining the appropriate allowance for doubtful accounts in the current period. Any increases or decreases to this allowance are charged or credited, respectively, as a bad debt expense to general and administrative expenses. We generally use an internal collection effort, which may include our sales personnel as we deem appropriate. After all internal collection efforts have been exhausted, we generally write off the account receivable.

Any accounts with significant balances are reviewed separately to determine an appropriate allowance based on the facts and circumstances of the specific account. During the quarter ended September 30, 2016, we wrote off $815,000 in accounts receivable related to one international customer that was past due on its payment arrangement, as we determined that the benefits of continued collections efforts did not outweigh the costs of legal proceedings.

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Our allowance for doubtful accounts previously included an allowance for this accounts receivable, and therefore, this write-off did not have an impact on net loss for the year ended December 31, 2016. During our review for 2017, we determined no additional reserves were necessary for specific accounts. Based on these criteria, management determined that allowances for doubtful accounts receivable of $254,000 and $226,000 at December 31, 2017 and 2016, respectively, were required.

Deferred Tax Assets - As of each reporting date, management considers new evidence, both positive and negative, that could impact its view with regard to future realization of deferred tax assets. Beginning in 2014, management determined that negative evidence outweighed the positive and established a full valuation allowance against our deferred tax assets. We maintained a full valuation allowance as of December 31, 2017 and 2016.

Our deferred tax assets in Hong Kong were fully reserved with a valuation allowance of $996,000 as of December 31, 2017 and 2016 and had been fully reserved in all prior periods due to the uncertainty of future taxable income in this jurisdiction to utilize the deferred tax assets. Charles & Colvard (HK) Ltd., our Hong Kong subsidiary, which was re-activated in December 2017, but had no operating activity during the year ended December 31, 2017, previously ceased operations during 2008 and became a dormant entity during 2009. If we use any portion of our deferred tax assets in future periods, the valuation allowance would need to be reversed and may impact our future operating results.

On December 22, 2017, the President signed the Tax Cuts and Jobs Act, or the “Tax Act,” which among other things, lowered the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. Consequently, we wrote down our net deferred tax assets as of December 31, 2017 by approximately $519,000 to reflect the estimated impact of the Tax Act. We also recorded a corresponding net adjustment to our valuation allowance related to the re-measurement of certain net deferred tax assets using the lower U.S. corporate income tax.

We have substantially completed our provisional analysis of the income tax effects of the Tax Act and recorded a reasonable estimate of such effects. However, the SEC staff issued guidance regarding application of Financial Accounting Standards Board income tax guidance in the reporting period that includes December 22, 2017 – the date on which the Tax Act was signed into law – to address situations when a company does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Act. We have estimated the tax impacts related to the impact to deferred tax assets and liabilities and included these amounts in our consolidated financial statements for the year ended December 31, 2017, on a provisional basis. In this regard, the Tax Act repeals the corporate alternative minimum tax, or AMT, regime, including claiming a refund and full realization of remaining AMT credits. We have not been able to make a reasonable estimate with respect to the realization of existing AMT credit carryforwards, and accordingly, continue to apply the income tax-related accounting guidance that was in effect immediately prior to the enactment of the Tax Act. In order for us to complete the income tax effects of the Tax Act on the existing AMT deferred tax asset, we need to further analyze the nature, validity, and recoverability of the AMT-related deferred tax credit carryforwards prior to recording the underlying appropriate tax benefit. Accordingly, the ultimate impact related to the Tax Act may differ, possibly materially, due to, among other things, completing our analysis of the realization of available AMT credit refunds, further refinement of our calculations, changes in interpretations and assumptions that we made, additional guidance that may be issued by the U.S. Government, and actions and related accounting policy decisions that we may take as a result of the Tax Act. We expect this analysis to be complete when our 2017 U.S. corporate income tax return is filed in 2018.

Uncertain Tax Positions - Effective January 1, 2007, we adopted U.S. GAAP guidance regarding the de-recognition, classification, accounting in interim periods, and disclosure requirements for uncertain tax positions. Determining which tax positions qualify as uncertain positions and the subsequent accounting for these positions requires significant estimates and assumptions. Our net accrued income tax liability under the provisions of this guidance was $462,000 and $434,000 at December 31, 2017 and 2016, respectively. This liability is only resolved when we obtain an official ruling from the tax authority on the positions or when the statute of limitations expires. As of December 31, 2017, our liability has increased by $28,000 for accrued interest on these positions.

Revenue Recognition - Revenue is recognized when title transfers at the time of shipment from our facility or a third-party fulfillment company’s facility, excluding consignment shipments as discussed below; evidence of an arrangement exists; pricing is fixed or determinable; and collectability is reasonably assured. At the time revenue is recognized, an allowance for estimated returns is established. Any change in the allowance for returns is charged against net sales. Our return policy for certain customers in our Online Channels segment provides for the return of purchases for any reason generally within 60 days of shipment in accordance with our warranty policy as disclosed on the charlesandcolvard.com website. Our return policy for customers in our Online Channels segment (excluding those of charlesandcolvard.com) and those in our Traditional segment allows for the return of jewels and finished jewelry for credit generally within 30 days of shipment if returned for a valid reason. We have established an allowance for returns based on our historical return rate, which takes into account any contractual return privileges granted to our customers. Periodically, we ship loose jewel goods, finished jewelry goods, and finished goods inventory to Traditional segment 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 that typically ranges from six months to one year. Our Traditional segment customers are generally required to make payments on consignment shipments within 60 days upon the customer informing us that it will keep the inventory. Accordingly, we do not recognize revenue on these consignment transactions until the earlier of (i) the customer informing us that it will keep the inventory, (ii) the expiration of the right of return period, or (iii) the customer informing us that the inventory has been sold.

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Recent Accounting Pronouncements - See Note 2 to our consolidated financial statements in Item 8, "Financial Statements and Supplementary Data", of this Annual Report on Form 10-K for a description of recent accounting pronouncements, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

2017 Summary

The following is a summary of key financial results and certain non-financial results achieved for the year ended December 31, 2017:

- Our total consolidated net sales decreased by $2.14 million, or 7%, to $27.03 million in 2017 from $29.17 million in 2016. The decrease in consolidated net sales was due primarily to the Legacy Inventory Sale in the first quarter of the prior year as a result of our efforts to reduce these legacy inventories in 2016. This decrease was partially offset by an increased demand for our Forever One™ gemstones during 2017 over the prior year and higher finished jewelry net sales during 2017.

- Operating expenses from continuing operations decreased by $533,000, or 4%, to $12.17 million in 2017 from $12.70 million in 2016. Of this decrease, general and administrative expenses decreased $855,000, or 15%, to $4.69 million primarily as a result of decreased compensation expenses and professional services expenses, partially offset by an increase in bank fees principally associated with the Credit Facility. Sales and marketing expenses increased $439,000, or 6%, to $7.48 million, primarily due to increased compensation expenses and professional services costs associated with implementing our new sales and marketing strategies, offset partially by a decrease in advertising expenses. We had no loss on abandonment of property and equipment for the year ended December 31, 2017 compared to approximately $118,000 for the year ended December 31, 2016, a decrease of $118,000, or 100% from the prior year. During the year ended December 31, 2016, we abandoned costs of construction in progress related to website branding and design for our direct-to-consumer e-commerce business, charlesandcolvard.com, due to a change in our corporate strategy to consolidate our web properties.

- Net loss from continuing operations decreased $3.50 million to a loss of $454,000 in 2017 from a net loss from continuing operations of $3.95 million in 2016. The reduction in net loss was due primarily to an increase in sales of our Forever One™ gemstones, which have a more favorable gross profit margin, and lower general and administrative expenses. These improvements were offset in part by an increase in sales and marketing expenses.

- Net loss decreased $4.07 million to a loss of $454,000 in 2017 from a net loss of $4.53 million in 2016. Net loss per share was $0.02 in 2017 compared to a net loss per share of $0.22 in 2016. The reduction in net loss was primarily due to an increase in sales of products with a more favorable profit margin and lower overall operating expenses. Our net loss in 2017 also reflected the $183,000 favorable impact of an insurance claim settlement and we incurred no losses from previously reported discontinued operations related to the discontinuance of our direct-to-consumer home party business in the prior year. In 2016, we also reported a $118,000 loss on the abandonment of property and equipment in connection with costs of construction in progress related to website branding and design for our direct-to-consumer e-commerce business.

- We generated negative cash flows from continuing operations of $2.56 million in 2017 compared to positive cash flows of $3.33 million from continuing operations in 2016. The primary drivers of our negative cash flow in 2017 were a net loss of $454,000; an increase in accounts receivable of $733,000; an increase in inventory of $3.50 million; and an increase in prepaid expenses and other assets of $36,000. These factors were offset partially by an increase in accounts payable of $489,000 and an increase in accrued liabilities of $246,000. Non-cash items partially offsetting the impact of net loss totaled $1.43 million.

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- Cash and cash equivalents at December 31, 2017 were $4.59 million compared to $7.43 million at December 31, 2016. The primary reason for this decrease is the $2.56 million of cash used in operations.

- Total inventory, including long-term and consignment inventory, was $30.97 million as of December 31, 2017, up from $28.13 million at December 31, 2016. This inventory increase was, in part, due to higher purchases of raw materials and higher levels of finished goods that were produced to meet increased product demand. Lower total inventory levels in the prior year reflected the Legacy Inventory Sale.

- We continue to carry no long-term debt and believe we can fund our growth strategies for the foreseeable future from operating cash flows.

Results of Operations

The following table sets forth certain consolidated statements of operations data for the years ended December 31, 2017 and 2016.

	Year Ended December 31,	
	2017	2016
Net sales	$27,032,964	$29,168,128
Costs and expenses:		
Cost of goods sold	15,470,617	20,401,439
Sales and marketing	7,477,354	7,038,277
General and administrative	4,689,823	5,544,452
Research and development	3,714	2,848
Loss on abandonment of property and equipment	-	117,930
Total costs and expenses	27,641,508	33,104,946
Loss from operations	(608,544)	(3,936,818)
Other income (expense):		
Interest expense	(541)	(1,737)
Gain on insurance claim settlement	183,217	-
Total other income (expense), net	182,676	(1,737)
Loss before income taxes from continuing operations	(425,868)	(3,938,555)
Income tax net expense from continuing operations	(27,609)	(13,480)
Net loss from continuing operations	(453,477)	(3,952,035)
Discontinued operations:		
Loss from discontinued operations	-	(586,124)
Gain on sale of assets from discontinued operations	-	12,398
Net loss from discontinued operations	-	(573,726)
Net loss	$(453,477)	$(4,525,761)

Consolidated Net Sales

Consolidated net sales for the years ended December 31, 2017 and 2016 comprise the following:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
Loose jewels	$16,580,748	$21,451,728	$(4,870,980)	-23 %
Finished jewelry	10,452,216	7,716,400	2,735,816	35 %

Total consolidated net sales	$27,032,964	$29,168,128	$(2,135,164)	-7%

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Consolidated net sales were $27.03 million for the year ended December 31, 2017 compared to $29.17 million for the year ended December 31, 2016, a decrease of $2.14 million, or 7%. The decrease in consolidated net sales for the year ended December 31, 2017 was due primarily to the Legacy Inventory Sale during the first quarter of the prior year. However, this decrease in 2017 was partially offset by increased demand for our Forever One™ gemstones during 2017 over the prior year. In addition, we experienced higher finished jewelry net sales during 2017 in both our Online Channels segment and Traditional segment.

Sales of loose jewels represented 61% and 74% of total consolidated net sales for the years ended December 31, 2017 and 2016, respectively. For the year ended December 31, 2017, loose jewel sales were $16.58 million compared to $21.45 million for the year ended December 31, 2016, a decrease of $4.87 million, or 23%. While this decrease was primarily due to the Legacy Inventory Sale during 2016, our Forever One™ gemstone sales during 2017 increased approximately 67% as compared to 2016 as demand for this product increased.

Sales of finished jewelry represented 39% and 26% of total consolidated net sales for the years ended December 31, 2017 and 2016, respectively. For the year ended December 31, 2017, finished jewelry sales were $10.45 million compared to $7.72 million for the year ended December 31, 2016, an increase of $2.74 million, or 35%. This increase was due primarily to strong finished jewelry sales in both our Online Channels segment and Traditional segment. These increases in finished jewelry sales resulted from leveraging our strategy to drive sales in 2017 through multiple channels. This is reflected in our expanded presence in Helzberg Diamonds stores in our Traditional segment and promotion of our updated brand platform and increased presence within our e-commerce outlets, including charlesandcolvard.com in our Online Channels segment.

U.S. net sales accounted for approximately 93% and 90% of total consolidated net sales during the years ended December 31, 2017 and 2016, respectively. As a percentage of net sales, U.S. net sales increased during 2017 as a result of increased demand in the U.S. distributor market and increased sales from U.S. customers in both our Traditional segment and Online Channels segment. While the share of our U.S. net sales increased in 2017, U.S. net sales decreased to $25.18 million, or 4%, during the year ended December 31, 2017 compared to $26.16 million in the prior year primarily as a result of the Legacy Inventory Sale in the first quarter of 2016.

Our largest U.S. customer during the year ended December 31, 2017 accounted for 21% of our total consolidated sales compared to 17% during the year ended December 31, 2016. A second U.S. customer accounted for 23% of our total consolidated net sales during the year ended December 31, 2016, but did not have net sales that represented 10% or more of total net sales for the year ended December 31, 2017. No additional U.S. customers accounted for more than 10% of total consolidated sales in 2017 or 2016. We expect that we will remain dependent on our ability, and that of our largest customers, to maintain and enhance retail programs. A change in or loss of any of these customer or retailer relationships could have a material adverse effect on our results of operations.

International net sales accounted for approximately 7% and 10% of total consolidated net sales during the years ended December 31, 2017 and 2016, respectively. International net sales decreased 38% during 2017 as we serve distributors in the Hong Kong and India markets and demand for loose jewels in these markets was down compared to 2016. We continue to evaluate these and other potential distributors in these international markets to determine the best long-term partner. Additionally, we anticipate the need to develop a direct-to-consumer presence, which would require marketing and e-commerce investment to drive expected growth in these regions. As a result, our sales in these markets may continue to fluctuate significantly each reporting period.

No international customers accounted for more than 10% of total consolidated sales in 2017 or 2016. A portion of our international consolidated sales represents jewels sold internationally that may be re-imported to U.S. retailers. Our top three international distributors by sales volume during the year ended December 31, 2017 were, in order of sales volume, located in Hong Kong, Canada, and Hong Kong.

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Costs and Expenses

Cost of Goods Sold

Cost of goods sold for the years ended December 31, 2017 and 2016 are as follows:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
Product line cost of goods sold				
Loose jewels	$8,524,843	$13,916,749	$(5,391,906)	-39 %
Finished jewelry	5,226,660	4,148,788	1,077,872	26 %
Total product line cost of goods sold	13,751,503	18,065,537	(4,314,034)	-24 %
Non-product line cost of goods sold	1,719,114	2,335,902	(616,788)	-26 %
Total cost of goods sold	$15,470,617	$20,401,439	$(4,930,822)	-24 %

Total cost of goods sold was $15.47 million for the year ended December 31, 2017 compared to $20.40 million for the year ended December 31, 2016, a decrease of $4.93 million, or 24%. Product line cost of goods sold is defined as product cost of goods sold in each of our Traditional segment and Online Channels segment excluding non-capitalized expenses from our 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-downs.

The decrease in cost of goods sold for 2017 as compared to the prior year was due primarily to the Legacy Inventory Sale during the first quarter of 2016. The net decrease in non-product line cost of goods sold comprises a $980,000 decrease in other inventory adjustments principally relating to production standard cost variances and a $76,000 decrease in non-capitalized manufacturing and production control expenses primarily due to timing of receiving work-in-process into inventory and allocating overhead. These decreases were offset in part by a $398,000 increase in inventory valuation allowances, including inventory obsolescence, shrinkage, recuts, and repairs reserves, and a $40,000 increase in freight out as a result of an increase in sales transaction volume. For further discussion of non-product line cost of goods sold, see Note 3, “Segment Information and Geographic Data”, in the Notes to Consolidated Financial Statements.

Sales and Marketing

Sales and marketing expenses for the years ended December 31, 2017 and 2016 are as follows:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
Sales and marketing	$7,477,354	$7,038,277	$439,077	6 %

Sales and marketing expenses were $7.48 million for the year ended December 31, 2017 compared to $7.04 million for the year ended December 31, 2016, an increase of approximately $439,000, or 6%.

The increase in sales and marketing expenses for the year ended December 31, 2017 compared to the year ended December 31, 2016 was primarily due to a $531,000 increase in compensation-related expense; a $201,000 increase in professional services fees; a $145,000 increase in software-related costs principally in connection with maintenance agreements associated with our migration to a cloud-based data storage arrangement as well as other software-related agreements; a $90,000 increase in general office-related expenses; a $24,000 increase in recruiting fees; a $12,000 increase in depreciation and amortization expense; and a $13,000 increase in miscellaneous other sales and marketing expenses. These increases were partially offset by a $596,000 decrease in advertising expenses; a $31,000 decrease in travel expense; and a $13,000 decrease in market research expenses.

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Compensation expenses for the year ended December 31, 2017 compared to the December 31, 2016 increased primarily as a result of a $362,000 increase in salaries, commissions, and related employee benefits in the aggregate; a $191,000 increase in severance expense primarily related to the departure of our Chief Revenue Officer during the first quarter of 2017; a $136,000 increase in bonus expense; and a $13,000 increase in relocation expense. These increases were partially offset by a $171,000 decrease in employee stock-based compensation expense.

The decrease in advertising expenses for the year ended December 31, 2017 compared to the year ended December 31, 2016 comprises an $849,000 decrease in outside agency fees and a $33,000 decrease in print media expenses. These decreases were partially offset by a $159,000 increase in promotional expenses; an $84,000 increase in cooperative advertising; a $33,000 increase in Internet marketing; and a $10,000 increase in all other advertising expenses.

Sales and marketing expenses are allocated across our Traditional segment and Online Channels segment, which in 2016 included allocations to Charles & Colvard Direct, LLC, a segment we are reporting as discontinued operations. See Note 13, "Discontinued Operations", in the Notes to the Consolidated Financial Statements for further discussion of discontinued operations. Approximately $61,000 of sales and marketing expenses for the year ended December 31, 2016, all of which were incurred during the first six months of 2016, are attributable to sales and marketing expenses that are now being allocated to our remaining two continuing operating segments that were previously allocated to Charles & Colvard Direct, LLC. We had no such sales and marketing expenses during the second half of 2016.

While our intent is to continue to invest in sales and marketing efforts to increase sales, we believe such expenses may also increase as part of our ongoing strategy to promote overall consumer awareness of moissanite and of our brands. However, this will be dependent on overall companywide marketing strategies and in which sales channels we may choose to make such further investments.

General and Administrative

General and administrative expenses for the years ended December 31, 2017 and 2016 are as follows:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
General and administrative	$4,689,823	$5,544,452	$(854,629)	-15 %

General and administrative expenses were $4.69 million for the year ended December 31, 2017 compared to $5.54 million for the year ended December 31, 2016, a decrease of approximately $855,000, or 15%.

The decrease in general and administrative expenses for the year ended December 31, 2017 compared to the year ended December 31, 2016 was primarily due to a $751,000 decrease in compensation expenses; $300,000 decrease in professional services; a $77,000 decrease in depreciation and amortization expense; a $74,000 decrease in insurance expenses; a $16,000 decrease in travel expenses; a $14,000 decrease in computer and software related expenses; and a $16,000 decrease in miscellaneous other general and administrative expenses. These decreases were partially offset by a $99,000 increase in bank fees, which includes fees associated with the Credit Facility and credit card clearing transactions; an $88,000 increase in bad debt expense associated with our allowance for doubtful accounts reserve policy; an $18,000 increase in equipment-related rental expense; an $8,000 increase in board retainer fees; and a $5,000 increase in business taxes and licenses.

Compensation expenses decreased for the year ended December 31, 2017 compared to the year ended December 31, 2016 primarily due to a $469,000 decrease in salaries and related employee benefits in the aggregate and a $380,000 decrease in employee stock-based compensation expense, principally due to changes in stock-based compensation performance measurements and the modification of restricted stock awards from wholly restricted stock awards to awards consisting of 70% restricted stock and 30% cash in lieu of restricted stock. These decreases were offset by a $56,000 increase in bonus expense and an increase of $42,000 in severance expenses related to personnel changes.

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Professional services decreased for the year ended December 31, 2017 compared to the year ended December 31, 2016 primarily due to a decrease of $230,000 in accounting services; a decrease of $105,000 in consulting and other professional services primarily related to human resources and sales and use tax projects in 2016; and a $1,000 decrease in investor and public relations expenses. These decreases were partially offset by an increase in legal fees of $36,000.

General and administrative expenses are allocated across our Traditional segment and Online Channels segment, which in 2016 included allocations to Charles & Colvard Direct, LLC, a segment we are reporting as discontinued operations. See Note 13, “Discontinued Operations”, in the Notes to the Consolidated Financial Statements for further discussion of discontinued operations. Approximately $175,000 of general and administrative expenses for the year ended December 31, 2016, all of which were incurred during the first six months of 2016, are attributable to general and administrative expenses that are now being allocated to our remaining two continuing operating segments that were previously allocated to Charles & Colvard Direct, LLC. We had no such general and administrative expenses during the second half of 2016.

Loss on Abandonment of Property and Equipment

Loss on abandonment of property and equipment for the years ended December 31, 2017 and 2016 is as follows:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
Loss on abandonment of property and equipment	$ -	$ 117,930	$(117,930)	-100 %

We had no loss on abandonment of property and equipment for the year ended December 31, 2017 compared to approximately $118,000 for the year ended December 31, 2016, a decrease of $118,000, or 100%. During the year ended December 31, 2016, we abandoned costs of construction in progress related to website branding and design for our e-commerce business, charlesandcolvard.com, due to a change in our corporate strategy to consolidate our web properties.

Gain on Insurance Claim Settlement

Gain on insurance claim settlement for the years ended December 31, 2017 and 2016 is as follows:

	Year Ended December 31,		Change	
	2017	2016	Dollars	Percent
Gain on insurance claim settlement	$ 183,217	$ -	$183,217	100 %

The gain on insurance claim settlement was approximately $183,000 for the year ended December 31, 2017, compared to $0 for the year ended December 31, 2016, an increase of $183,000, or 100%. In the fourth quarter of 2017, we settled an outstanding insurance claim related to recovery of costs previously expensed and written off during 2017 associated with insured losses incurred in connection with a shipment of work-in-process materials. The gain represents the excess recovery over amounts previously expensed and written off.

Provision for Income Taxes

We recognized an income tax net expense of approximately $28,000 and 13,000 for the years ended December 31, 2017 and 2016, respectively. Income tax provisions in these years primarily relate to estimated tax, penalties, and interest associated with uncertain tax positions.

As of each reporting date, management considers new evidence, both positive and negative, that could impact its view with regard to future realization of deferred tax assets. Beginning in 2014, management determined that negative evidence outweighed the positive and established a full valuation allowance against our deferred tax assets. We maintained a full valuation allowance as of December 31, 2017 and 2016.

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Our statutory tax rate is 23.25% and consists of the federal income tax rate of 21% and a blended state income tax rate of 2.25%, net of the federal benefit.

On December 22, 2017, the President signed the Tax Act that among other things lowered the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. For further discussion of the effects of the Tax Act on our deferred tax assets, see Note 12, “Income Taxes”, in the Notes to the Consolidated Financial Statements.

Liquidity and Capital Resources

We require cash to fund our operating expenses and working capital requirements, including outlays for capital expenditures. As of December 31, 2017, our principal sources of liquidity were cash and cash equivalents totaling $4.59 million, trade accounts receivable of $3.38 million, and net current inventory of $11.21 million, as compared to cash and cash equivalents totaling $7.43 million, trade accounts receivable of $2.80 million, and net current inventory of $9.77 million as of December 31, 2016. As described more fully below, we also have access to our $10.00 million Credit Facility.

During the year ended December 31, 2017, our working capital decreased by approximately $1.37 million to $14.70 million from $16.07 million at December 31, 2016. As described more fully below, the decrease in working capital at December 31, 2017 is primarily attributable to a decrease in our cash and cash equivalents resulting from cash used in our operations and increases in accounts payable, accrued cooperative advertising, and accrued expenses and other liabilities. These factors were offset partially by an increase in our allocation of inventory to short-term from long-term, and increases in accounts receivable, and prepaid expenses and other assets.

During the year ended December 31, 2017, $2.56 million of cash was used by our continuing operations. The primary drivers of our use of cash were a net loss of $454,000; an increase in accounts receivable of $733,000; an increase in inventory of $3.50 million and an increase in prepaid expenses and other assets of $36,000. These factors were offset partially by an increase in accounts payable of $489,000 and an increase in accrued liabilities of $246,000. Non-cash items partially offsetting the impact of net loss totaled $1.43 million. The inventory increase was, in part, due to the purchase of new raw material SiC crystals during the period pursuant to the Supply Agreement; production of moissanite jewels; and purchases of jewelry castings and other jewelry components due to increased demand in certain channels and preparation for market demand.

Accounts receivable increased principally due to increased sales during the fourth quarter of 2017 as compared with the same period in the prior year, as well as an overall increase of sales in our Online Channels segment in 2017 compared with 2016. We did not offer any extended Traditional segment customer payment terms during the year ended December 31, 2017; however, we may offer these terms from time to time, which may not immediately increase liquidity as a result of current-period sales. We believe our competitors and other vendors in the wholesale jewelry industry have expanded their use of extended payment terms and, in aggregate, we believe that through our use of extended payment terms, we provide a competitive response in our market and that our net sales have been favorably impacted. We are unable to estimate the impact of this program on our net sales, but if we ceased providing extended payment terms in select instances, we believe we would not be competitive for some Traditional segment customers in the marketplace and that our net sales and profits would likely decrease. During the year ended December 31, 2016, we wrote off $815,000 in accounts receivable related to one international customer that was past due on its payment arrangement as we determined that the benefits of continued collections efforts did not outweigh the costs of legal proceedings. We do not believe our commercial terms were a factor with this customer’s non-payment. Our allowance for doubtful accounts previously included an allowance for this customer’s accounts receivable balance, and therefore, this write-off did not have an impact on our net loss for the year ended December 31, 2016. We have not experienced any other significant accounts receivable write-offs related to revenue arrangements with extended payment terms.

Prepaid expenses and other assets increased principally as a result of the timing of the receipt of an insurance claim settlement offset partially by the timing of payments in advance of goods or services received. Accounts payable increased primarily as a result of the timing of costs incurred but not yet paid as of December 31, 2017 associated with inventory-related purchases and professional services incurred but not yet due under our vendors' payment terms. Likewise, accrued expenses and other liabilities increased principally due to the timing of travel-related expenses and services incurred but not yet due under our vendors' payment terms.

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We manufactured approximately $15.26 million in loose jewels and $7.61 million in finished jewelry, which includes the cost of the loose jewels and the purchase of precious metals and labor in connection with jewelry production, during the year ended December 31, 2017. We expect our purchases of precious metals and labor to increase as we increase our finished jewelry business. In addition, from the beginning of 2006 through the year ended December 31, 2017, the price of gold has increased significantly, resulting in higher retail price points for gold jewelry. Because the market price of gold and other precious metals is beyond our control, the upward price trends could continue and have a negative impact on our operating cash flow as we manufacture finished jewelry.

Historically, our raw material inventories of SiC crystals had been purchased under exclusive supply agreements with a limited number of suppliers. Because the supply agreements restricted the sale of these crystals exclusively to us, the suppliers negotiated minimum purchase commitments with us that, when combined with our reduced sales during the periods when the purchase commitments were in effect, have resulted in levels of inventories that are higher than we might otherwise maintain. As of December 31, 2017, $19.77 million of our inventories were classified as long-term assets. Loose jewel sales and finished jewelry that we manufacture will utilize both the finished goods loose jewels currently on-hand and, as we deplete certain shapes and sizes, our on-hand raw material SiC crystals of $4.29 million and new raw material that we are purchasing pursuant to the Supply Agreement.

Our inventory principally comprises the following two types of materials: (i) new material that has been produced since September 2015 to the present, which is the raw materials for our Forever One™ products with colorless and near colorless gemstones, or New Material; and (ii) legacy material that was produced through the period ended August 2015, which is the raw materials for our Forever Classic™, Forever Brilliant® and lower grade gemstones, or Legacy Material. Of our total inventory as of December 31, 2017, 64% of the total inventory was New Material, while 36% was Legacy Material, as compared to percentages of total inventory of 49% of New Material and 51% of Legacy Material at December 31, 2016. We are actively selling goods set with the Legacy Material gemstones through our omni-channel strategy in such outlets as marketplaces, drop-ship and pure-play retailers. A more detailed description of our inventories is included in Note 5, “Inventories,” in the Notes to Consolidated Financial Statements.

On December 12, 2014, we entered into the Supply Agreement with Cree. Under the Supply Agreement, subject to certain terms and conditions, we agreed to exclusively purchase from Cree, and Cree agreed to exclusively supply, 100% of our required SiC materials in quarterly installments that must equal or exceed a set minimum order quantity. The initial term of the Supply Agreement will expire on June 24, 2018, unless extended by the parties. Accordingly, we are reviewing various alternatives with respect to our purchase of SiC material, including whether to exercise our unilateral option, subject to certain conditions, to renew the Supply Agreement for an additional two-year period. Our total purchase commitment under the Supply Agreement until June 2018 is dependent upon the size of the SiC material and ranges between approximately $29.60 million and approximately $31.50 million. As of December 31, 2017, our remaining purchase commitment through June 2018 under the Supply Agreement ranges from approximately $5.15 million to approximately $7.05 million.

During the year ended December 31, 2017, we purchased approximately $9.39 million of SiC crystals from Cree. We expect to use existing cash and cash equivalents and other working capital, together with future cash expected to be provided by operating activities and, if necessary, our Credit Facility, to finance our purchase commitment under the Supply Agreement.

We made no income tax payments during the year ended December 31, 2017. As of December 31, 2017, we had approximately $884,000 of remaining federal income tax credits, $533,000 of which expire between 2018 and 2021 and the balance without an expiration, which can be carried forward to offset future income taxes. As of December 31, 2017, we also had federal tax net operating loss carryforwards of approximately $24.59 million, expiring between 2020 and 2036, which can be used to offset against future federal taxable income; North Carolina tax net operating loss carryforwards of approximately $20.22 million expiring between 2023 and 2032; and various other state tax net operating loss carryforwards expiring between 2021 and 2036, which can be used to offset against future state taxable income.

On June 25, 2014, we and our wholly owned subsidiaries, Charles & Colvard Direct, LLC, and Moissanite.com, LLC (now charlesandcolvard.com, LLC), collectively referred to as the Borrowers, obtained the Credit Facility from Wells Fargo. The Credit Facility may be used for general corporate and working capital purposes, including transaction fees and expenses incurred in connection therewith and the issuance of letters of credit up to a $1.00 million sublimit. The Credit Facility was scheduled to mature on June 25, 2017.

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Effective June 22, 2017, the Credit Facility was amended to extend the maturity date to June 25, 2018. The Credit Facility was also amended to reduce the interest rate payable on advances under the Credit Facility to a rate equal to Wells Fargo's daily three-month LIBOR rate plus 2.00%, calculated on an actual/360 basis and payable monthly in arrears. In addition, the Credit Facility was amended further to include the addition of an EBITDA covenant, whereby the Borrowers were required to maintain a specified minimum monthly EBITDA through December 2017 if the cash position for the Borrowers' demand deposit account maintained at Wells Fargo falls below $3.00 million or the Borrowers draw upon the Credit Facility.

The Credit Facility includes a $5.00 million sublimit for advances that are supported by a 90% guaranty provided by the U.S. Export-Import Bank. Advances under the Credit Facility are limited to a borrowing base, which is computed by applying specified advance rates to the value of the Borrowers' eligible accounts and inventory, less reserves. Advances against inventory are further subject to an initial $3.00 million maximum. The Borrowers must maintain a minimum of $1.00 million in excess availability at all times.

Each advance accrues interest at a rate equal to either (i) Wells Fargo's three-month LIBOR rate plus 2.00%, or (ii) Wells Fargo's Prime Rate plus 1%, each calculated on an actual/360 basis and payable monthly in arrears. Principal outstanding during an event of default accrues interest at a rate of 3% in excess of the above rate. Any advance may be prepaid in whole or in part at any time. There are no mandatory prepayments or line reductions.

The Credit Facility is secured by a lien on substantially all assets of the Borrowers, each of which is jointly and severally liable for all obligations thereunder. Wells Fargo's security interest in certain SiC materials is subordinate to Cree's security interest in such materials pursuant to the Supply Agreement and an Intercreditor Agreement with Wells Fargo.

The Credit Facility is evidenced by a Credit and Security Agreement, dated as of June 25, 2014, as amended, or the Credit Agreement, and customary ancillary documents. The Credit Agreement contains customary covenants, representations and cash dominion provisions, including a financial reporting covenant and limitations on dividends, distributions, debt, contingent obligations, liens, loans, investments, mergers, acquisitions, divestitures, subsidiaries, affiliate transactions, and changes in control.

Events of default under the Credit Facility include, without limitation, (i) any impairment of the Export-Import Bank guaranty, unless the guaranteed advances are repaid within two business days, (ii) an event of default under any other indebtedness of the Borrowers in excess of $200,000, and (iii) a material adverse change in the ability of the Borrowers to perform their obligations under the Credit Agreement or in the Borrowers' assets, liabilities, businesses or prospects, or other circumstances that Wells Fargo believes may impair the prospect of repayment. If an event of default occurs, Wells Fargo is entitled to take enforcement action, including acceleration of amounts due under the Credit Agreement and foreclosure upon collateral.

The Credit Agreement contains other customary terms, including indemnity, expense reimbursement, yield protection, and confidentiality provisions. Wells Fargo is permitted to assign the Credit Facility.

Since the current amendment to the Credit Facility matures on June 25, 2018, we are currently reviewing various credit facility alternatives. Given the Company's market growth and our improved financial strength over the past year, we believe that we may have access to additional sources of working capital that may provide more advantageous terms than the existing Credit Agreement.

As of December 31, 2017, we had not borrowed against the Credit Facility.

We believe that our existing cash and cash equivalents and other working capital, together with future cash expected to be provided by operating activities, will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Our future capital requirements and the adequacy of available funds will depend on many factors, including our rate of sales growth; the expansion of our sales and marketing activities; the timing and extent of raw materials and labor purchases in connection with loose jewel production to support our moissanite jewels business and precious metals and labor purchases in connection with jewelry production to support our finished jewelry business; the timing of capital expenditures; and risk factors described in more detail in “Risk Factors” in Part I, Item 1A of this Annual Report on Form 10-K. We obtained the Credit Facility to mitigate these risks to our cash and liquidity position. Also, we may make investments in, or acquisitions of, complementary businesses, which could also require us to seek additional equity or debt financing.

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Off-Balance Sheet Arrangements

We do not use off-balance sheet arrangements with unconsolidated entities or related parties, nor do we use other forms of off-balance sheet arrangements. Accordingly, our liquidity and capital resources are not subject to off-balance sheet risks from unconsolidated entities. As of December 31, 2017, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K.

We have entered into an operating lease for approximately 36,350 square feet of mixed-use space, which we currently occupy, from an unaffiliated third-party for our offices and manufacturing facility in the normal course of business. This type of arrangement is often referred to as a form of off-balance sheet financing.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not applicable.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
Charles & Colvard, Ltd.
Morrisville, North Carolina

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Charles & Colvard, Ltd. (the "Company") and subsidiaries as of December 31, 2017 and 2016, the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

We have served as the Company's auditor since 2010.

Raleigh, North Carolina
March 8, 2018

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CHARLES & COLVARD, LTD.
CONSOLIDATED BALANCE SHEETS

	December 31, 2017	2016
ASSETS		
Current assets:		
Cash and cash equivalents	$4,594,007	$7,427,273
Accounts receivable, net	3,377,451	2,794,626
Inventory, net	11,208,658	9,770,206
Prepaid expenses and other assets	969,857	682,083
Total current assets	20,149,973	20,674,188
Long-term assets:		
Inventory, net	19,764,959	18,360,211
Property and equipment, net	1,242,200	1,391,116
Intangible assets, net	8,597	8,808
Other assets	64,978	71,453
Total long-term assets	21,080,734	19,831,588
TOTAL ASSETS	$41,230,707	$40,505,776
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$4,466,163	$3,977,149
Accrued expenses and other liabilities	980,800	631,107
Total current liabilities	5,446,963	4,608,256
Long-term liabilities:		
Deferred rent	463,526	594,916
Accrued income taxes	461,592	433,983
Total long-term liabilities	925,118	1,028,899
Total liabilities	6,372,081	5,637,155
Commitments and contingencies (Note 9)		
Shareholders’ equity:		
Common stock, no par value; 50,000,000 shares authorized; 21,580,102 and 21,369,885 shares issued and outstanding at December 31, 2017 and 2016, respectively	54,243,816	54,243,816
Additional paid-in capital	14,726,438	14,282,956
Accumulated deficit	(34,111,628)	(33,658,151)
Total shareholders’ equity	34,858,626	34,868,621
TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY	$41,230,707	$40,505,776

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31, 2017			2016		
Net sales	$	27,032,964		$	29,168,128	
Costs and expenses:						
Cost of goods sold		15,470,617			20,401,439	
Sales and marketing		7,477,354			7,038,277	
General and administrative		4,689,823			5,544,452	
Research and development		3,714			2,848	
Loss on abandonment of property and equipment		-			117,930	
Total costs and expenses		27,641,508			33,104,946	
Loss from operations		(608,544	)		(3,936,818	)
Other income (expense):						
Interest expense		(541	)		(1,737	)
Gain on insurance claim settlement		183,217			-	
Total other income (expense), net		182,676			(1,737	)
Loss before income taxes from continuing operations		(425,868	)		(3,938,555	)
Income tax net expense from continuing operations		(27,609	)		(13,480	)
Net loss from continuing operations		(453,477	)		(3,952,035	)
Discontinued operations:						
Loss from discontinued operations		-			(586,124	)
Gain on sale of assets from discontinued operations		-			12,398	
Net loss from discontinued operations		-			(573,726	)
Net loss	$	(453,477	)	$	(4,525,761	)
Net loss per common share:						

Basic - continuing operations	$	(0.02	)	$	(0.19	)
Basic - discontinued operations		-			(0.03	)
Basic - total	$	(0.02	)	$	(0.22	)
Diluted - continuing operations	$	(0.02	)	$	(0.19	)
Diluted - discontinued operations		-			(0.03	)
Diluted - total	$	(0.02	)	$	(0.22	)
Weighted average number of shares used in computing net loss per common share:						
Basic		21,193,793			20,926,120	
Diluted		21,193,793			20,926,120	

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

	Common Stock				
	Number of Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Total Shareholders' Equity
Balance at December 31, 2015	21,111,585	$54,240,247	$13,280,920	$(29,132,390)	$38,388,777
Stock-based compensation	-	-	1,003,305	-	1,003,305
Issuance of restricted stock	255,800	-	-	-	-
Stock option exercises	2,500	3,569	(1,269)	-	2,300
Net loss	-	-	-	(4,525,761)	(4,525,761)
Balance at December 31, 2016	21,369,885	$54,243,816	$14,282,956	$(33,658,151)	$34,868,621
Stock-based compensation	-	-	443,482	-	443,482
Issuance of restricted stock	210,217	-	-	-	-
Net loss	-	-	-	(453,477)	(453,477)
Balance at December 31, 2017	21,580,102	$54,243,816	$14,726,438	$(34,111,628)	$34,858,626

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(453,477)	$(4,525,761)
Net loss from discontinued operations	-	(573,726)
Net loss from continuing operations	(453,477)	(3,952,035)
Adjustments to reconcile net loss from continuing operations to net cash (used in) provided by operating activities of continuing operations:		
Depreciation and amortization	422,018	557,393
Stock-based compensation	443,482	959,134
Provision for uncollectible accounts	28,000	(73,300)
Provision for sales returns	122,000	(316,000)
Provision for inventory reserves	598,000	200,000
Gain on insurance claim settlement	(183,217)	-
Loss on abandonment of property and equipment	-	117,930
Changes in operating assets and liabilities:		
Accounts receivable	(732,825)	1,447,325
Inventory	(3,503,032)	3,998,003
Prepaid expenses and other assets, net	(36,250)	162,157
Accounts payable	489,014	654,001
Deferred rent	(131,390)	(99,656)
Accrued income taxes	27,609	13,480
Accrued expenses and other liabilities	349,693	(333,731)
Net cash (used in) provided by operating activities of continuing operations	(2,560,375)	3,334,701
Net cash used in operating activities of discontinued operations	-	(1,125,578)
Net cash (used in) provided by operating activities	(2,560,375)	2,209,123
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(271,390)	(421,761)
Intangible assets	(1,501)	(5,615)
Proceeds from sale of long-term assets	-	250
Net cash used in investing activities of continuing operations	(272,891)	(427,126)
Net cash provided by investing activities of discontinued operations	-	368,671
Net cash used in investing activities	(272,891)	(58,455)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	-	2,300
Net cash provided by financing activities of continuing operations	-	2,300
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(2,833,266)	2,152,968
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	7,427,273	5,274,305
CASH AND CASH EQUIVALENTS, END OF PERIOD	$4,594,007	$7,427,273
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	$541	$1,737

See Notes to the Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 meteorite crater. Because naturally occurring SiC crystals are too small for commercial use, larger crystals must be grown in a laboratory. The Company sells loose moissanite jewels and finished jewelry at wholesale prices to distributors, manufacturers, retailers, television shopping networks, and designers, including some of the largest distributors and jewelry manufacturers in the world, which mount them into fine jewelry to be sold at retail outlets and via the Internet. The Company sells at retail prices to end consumers through its wholly owned operating subsidiaries, charlesandcolvard.com, LLC (formerly Moissanite.com, LLC) and Charles & Colvard Direct, LLC (through March 2016), third-party online marketplaces, drop-ship, and other pure-play, exclusively e-commerce outlets. 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 13, "Discontinued Operations." The Company is now presenting the operating results of Charles and Colvard Direct, LLC as a discontinued operation.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying consolidated financial statements as of and for the years ended December 31, 2017 and 2016 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, which was re-activated in December 2017, but had no operating activity during the year ended December 31, 2017. Charles & Colvard (HK) Ltd. previously became dormant in the second quarter of 2009 after its operations ceased in 2008. All intercompany accounts have been eliminated.

Change in Fiscal Year-End – On January 30, 2018, the Board of Directors of the Company approved a change in the Company's fiscal year from a fiscal year beginning on January 1 and ending on December 31 of each year to a fiscal year beginning on July 1 and ending on June 30 of each year. This change in the Company's fiscal year-end enables management to shift its annual planning and budgeting process away from the holiday season, so that management's focus during that time is on revenue-generating opportunities with customers. This change to the fiscal year reporting cycle will begin July 1, 2018. As a result of the change, the Company will have a six-month transition period from January 1, 2018 to June 30, 2018. During this period, the Company plans to file its results for the three-month period ending March 31, 2018 in the Company's Quarterly Report on Form 10-Q for the quarter ending March 31, 2018 and to file a transition report with its results for the six-month period ending June 30, 2018 on Form 10-KT with the Securities and Exchange Commission.

Discontinued Operations - The results of operations for businesses that have been disposed of or classified as held-for-sale are segregated from the results of the Company’s continuing operations and classified as discontinued operations for each period presented in the Company’s consolidated income statements. Similarly, the assets and liabilities of such businesses are reclassified from continuing operations and presented as discontinued operations for each period presented on the Company’s consolidated balance sheets.

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Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("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, uncertain tax positions, cooperative advertising, and revenue recognition. Actual results could differ materially from those estimates.

Reclassifications - Certain amounts in the prior year's 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 and in Note 8, "Accrued Expenses and Other Liabilities", relating to the reclassification of certain accrued expenses.

Cash and Cash Equivalents - All highly liquid investments with an original maturity of three months or less from the date of purchase are considered to be cash equivalents.

Concentration of Credit Risk - Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. At times, cash balances may exceed the Federal Deposit Insurance Corporation ("FDIC") insurable limits. The Company has never experienced any losses related to these balances. Non-interest-bearing amounts on deposit in excess of FDIC insurable limits at December 31, 2017 approximated $4.32 million.

Trade receivables potentially subject the Company to credit risk. Payment terms on trade receivables for the Company's Traditional segment customers are generally between 30 and 120 days, though it may offer extended terms with specific customers and on significant orders from time to time. The Company believes its competitors and other vendors in the wholesale jewelry industry have also expanded their use of extended payment terms and, in aggregate, the Company believes that by expanding its use of extended payment terms, it has provided a competitive response in its market and that its net sales have been favorably impacted. The Company is unable to estimate the impact of this program on its net sales, but if it ceased providing extended payment terms in select instances, the Company believes it would not be competitive for some Traditional segment customers in the marketplace and that its net sales and profits would likely decrease. The Company extends credit to its customers based upon a number of factors, including an evaluation of the customer's financial condition and credit history that is verified through trade association reference services, the customer's payment history with the Company, the customer's reputation in the trade, and/or an evaluation of the Company's opportunity to introduce its moissanite jewels or finished jewelry featuring moissanite to new or expanded markets. Collateral is not generally required from customers. The need for an allowance for doubtful accounts is determined based upon factors surrounding the credit risk of specific customers, historical trends, and other information. During the year ended December 31, 2016, the Company wrote off $815,000 in accounts receivable related to one international customer that was past due on its payment arrangement as it determined that the benefits of continued collections efforts did not outweigh the cost of legal proceedings. The Company does not believe its commercial terms were a factor with this customer's non-payment. The Company's allowance for doubtful accounts previously included an allowance for this accounts receivable, and therefore, this write-off did not have an impact on net loss for the year ended December 31, 2016. The Company has not experienced any other significant accounts receivable write-offs related to revenue arrangements with extended payment terms.

See Note 14, "Major Customers and Concentration of Credit Risk", for further discussion of credit risk within trade accounts receivable.

Accounts Receivable Reserves - Estimates are used to determine the amount of two reserves against trade accounts receivable. The first reserve is an allowance for sales returns. At the time revenue is recognized, the Company estimates future returns using a historical return rate that is reviewed quarterly with consideration of any contractual return privileges granted to customers, and it reduces sales and trade accounts receivable by this estimated amount. The allowance for sales returns was $537,000 and $415,000 at December 31, 2017 and 2016, respectively.

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The following is a reconciliation of the allowance for sales returns:

	Year Ended December 31,	
	2017	2016
Balance, beginning of year	$ 415,000	$ 731,000
Additions charged to operations	3,878,736	3,574,297
Sales returns		