CHARLES & COLVARD LTD
Form 10-Q
May 14, 2012

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from ______ to ______

Commission File Number: 000-23329

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

As of May 9, 2012, there were approximately 19,528,879 shares of the registrant’s common stock, no par value per share, outstanding.

CHARLES & COLVARD, LTD.

FORM 10-Q
For the Quarterly Period Ended March 31, 2012

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PART I – FINANCIAL INFORMATION

Item 1.Financial Statements

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

	March 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$6,836,283	$6,701,701
Accounts receivable, net	5,942,003	6,064,764
Interest receivable	14,412	12,109
Inventory, net	7,202,319	6,849,592
Prepaid expenses and other assets	439,518	419,729
Total current assets	20,434,535	20,047,895
Long-term assets:		
Held-to-maturity investments	3,759,076	3,760,399
Inventory, net	27,360,983	28,157,497
Property and equipment, net	1,670,555	1,420,971
Intangible assets, net	238,098	248,812
Other assets	13,116	13,746
Total long-term assets	33,041,828	33,601,425
TOTAL ASSETS	$53,476,363	$53,649,320
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,567,508	$1,060,937
Accrued cooperative advertising	150,000	213,000
Accrued expenses and other liabilities	305,651	581,009
Total current liabilities	2,023,159	1,854,946
Long-term liabilities:		
Accrued income taxes	380,447	741,645
Total liabilities	2,403,606	2,596,591
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value	53,236,809	52,833,716
Additional paid-in capital – stock-based compensation	7,760,658	7,767,877
Accumulated deficit	(9,924,710)	(9,548,864)
Total shareholders' equity	51,072,757	51,052,729
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$53,476,363	$53,649,320

See Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2012	2011
Net sales	$4,178,385	$2,977,556
Costs and expenses:		
Cost of goods sold	2,027,686	1,328,521
Sales and marketing	1,501,921	681,285
General and administrative	1,357,172	1,184,972
Research and development	8,408	12,548
Total costs and expenses	4,895,187	3,207,326
Loss from operations	(716,802)	(229,770)
Other income (expense):		
Interest income	23,865	17,919
Interest expense	(477)	(12)
Loss on call of long-term investments	-	(2,913)
Total other income	23,388	14,994
Loss before income taxes	(693,414)	(214,776)
Income tax net benefit (expense)	317,568	(21,612)
Net loss	$(375,846)	$(236,388)
Net loss per common share:		
Basic	$(0.02)	$(0.01)
Fully diluted	$(0.02)	$(0.01)
Weighted average number of shares used in computing net loss per common share:		
Basic	19,470,511	19,297,861
Fully diluted	19,470,511	19,297,861

See Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31, 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(375,846)	$(236,388)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	116,600	42,439
Amortization of bond premium	1,323	1,165
Stock-based compensation	289,409	219,343
Provision for uncollectible accounts	151,952	29,000
Provision for sales returns	(42,000)	(76,000)
Provision for inventory reserves	(46,000)	21,000
Loss on call of long-term investments	-	2,913
Changes in assets and liabilities:		
Accounts receivable	12,809	(287,508)
Interest receivable	(2,303)	(5,626)
Income tax receivable	-	113,030
Inventory	489,787	578,489
Prepaid expenses and other assets, net	(19,159)	35,316
Accounts payable	506,571	145,821
Accrued cooperative advertising	(63,000)	5,000
Accrued income taxes	(361,198)	21,611
Other accrued liabilities	(275,358)	(118,585)
Net cash provided by operating activities	383,587	491,020
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(351,793)	(271,035)
Purchases of long-term investments	-	(495,625)
Proceeds from call of long-term investments	-	500,000
Patent, license rights, and trademark costs	(3,677)	(6,435)
Net cash used in investing activities	(355,470)	(273,095)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	106,465	19,162
Net cash provided by financing activities	106,465	19,162
NET INCREASE IN CASH AND CASH EQUIVALENTS	134,582	237,087
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,701,701	7,736,044
CASH AND CASH EQUIVALENTS, END OF PERIOD	$6,836,283	$7,973,131
Supplemental disclosures of cash flow information:		
Cash paid during the year for interest	$477	$12
Cash paid during the year for income taxes	$11,800	$-

See Notes to Condensed Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. DESCRIPTION OF BUSINESS

Charles & Colvard, Ltd. (the "Company"), a North Carolina corporation founded in 1995, manufactures, markets, and distributes Charles & Colvard Created Moissanite® jewels (hereinafter referred to as moissanite or moissanite jewels) and finished jewelry featuring moissanite for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide ("SiC"), is a rare mineral first discovered in a meteor crater. Because naturally occurring SiC crystals are too small for commercial use, larger crystals must be grown in a laboratory. Leveraging its advantage of being the sole source worldwide of created moissanite jewels, the Company's strategy is to establish itself with reputable, high-quality, and sophisticated brands and to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond. The Company believes this is possible due to moissanite's exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market. The Company sells loose moissanite jewels and finished jewelry at wholesale to distributors, manufacturers, and retailers and at retail to end consumers through its wholly owned operating subsidiaries Moissanite.com, LLC and Charles & Colvard Direct, LLC.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying condensed consolidated financial statements included in this Quarterly Report on Form 10-Q have been prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") for interim financial information. However, certain information or footnote disclosures normally included in complete financial statements prepared in accordance with U.S. GAAP have been condensed, or omitted, pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). In the opinion of the Company's management, the unaudited statements in this Quarterly Report on Form 10-Q include all normal and recurring adjustments necessary for the fair statement of the results for the interim periods presented. The results for the three months ended March 31, 2012 are not necessarily indicative of the results to be expected for the fiscal year ending December 31, 2012.

The condensed consolidated financial statements as of and for the three months ended March 31, 2012 and 2011 included in this Quarterly Report on Form 10-Q are unaudited. The balance sheet as of December 31, 2011 is derived from the audited financial statements as of that date. The accompanying statements should be read in conjunction with the audited financial statements and related notes, together with Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 filed with the SEC on March 29, 2012 (the "2011 Annual Report").

The accompanying condensed consolidated financial statements as of and for the three months ended March 31, 2012 and 2011 include the accounts of the Company and its wholly owned subsidiaries Moissanite.com, LLC, formed in 2011; Charles & Colvard Direct, LLC, formed in 2011; and Charles & Colvard (HK) Ltd., the Company's Hong Kong subsidiary that became a dormant entity in the second quarter of 2009 and the operations of which ceased in 2008. All intercompany accounts have been eliminated.

Significant Accounting Policies - In the opinion of the Company's management, the significant accounting policies used for the three months ended March 31, 2012 are consistent with those used for the year ended December 31, 2011. Accordingly, please refer to the 2011 Annual Report for the Company's significant accounting policies.

Use of Estimates - The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The most significant estimates impacting the Company's consolidated financial statements relate to valuation and classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions, stock compensation expense, and cooperative advertising. Actual results could differ materially from those estimates.

Reclassifications - Certain amounts in the prior year's condensed consolidated financial statements have been reclassified to conform to the current year presentation.

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Recently Adopted/Issued Accounting Pronouncements - All new and recently issued, but not yet effective, accounting pronouncements have been deemed to be not relevant to the Company and therefore are not expected to have any impact once adopted.

3. SEGMENT INFORMATION AND GEOGRAPHIC DATA

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

The Company manages its business primarily by its product lines. Accordingly, the Company determined its two operating and reporting segments to be loose jewels and finished jewelry. The accounting policies of these segments are the same as those described in Note 2, “Basis of Presentation and Significant Accounting Policies,” of this Quarterly Report on Form 10-Q and in the Notes to Consolidated Financial Statements in the 2011 Annual Report.

The Company evaluates the performance of its segments based on net sales and segment gross profit, or the excess of product sales over segment cost of goods sold. Segment cost of goods sold is defined as product cost of goods sold excluding non-capitalized expenses from the Company’s manufacturing and production control departments, comprising personnel costs, depreciation, rent, utilities, and corporate overhead allocations; freight out; inventory valuation allowance adjustments; and other inventory adjustments, comprising costs of quality issues, damaged goods, and inventory writeoffs. Accordingly, also excluded from the Company’s segment performance measures are operating expenses, comprising sales and marketing, general and administrative, and research and development expenses; interest; and taxes.

Summary information by segment is as follows:

	Three Months Ended March 31,	
	2012	2011
Loose jewels		
Net sales	$2,458,321	$2,567,153
Segment cost of goods sold	811,613	854,311
Segment gross profit	$1,646,708	$1,712,842
Finished jewelry		
Net sales	$1,720,064	$410,403
Segment cost of goods sold	761,173	245,362
Segment gross profit	$958,891	$165,041

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

	Three Months Ended March 31,	
	2012	2011
Segment cost of goods sold	$1,572,786	$1,099,673
Non-capitalized manufacturing and production control expenses	406,129	155,929
Freight out	17,383	19,391
Inventory valuation allowances	(46,000)	21,000

Other inventory adjustments	77,388	32,528
Cost of goods sold	$2,027,686	$1,328,521

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

	March 31, 2012	December 31, 2011
Loose jewels		
Raw materials	$3,710,269	$6,047,047
Work-in-process	4,341,866	2,505,219
Finished goods	21,534,978	21,722,869
Finished goods on consignment	560,955	505,753
Totals	$30,148,068	$30,780,888
Finished jewelry		
Raw materials	$249,737	$226,972
Work-in-process	203,710	85,786
Finished goods	3,601,370	3,292,810
Finished goods on consignment	249,941	499,577
Totals	$4,304,758	$4,105,145

Supplies inventories of approximately $110,000 and $121,000 at March 31, 2012 and December 31, 2011, respectively, included in finished goods inventories in the consolidated financial statements are omitted from inventories by segment because they are used in both product lines and are not maintained separately.

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

	Three Months Ended March 31,	
	2012	2011
Net sales		
United States	$3,390,947	$1,389,643
International	787,438	1,587,913
Total	$4,178,385	$2,977,556

	March 31, 2012	December 31, 2011
Property and equipment, net		
United States	$1,670,555	$1,420,971
International	-	-
Total	$1,670,555	$1,420,971

	March 31, 2012	December 31, 2011
Intangible assets, net		
United States	$72,883	$73,701
International	165,215	175,111
Total	$238,098	$248,812

4. INVESTMENTS

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

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The following table summarizes information about held-to-maturity investments at March 31, 2012:

	Amortized Cost	Gross Unrealized Gains	Estimated Fair Value
U.S. government agency securities	$3,759,076	$20,564	$3,779,640

As of March 31, 2012, the estimated fair value of the investments was greater than the amortized cost. Because management intends to hold the investments until their maturity dates, this unrealized gain was not recorded in the consolidated financial statements.

The maturities of held-to-maturity investments at March 31, 2012 were as follows:

	After 1 Year through 2 Years	After 2 Years through 3 Years	After 3 Years through 4 Years	After 4 Years through 5 Years	Total
U.S. government agency securities	$1,009,076	$2,000,000	$-	$750,000	$3,759,076

5. FAIR VALUE MEASUREMENTS

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

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

The Company evaluates assets and liabilities subject to fair value measurements on a recurring and non-recurring basis to determine the appropriate level to classify them for each reporting period. This determination requires significant judgments to be made by management of the Company. The instruments identified as subject to fair value measurements on a recurring basis are cash and cash equivalents, trade accounts receivable, held-to-maturity investments, trade accounts payable, and accrued expenses. All instruments other than held-to-maturity investments are reflected in the consolidated balance sheets at carrying value, which approximates fair value due to the short-term nature of these instruments. The estimated fair value of the Company’s held-to-maturity investments as of March 31, 2012 utilized Level 2 inputs of similar investments traded on active securities exchanges.

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

6. INVENTORIES

The Company's total inventories, net of reserves, consisted of the following as of March 31, 2012 and December 31, 2011:

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	March 31, 2012	December 31, 2011
Raw materials	$3,960,006	$6,274,019
Work-in-process	4,545,576	2,591,005
Finished goods	25,462,824	25,398,735
Finished goods on consignment	821,896	1,016,330
Less inventory reserves	(227,000)	(273,000)
Totals	$34,563,302	$35,007,089
Short-term portion	$7,202,319	$6,849,592
Long-term portion	27,360,983	28,157,497
Totals	$34,563,302	$35,007,089

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

The Company's 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. The Company's 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 March 31, 2012 and December 31, 2011, work-in-process inventories issued to active production jobs approximated $1.00 million and $513,000, respectively.

Obsolescence is not a factor in the Company's loose jewel inventory valuation. The Company's jewels do not degrade over time and inventory generally consists of the shapes and sizes most commonly used in the jewelry industry. In addition, the majority of jewel inventory is not mounted in finished jewelry settings and is therefore not subject to fashion trends. The Company has very small market penetration in the worldwide jewelry market, and the Company has the exclusive right in the U.S. through mid-2015 and in many other countries through mid-2016 to produce and sell created SiC for use in jewelry applications. In view of the foregoing factors, management has concluded that no excess or obsolete loose jewel inventory reserve requirements existed as of March 31, 2012.

In 2010, the Company began manufacturing finished jewelry featuring moissanite. Finished jewelry is more fashion oriented and subject to styling trends that could render certain designs obsolete. The majority of the Company's finished jewelry is held in inventory for resale and consists of such basic designs as stud earrings, solitaire and three-stone rings, pendants, and bracelets that tend not to be subject to significant obsolescence risk due to their classic styling. In addition, the Company manufactures small individual quantities of designer-inspired fashion jewelry as part of its sample line that are used in the selling process to its wholesale customers. Typically in the jewelry industry, slow-moving or discontinued lines are sold as closeouts in alternative sales channels. The Company reviews the finished jewelry inventory on an ongoing basis for any lower of cost or market and obsolescence issues and has concluded that no such finished jewelry inventory reserve requirements relating to the Company's finished jewelry products existed as of March 31, 2012.

Periodically, the Company ships finished goods inventory to customers on consignment terms. Under these terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Finished goods on consignment are net of a shrinkage reserve of $11,000 at each of March 31, 2012 and December 31, 2011 to allow for certain loose jewels and finished jewelry on consignment with customers that may not be returned or may be returned in a condition that does not meet the Company's current grading standards.

Total net loose jewel inventories at March 31, 2012 and December 31, 2011, including inventory on consignment net of reserves, were $30.15 million and $30.78 million, respectively. The loose jewel inventories at March 31, 2012 and December 31, 2011 include an inventory reserve for shrinkage, or jewels on review with prospective customers and vendors that may not be returned to the Company, of $5,000 and $14,000, respectively. Loose jewel inventories

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at March 31, 2012 and December 31, 2011 also include an inventory reserve for recuts, or the projected material loss resulting from the recutting of damaged jewels into smaller loose jewels to remove the damage, of $33,000 and $30,000, respectively.

Total net jewelry inventories at March 31, 2012 and December 31, 2011, including inventory on consignment net of reserves and including new jewelry manufactured by the Company since entering the finished jewelry business in 2010, were $4.30 million and $4.11 million, respectively. Jewelry inventories consist primarily of finished goods, a portion of which the Company acquired as part of a January 2009 settlement agreement with a former manufacturer customer to reduce the outstanding receivable to the Company. Due to the lack of a plan to market this inventory at that time, a jewelry inventory reserve was established to reduce the majority of the jewelry inventory value to scrap value, or the amount the Company would expect to obtain by melting the gold in the jewelry and returning to loose-jewel finished goods inventory those jewels that meet grading standards. This scrap reserve has declined as the associated jewelry is sold down, with a balance of $130,000 and $173,000 at March 31, 2012 and December 31, 2011, respectively. Because the finished jewelry the Company began manufacturing in 2010 after it entered that business was made pursuant to an operational plan to market and sell the inventory, it is not subject to this reserve. The finished jewelry inventories at March 31, 2012 and December 31, 2011 also include an inventory reserve for jewelry in need of repair of $48,000 and $45,000, respectively.

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

7. INCOME TAXES

The Company recognized an income tax net benefit of approximately $318,000 for the three months ended March 31, 2012 compared to an income tax expense of approximately $22,000 for the three months ended March 31, 2011.

During 2008, the Company recorded a full valuation allowance against certain deferred tax assets consisting primarily of net operating loss carryforwards. Due to continued uncertainty over sufficient future taxable income to fully utilize these deferred tax assets, the Company did not record an income tax expense or income tax benefit for the pretax income and pretax losses incurred during the three months ended March 31, 2012 and 2011, respectively, nor did the Company reduce the valuation allowance against these deferred tax assets. Until such time that the uncertainty for utilization of the remaining net operating losses is overcome, the Company does not expect to recognize income tax expense or benefit for operating income or loss, respectively, in future periods.

During the three months ended March 31, 2012, the Company entered into a voluntary disclosure agreement with a taxing authority for which the Company had previously recorded a liability for an uncertain tax position. As a result of the agreement, the Company reduced its total recorded liabilities relating to uncertain tax positions by approximately $320,000 and recognized a corresponding income tax benefit. This benefit was offset by approximately $2,000 of income tax expense for estimated tax, penalties, and interest for other uncertain tax positions.

During the three months ended March 31, 2011, the Company recognized approximately $22,000 of income tax expense for estimated tax, penalties, and interest associated with uncertain tax positions.

8. COMMITMENTS AND CONTINGENCIES

Lease Commitments

In March 2004, the Company entered into a seven-year lease, beginning in August 2004, for approximately 16,500 square feet of mixed-use space from an unaffiliated third party at a base cost with escalations throughout the lease term plus additional common-area expenses based on the Company’s proportionate share of the lessor’s operating costs.

The lease provided for two rent holidays, during which no rent was payable, and a moving allowance. In January 2011, the Company amended the lease effective January 1, 2011 to extend the term through January 2017 in exchange for a reduced rental rate and 50% rent abatement in the first 12 months of the extended term. The amended lease includes 3% annual rent escalations and a one-time option to terminate the lease effective as of July 31, 2014. The Company recognizes rent expense on a straight-line basis, giving consideration to the rent holidays, the moving allowance paid to the Company, and the rent abatement. At the Company's option, the amended lease can be extended for one five-year period. As of March 31, 2012, the Company's future minimum payments under this operating lease were as follows:

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2012	$101,437
2013	139,307
2014	143,486
2015	147,791
2016	152,224
2017	13,066
Total	$697,311

Rent expense for the three months ended March 31, 2012 and 2011 was approximately $51,000 and $46,000, respectively.

Purchase Commitments

On June 6, 1997, the Company entered into an amended and restated exclusive supply agreement with Cree, Inc. (“Cree”). The exclusive supply agreement had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the amended and restated exclusive supply agreement, the Company has committed to purchase from Cree a minimum of 50%, by dollar volume, of its raw material SiC crystal requirements. If the Company’s orders require Cree to expand beyond specified production levels, the Company must commit to purchase certain minimum quantities. No outstanding purchase commitments existed under the amended and restated exclusive supply agreement as of March 31, 2012.

Legal Proceedings

On July 26, 2011, the Company learned that BetterThanDiamond.com requested that the U.S. Patent and Trademark Office (“USPTO”) conduct an ex parte re-examination of the Company’s U.S. Patent No. 5,723,391 (the “‘391 Patent”) for manufacturing silicon carbide gemstones based on claims of prior art. On October 5, 2011, the USPTO granted the re-examination request based on its finding that the information provided in the request raises “a substantial new question of patentability.” The Company firmly believes that the ‘391 Patent is valid and enforceable and is committed to vigorously defending the ‘391 Patent.

9. STOCK-BASED COMPENSATION

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

	Three Months Ended March 31,	
	2012	2011
Employee stock options	$165,274	$109,772
Consultant stock options	-	38,861
Restricted stock awards	124,135	70,710
Income tax benefit	(45,006)	(39,726)
Totals	$244,403	$179,617

Due to the Company’s valuation allowance against deferred tax assets, all of the above income tax benefit was reserved as of March 31, 2012. No stock-based compensation was capitalized as a cost of inventory during the three months ended March 31, 2012 and 2011.

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Stock Options - The following is a summary of the stock option activity for the three months ended March 31, 2012:

	Shares	Weighted Average Exercise Price
Outstanding, December 31, 2011	1,157,579	$2.16
Granted	101,136	$4.08
Exercised	(50,440)	$2.11
Forfeited	(5,000)	$0.46
Expired	(7,039)	$7.82
Outstanding, March 31, 2012	1,196,236	$2.30

The weighted average grant date fair value of stock options granted during the three months ended March 31, 2012 was $2.89. The total fair value of stock options that vested during the three months ended March 31, 2012 was approximately $169,000. The fair value of each stock option is estimated on the date of grant using the Black-Scholes-Merton option pricing model with the following weighted average assumptions for stock options granted during the three months ended March 31, 2012:

Dividend yield	0.0 %
Expected volatility	92.7 %
Risk-free interest rate	0.84 %
Expected lives (years)	5.0

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

The following table summarizes information about stock options outstanding at March 31, 2012:

Options Outstanding			Options Exercisable			Options Vested or Expected to Vest		
Balance as of 3/31/2012	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 3/31/2012	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 3/31/2012	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
1,196,236								