CHARLES & COLVARD LTD
Form 10-K
March 29, 2010

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2009

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)

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 x

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 x

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 ¨

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" 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 ¨ No x

As of June 30, 2009, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates of the registrant was $8,122,071 based on the closing sales price as reported on the NASDAQ Global Select Market.

As of March 25, 2010, there were approximately 19,021,249 shares of the registrant's common stock, no par value per share, outstanding.

DOCUMENT INCORPORATED BY REFERENCE

Certain portions of the Proxy Statement for the registrant's 2010 Annual Meeting of Shareholders to be held on May 20, 2010 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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CHARLES & COLVARD, LTD.

FORM 10-K
For the Fiscal Year Ended December 31, 2009

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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, or the Securities Act, 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 although some 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, the recent downturn in the worldwide economy and its ongoing impact on our business and the business of our customers and suppliers, any continued trends in the general economy that would adversely affect consumer spending, a further decline in our sales, dependence on consumer acceptance of our products, dependence on Cree, Inc., or Cree, as the current supplier of the raw material, ability to develop a material second source of supply, dependence on a limited number of customers, risks of conducting business in foreign countries, dependence on third parties for the sales and marketing of our products to end consumers, and the impact of significant changes in our management on our ability to execute our business strategy in the near-term, 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

General

Charles & Colvard, Ltd., a North Carolina corporation founded in 1995 (which may be referred to as the Company, Charles & Colvard, we, us, or our), manufactures, markets, and distributes Charles & Colvard Created Moissanite® jewels (which we refer to as moissanite or moissanite jewels) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide, or 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 our advantage of being the sole source worldwide of lab-created moissanite jewels, our strategy is to establish Charles & Colvard with reputable, high-quality, and sophisticated brands to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond. We believe this is possible due to moissanite’s exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market.

We primarily sell loose moissanite jewels to some of the largest jewelry manufacturers and distributors in the world, which mount them into fine jewelry. We have also begun to wholesale a limited amount of finished moissanite jewelry.

Our moissanite jewels are made from gem-grade SiC crystals. We obtain the majority of our SiC crystals from Cree. In February 2005, we established a new relationship for the supply of SiC crystals with Norstel AB, or Norstel, a Swedish company, that has demonstrated an ability to produce suitable SiC crystals in limited quantities. We have certain exclusive supply rights with Cree and Norstel for SiC crystals to be used for gemstone applications.

We operate as a single business segment, with U.S. sales representing 64% and 70% of total net sales for the years ended December 31, 2009 and 2008, respectively. Our largest customer during the year ended December 31, 2009 accounted for 19% of our total sales compared to 21% during the year ended December 31, 2008. No additional customers accounted for more than 10% of sales in 2009 or 2008. We expect that we will remain dependent on our

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ability and that of our largest customers to maintain and enhance their 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.

Our future growth strategy is closely linked to our statement of purpose: “We will grow by providing consumers in all parts of the world an affordable luxury experience.” We plan to accomplish this by growing our core business with key jewelry manufacturers and distributors, becoming consumer-centric with our product, and developing leading global jewelry brands featuring moissanite with an unrelenting focus on design.

Growing our core business - We will continue to focus on our core business of manufacturing and distributing the moissanite jewel because this is the primary way we reach consumers, and we believe there is substantial opportunity to capture a larger share of the jewelry market:

- The global jewelry business is a $120 billion market
- The U.S. jewelry business is a $52 billion market, of which diamond jewelry comprises $18 billion

We plan to focus on growing market share profitably across all these businesses by partnering more closely with our existing manufacturing and distributor customers and by pursuing new strategic relationships with key players in the jewelry industry. As economies recover, we believe we will be positioned to leverage our market advantage and further increase our share position.

Winning with consumers - The second growth strategy is key: we must effectively communicate the value proposition of moissanite to consumers by increasing awareness of its quality and making our products more accessible and affordable.

To help accomplish this, we are pursuing opportunities through appropriate partners or, in some cases, directly with targeted retailers in several priority areas, focusing on the best in class within each sales channel:

- Department stores - This is a significant opportunity across many areas of our business.

- Mall-based jewelers - A key relationship within this channel would fill a market void for many of our potential consumers.

- Independent jewelers - The aggregate market penetration of independent jewelry stores is substantial and, if a single retailer, would be our largest customer in terms of sales volume.

- Mass merchandisers - Jewelry sales within this channel are growing faster than traditional jewelry retailers and will most likely become the primary source of moissanite products for the majority of consumers.

- Outlet jewelers - We believe this sales channel is the best medium for efficiently moving discontinued products.

- E-commerce - Our consumer-centric focus means that we must be available to consumers when and where they seek to research or purchase moissanite products. We envision e-commerce as a part of a broader effort to establish online connections with consumers that build our brands and our business with retail partners.

- TV shopping networks - This channel sets the stage for more aggressive business expansion as our economies develop.

- Alternate channels - Unconventional sales channels are underdeveloped and have meaningful potential.

As we touch consumers' lives by providing the affordable luxury experience of our moissanite jewel, we believe additional opportunities will arise to impact more consumers in a positive and motivating way.

Developing leading global jewelry brands - Our third growth strategy is to establish brands with attractive and unique designs featuring moissanite to facilitate the development of faster growing, structurally attractive businesses. We are currently concentrating on opportunity areas within the premium end of the bridal and fashion jewelry market segments, bringing high quality, specially designed products to market to increase consumer value

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and provide for improved sales and margin for retailers. We expect that this third strategy of building brand recognition will help support revenue streams as our intellectual property rights expire in the future.

Moissanite

Moissanite is a rare, naturally occurring mineral that is generally very small in size, dark green or black in color, and not a commercially viable source of gemstone material. Therefore, we expect only lab-grown SiC crystals to provide a sustainable source of moissanite for jewels.

It is generally accepted that, in addition to carat size, the most important characteristics of a gemstone are beauty, durability, and rarity. The beauty of a gemstone is characterized by its color, brilliance, fire, and luster. 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. Luster is the amount of light that is reflected back to the observer from the surface of a gemstone. 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, luster, durability, and rarity. Moissanite's beauty is objectively derived from its refractive index, which is higher than other gemstones including diamond, and its hardness is greater than all known gemstone materials except 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 designed to maximize the brilliance and fire of the material. Additionally, 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 jewel-quality moissanite, we believe that moissanite is among the rarest of jewels.

To date, we have focused our development, manufacturing, and distribution efforts on near-colorless moissanite jewels, although we have produced and sold limited quantities of green moissanite jewels.

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

Comparison Chart (1)

Description	Refractive Index	Dispersion	Luster	Hardness (Mohs Scale)(2)	Toughness
Charles & Colvard Created Moissanite®	2.65-2.69	0.104	20.4%	9 ¼	Excellent
Diamond	2.42	0.044	17.2%	10	Excellent*
Cubic Zirconia (CZ)	2.17	0.060	13.6%	8 ½	Good
Ruby	1.77	0.018	7.7%	9	Excellent**
Sapphire	1.77	0.018	7.7%	9	Excellent**
Emerald	1.58	0.014	5.1%	7 ½	Good to Poor
*In cleavage direction, toughness is "good" **Except twinned stones					

1. 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 891-906 (4th Ed. 1994); 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-Boemstein 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).

2. The Mohs Scale is a relative scale only, and 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.

Products and Product Development

Moissanite jewels - We primarily sell near-colorless moissanite jewels cut in a variety of shapes including round, square brilliant, cushion, radiant, pear, marquise, and oval in sizes ranging from approximately 2 to 12 millimeters (approximately 0.03 to 5.3 carats). To evaluate the market potential of colored moissanite, we had produced and distributed with moderate success a limited quantity of green moissanite jewels but, to date, we have not elected to expand these product offerings. In the future, we may elect to offer, from time to time, additional cuts, sizes, and colors of moissanite jewels.

We significantly reduced our raw material purchase commitments beginning in 2008 compared to prior years to improve cash flow from operations. Further, we were able to negotiate with our two leading raw material suppliers to defer purchases during the three months ended December 31, 2008 and throughout 2009, while keeping in place our long-term exclusive supply agreements. These reduced and deferred purchase commitments helped us to convert inventory into cash at a faster rate. There were no raw material purchases in 2009, and we purchased $2.2 million of raw materials in 2008.

Amended and Restated Exclusive Supply Agreement with Cree - In June 1997, we entered into an Amended and Restated Exclusive Supply Agreement with Cree, or the Cree Exclusive Supply Agreement, in which we agreed to purchase from Cree at least 50%, by dollar volume, of our raw material SiC crystal requirements for use in the manufacture of moissanite jewels in each calendar quarter during the term of the Cree Exclusive Supply Agreement, and Cree agreed to supply this amount of crystals to us. We purchased no SiC crystals from Cree in 2009, and we purchased approximately $1.7 million of SiC crystals during 2008. As a result of our deferral in purchases, our price per gram for SiC purchases from Cree during 2009 and 2008 increased by approximately 22% over what we paid per gram in the fourth quarter of 2007 and 33% over what we paid per gram during the first three quarters of 2007. In September 2008, we amended and supplemented our letter agreement with Cree to suspend our commitment to purchase $710,000 of SiC inventory during the fourth quarter of 2008. Effective March 22, 2010, we entered into a letter agreement with Cree in connection with the Cree Exclusive Supply Agreement under which we agreed to purchase approximately $1.2 million of SiC crystals over a period of approximately eight months in 2010 to satisfy this existing purchase commitment and to preserve the exclusivity terms of the Cree Exclusive Supply Agreement.

The Cree Exclusive Supply Agreement prohibits us, without Cree’s consent, from entering into an exclusive marketing or distribution agreement with any party that Cree reasonably believes is affiliated with any of the following parties:

- DeBeers;
- the Central Selling Organization (the international cartel of diamond producers) or its successors;
- any party whose primary business is the development, manufacture, marketing, or sale of diamond gemstones; or
- any non-gemstone and non-jewelry industry competitor of Cree.

These provisions may limit our potentially available avenues of distribution and could prevent us from entering into certain potentially profitable transactions.

Exclusive Supply Agreement with Norstel - In February 2005, we entered into an Exclusive Supply Agreement with Norstel, or the Norstel Exclusive Supply Agreement, for the supply of raw material SiC crystals for use in the manufacture of moissanite jewels. This agreement gave us the exclusive right to purchase SiC crystals from Norstel for the purpose of fabricating, distributing, or selling faceted jewels. In April 2008, we entered into an amendment to the Norstel Exclusive Supply Agreement due to an update of Norstel’s delivery schedule and capability and also due to our desire to limit our purchase of raw materials. Under this amendment, our minimum purchase commitment from Norstel was to continue until (i) we have purchased an aggregate amount of approximately $7.9 million of SiC crystals, or (ii) September 26, 2011, whichever occurs first. We have purchased from Norstel approximately $550,000 of SiC crystals since inception of the Norstel Exclusive Supply Agreement. In October 2008, we entered into a new letter agreement with Norstel that amended and supplemented the April 2008 amendment. Pursuant to the new letter agreement, our aggregate deferred commitment to purchase approximately $750,000 of SiC from Norstel was suspended.

In addition, as part of the Norstel Exclusive Supply Agreement, we advanced $400,000 to Norstel in 2005 for the purchase of certain equipment. This advance, which is in the form of a note receivable, began to be repaid in January 2007 through a 20% reduction on each invoice for subsequent purchases of SiC crystals. Effective March 1, 2008, pursuant to the April 2008 amendment, we began receiving a 30% reduction on each invoice for subsequent purchases of SiC crystals. The balance on the advance as of December 31, 2008 was $224,627. In December 2009,

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we received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. Though we did not consent to the composition offer, we received notice in January 2010 that the District Court of Norrköping had approved it, and we received a cash payment of $56,127 in February 2010. It is our position that, as a result of the failure of Norstel to repay the advance in full as stipulated in the Norstel Exclusive Supply Agreement, we have no further purchase obligations under the agreement.

Intellectual Property

We have United States product and method patents for moissanite jewels, expiring in 2015, under which we have broad, exclusive rights to manufacture, use, and sell moissanite jewels in the United States. We have these same patents in a number of foreign jurisdictions. In addition, we have certain trademarks and pending trademark applications that support our moissanite branding strategy. Our success and our ability to compete successfully depend heavily upon our proprietary technology. In addition to our 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. Cree is exclusively licensed to use a patent concerning a process for growing large single crystals of SiC, has certain patents of its own relating to growth of large single crystals of SiC, and has a patent for a process for growing near-colorless SiC crystals.

Manufacturing and Quality Assurance

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.

Following are the key manufacturing processes of our moissanite jewels:

- growing gem-grade raw SiC crystals;
- manufacturing rough preforms;
- polishing jewels; and
- inspecting, sorting, and grading.

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 Cree Exclusive 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 cut of the finished jewel.

Polishing jewels - Each preform is hand faceted and polished 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.

Inspecting, sorting, and grading - Similar to other gemstones, each faceted moissanite jewel is individually graded against established master standards using 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.

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Marketing and Distribution

Because channel sell-through, as opposed to sell-in, generates reorders and also leads to long-term sustainable sales, the development of our current marketing strategy began with the analysis of thousands of historic sales records to identify what customer demographic historically purchased moissanite products. Our review indicated that the target demographic is predominantly a female between the ages of 35 and 55 with middle to upper-middle income. Retail price points were strongest from $99 to $399. Through multiple prior focus groups and interviews, it was also revealed that moissanite was purchased as a diamond alternative; however, the product is positioned above all other alternatives in that it is a unique jewel with properties similar to and, in some cases, better than a diamond.

Recognizing that the United States is a $52 billion jewelry market, we see an opportunity to position jewelry containing moissanite as a provider of incremental sales and margin for savvy retailers. As such, we are currently focusing our efforts where we can achieve the most meaningful sales inroads, developing exclusive supply relationships with select jewelry manufacturers that provide sales and distribution rights for retailers currently in their portfolio.

With the assurance of exclusivity, key manufacturers are more willing to make the investment in gold and labor, as well as marketing and display materials, to produce moissanite jewelry. We have made progress with both existing and new relationships, domestic and international. The process is slow and deliberate, usually requiring a pilot program that could take several months prior to a complete rollout.

In addition, we are creating portfolio collections containing designs that are intended to establish brands under Charles & Colvard. These exclusive brands are targeted to be marketed by select retail channels and could include men's and ladies' fashion brands, an upscale brand, loose stone brand, religious jewelry brand, and a bridal brand.

Marketing

We have historically marketed moissanite to the self-purchasing woman as the perfect reward or indulgence to celebrate her achievements or milestones in life. However, in 2009, we expanded our marketing message beyond the self-purchasing woman to more segments of the larger marketplace of jewelry for every occasion including bridal, anniversary, and gift-giving. With the assistance of our recently engaged marketing agency, we are revising our messaging to expand moissanite's global reach, increase market awareness of our moissanite jewels, develop additional marketing channels to the jewelry trade and the consumer, and help create a more compelling consumer value proposition that we believe will drive increased demand for our product.

We believe that moissanite has a quality and value proposition to the consumer that is unique in the marketplace. By revising and broadening our marketing message, we intend to develop additional marketing channels to the jewelry trade and the consumer so that we can reach a larger market audience and help increase overall awareness levels of moissanite and corresponding sell-through.

As many retailers currently have an excess of in-case inventory, marketing efforts designed to increase sell-through are extremely important. The market is especially challenging as consolidation pressures on both department store retailers and jewelry store retailers are intensifying.

Consumer Advertising - As a result of the economic downturn, we experienced a reduced cooperative marketing effort from both our manufacturers and their retail partners in 2008. In response, we explored a variety of avenues focusing on Internet retail messaging. During the third quarter of 2009, we marketed with The Knot, a leading wedding planning solution, for a two-month campaign promoting moissanite bridal jewelry both online and in its fall magazine. Additionally, we have utilized social media including Twitter and Facebook to further develop our electronic consumer messaging. We have continued to enhance and promote the educational website www.whatismoissanite.com that we launched in early 2008. This comprehensive, interactive website allows visitors to learn about moissanite - its history, comparison of the jewel's properties with other jewels, and its features described by streaming video with expert commentary. The website also serves as a related hotlink or microsite that is located on the retailer's moissanite landing page and allows the consumer to learn more without leaving the retailer's website.

Prior to 2008, we had traditionally used print advertising as the marketing medium of choice. The marketing message was delivered through fashion, lifestyle, and consumer magazine advertisements. Moissanite special events had been augmented by regional and local newspaper advertising, and we supported national newspaper advertising with our manufacturers and retailers through our cooperative advertising program. However, due to declining readership of print media and reduced effectiveness, we decreased its use in favor of more cost-effective mediums and will continue to assess its usefulness in future campaigns.

Public Relations - Public relations activities can be an important component of our marketing and are integral to supporting the launch of new moissanite retailers and independent jewelers. We focused our efforts in 2009 on events intended to increase moissanite awareness, interest, and purchase intent at the consumer level by generating editorial coverage and moissanite jewelry product placement, including Internet promotions and sweepstakes giving away moissanite jewelry. We are continuing our pursuit of public relations activities in 2010, which include editorial efforts such as the CBS Early Show and product placement opportunities.

Marketing to the Trade - From 2004 through 2008, our marketing message to the jewelry trade positioned moissanite as a new jewel and jewelry category that could provide an additional opportunity to build incremental revenue and profits. Over the last four years, we augmented this message by partnering with National Jeweler magazine and our manufacturers to create a Moissanite Supplement. This 28-page-plus yearly insert provides the trade industry an in-depth publication that includes education about the jewel, elaboration of the overall business opportunity, profiles and interviews of female purchasers, industry research and statistics from current retailers selling moissanite, and successful moissanite retail jewelry trade testimonials. As we proceed with a broader message, we currently plan to shift from trade marketing to an increased emphasis on marketing to the consumer to motivate their purchases.

Trade Shows - Our attendance at leading jewelry trade shows, worldwide, has assisted us in extending our outreach to customers as the economic climate and corporate structure has continued to change. Whether we engage as a sponsor, an exhibitor, or a participant assisting manufacturing clients, it is apparent that our customers appreciate our efforts to connect personally with them. In 2010, we plan to attend major domestic and international jewelry industry trade shows, including JCK in Las Vegas, the Hong Kong Gem and Jewellery Fair, and the Vicenza Jewelry Show in Italy.

Distribution

Domestic - Traditionally, consumers have purchased jewelry through independent and chain jewelry stores and department stores. More recently, major shifts are occurring in the retail environment for jewelry. Traditional sales channels (such as independent jewelry stores, mall-based chain jewelers, and mid-market department stores) are contracting while other channels, such as e-commerce, wholesale shopping clubs, and discounters such as Wal-Mart are expanding their presence in the jewelry market. Traditional retailers have consolidated by closing non-productive locations and some have declared bankruptcy. At the manufacturing level in the United States, the shift of jewelry production and design to low-cost markets such as China and India has created dramatic consolidation, with remaining manufacturers struggling to survive or create a competitive advantage. Today, moissanite jewelry is sold to consumers through a broad range of channels, including single- and multiple-location independent jewelry stores, jewelry store chains, online, television shopping channels, department stores, and catalogs. We primarily sell to distributors and finished jewelry manufacturers, which in turn sell to retailers. In addition to this customer base, we anticipate that in 2010 we will also provide finished moissanite jewelry to some retailers, including television shopping channels.

As a result of retail price points in relation to other gemstones, we believe that moissanite jewels provide retailers with an opportunity to earn a profit margin from the moissanite jewelry category that compares favorably with other jewelry products as well as provide the consumer with a wider range of price points from which to choose. We also believe moissanite jewelry margins create incentives for retailers to maximize their sales and promotional efforts, which may result in additional consumer demand for our moissanite jewels.

We continue to evaluate the most appropriate structure for distribution in North America and may, in certain circumstances, enter into direct distribution arrangements, including arrangements with selected department stores, specialty jewelry chains, and distribution channels such as moissanite retail stores, catalog sales, or Internet sales.

As part of the settlement agreement we entered into with Reeves Park in January 2009, we assumed operating responsibility for the 2009 schedule of trunk shows for JCPenney. In September 2009, JCPenney canceled the remaining trunk shows. As we seek to reposition moissanite and connect with consumers, we will continue to support trunk shows with retailers in the future that will enable us to introduce moissanite jewelry at new points of distribution and improve sales at existing retailers. We seek to participate with retailers in training their sales and marketing personnel in moissanite sales positioning and strategies and in working with them to create focused advertising and promotional efforts to publicize trunk shows and other special sales events at select store locations. In addition, to facilitate new or expanded distribution, we have allowed inventory to be placed in stores on a consignment basis.

We generally have contracts and agreements with our distributors and manufacturers with some variations in terms and duration. Beginning in the latter part of 2008 and into 2009, we permitted some of these agreements to expire as we renegotiated select agreements with existing distributors and manufacturers that we felt were viable to our future strategy. We also identified key distributors and manufacturers with specific retailers in their portfolios fitting our future strategy with which we are negotiating to allow exclusive moissanite jewelry relationships with these retailers.

International – We believe there was a continued concentration on global congruency of the marketing message of moissanite in 2009. Most of our international distributors continue to educate their clients and consumers about our jewel. Distributors that adhere to our branding guidelines have been eligible for cooperative advertising and marketing allowances. Recognizing that each distributor's approach to market can be as unique as the culture in which they operate, we relaxed our branding guidelines to accommodate more flexibility in order to achieve greater acceptance in more markets. We continue to educate, work with, and support our distributors as they develop advertising, marketing, and public relations campaigns that are designed to be successful in their markets. With the world market opportunities being an integral part of our overall goals, we will continue to explore international promotional support initiatives.

In October 2000, we established a wholly-owned subsidiary in Hong Kong, Charles & Colvard (HK) Ltd., for the purpose of gaining better access to the Far East markets. In August 2003, to enhance our presence in this market, we established a Charles & Colvard controlled company in China named Guangzhou Charles & Colvard Trading Limited. During 2008, we closed the operations of both our Hong Kong subsidiary and the controlled company in China in an effort to contain costs.

We currently have distributors for moissanite jewels covering portions of Western Europe, Australia, India, and certain countries in Southeast Asia and the Middle East. We have approximately 25 international distributors and may increase this number. We have continued to invest in certain international markets that we believe have the most potential with respect to acceptance and sales of the moissanite jewel. Export sales aggregated approximately $3.0 million, or 36% of total sales, and $4.4 million, or 30% of total sales, in 2009 and 2008, respectively. It should be noted that a portion of our international sales consists of jewels sold internationally that are re-imported to North American retailers. More details on our financial information by geographic area are included in Note 2 to our consolidated financial statements included in Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

Seasonality

Sales in the retail jewelry industry are typically seasonal due to increased consumer purchases during the Christmas and holiday season. Because we primarily sell our jewels direct to manufacturers and distributors, our sales to support the holiday season largely take place during the third and beginning of the fourth calendar quarters, depending on the level of advance planning and production our customers undertake; 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 position held by our customers. We have not experienced a high degree of seasonality over the past several years as a result of the high level of inventory in the sales channels. However, these factors may in the future significantly affect our sales in a given quarter.

Working Capital Practices

Our primary source of working capital is cash on hand and cash generated by operations. Because our supply agreements prohibit our suppliers from selling SiC crystals for jewelry applications to anyone but us, our suppliers negotiate minimum purchase commitments with us that may result in inventories that are higher than we might otherwise maintain. Our current inventory levels are sufficient to enable us to respond promptly to customer orders and we currently have no material order backlogs.

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Our standard payment terms are generally between 30 and 90 days. We extend credit to our customers based upon a number of factors, including an evaluation of the customer's credit history, the customer's payment history with us, the customer's reputation in the trade, and an evaluation of the customer's opportunity to introduce our jewel to new or expanded markets.

Our general return policy is that jewels can only be returned for credit within 30 days of shipment and must be returned for a valid reason (such as quality problems or a shipment of the wrong jewels). Some customers, however, have a contractual right to return a certain percentage of sales for any reason for specific periods of time. 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 inventory to customers on consignment, or memo, terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period.

Competition

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 jewel competes with fine gemstones such as ruby, sapphire, emerald, and tanzanite as well as with natural, synthetic, and treated diamonds. 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, have substantially greater financial, technical, manufacturing, and marketing resources and greater access to distribution channels than we do.

We market our unique jewel as an affordable, luxurious alternative to diamond at price points that make our jewel more attainable by many consumers. The diamond industry enjoys higher consumer desirability and acceptance, which has been iconicized by the "Diamonds are Forever" marketing campaign. Historical efforts to differentiate moissanite from diamond as a unique jewel by virtue of its distinctive composition and its superior optical characteristics remains a challenge, as moissanite resembles diamond in the eyes of consumers. Therefore, we have shifted our marketing strategy of moissanite to be a high quality alternative to diamond beginning in the fourth quarter of 2009.

The worldwide market for large, uncut, high-quality natural diamonds is significantly consolidated and controlled by DeBeers (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.

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 for the past 20 years in the jewelry industry 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; however, most synthetic diamonds that are sold today are in the yellow color range. Although we believe that colorless gemstone-quality synthetic and treated diamonds presently cannot be produced at prices competitive with those currently offered for our near-colorless moissanite jewels, there can be no assurances that such competitive prices cannot be achieved in the future by the producers of either or both of synthetic and treated diamonds. The primary producers of synthetic diamonds used for industrial applications are DeBeers, Sumitomo, and GE. There are also a number of Russian producers of synthetic diamonds for industrial uses. In addition, companies such as Gemesis Corporation, Chatham, and Apollo Diamonds are, we understand, synthesizing diamonds in limited quantities, limited carat sizes, and in limited ranges of color. Synthetic diamond

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films can be grown at commercially viable prices in thicknesses that can be applied to various surfaces such as other synthetic materials.

Although we believe that our products have a proprietary position, we could face competition from other companies that develop competing SiC technologies. Some of these technologies could be developed by producers of SiC used for other industrial applications. Manufacturers of industrial SiC products include The Carborundum Corporation (currently for abrasive uses); and Cree, Siemens AG, Norstel, Bridgestone ABB, Dow Chemical, SiC Crystal AG, and Northrop Grumman Corporation (currently for semiconductor uses). We believe that Cree and Norstel are currently the only suppliers of SiC crystals in colors, sizes, and volumes that are suitable for gemstone applications. It is possible, however, that these or other producers of SiC could develop SiC crystals suitable for gemstone applications and produce moissanite jewels until we could obtain judicial enforcement of our patent rights. It is also possible that such competition could emerge in geographic territories where we might not have adequate patent protection.

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 introduction 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.

We intend to compete primarily on the basis that moissanite is the highest quality, affordable alternative available to more expensive gemstones such as diamond. Based on its retail price points, especially in the one-carat size and larger, and its exceptional brilliance, fire, luster, durability, and rarity, we will continue to focus our marketing efforts expounding moissanite as a primary consumer choice in fine jewelry. In addition, we believe that the Charles & Colvard Created Moissanite® brand, which is being developed pursuant to our marketing programs, may create a long-term competitive advantage for our products as we build brand recognition. Our competitive success is reliant upon, in part, the following:

- the increasing interest and demand for moissanite jewelry at the consumer level;
- the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote Charles & Colvard Created Moissanite® jewels to the retail jewelry trade;
- the willingness of distributors, retailers, and others in the channel of distribution to purchase loose Charles & Colvard Created Moissanite® jewels and the willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;
- the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;
- the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in jewelry with high quality workmanship; and
- the ability of retail jewelers to effectively market and sell jewelry containing Charles & Colvard Created Moissanite® to consumers.

Government Regulation

We are subject to governmental regulations in the manufacture and sale of moissanite jewels. In particular, the Federal Trade Commission, or FTC, has the power to restrict the offer and sale of products that could deceive or have the tendency or effect of misleading or deceiving purchasers or prospective purchasers with regard to their type, kind, quality, character, origin, or other characteristics. 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. If our actions are found to be in violation of FTC regulations, we could be forced to suspend marketing of our products and could incur significant expenses in developing new marketing strategies and materials that would not violate FTC regulations.

Research and Development

We invested $401,000 and $114,000 in research and development during the years ended December 31, 2009 and 2008, respectively, primarily for the study of product diversity.

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Employees

At March 25, 2010, we had a total of 26 employees, 25 of which are full-time. None of our employees are represented by a labor union. We believe that our employee relations are good.

Directors and Executive Officers of the Company

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

George R. Cattermole
Chairman of the Board

H. Marvin Beasley
Retired former Chief Executive Officer of Helzberg Diamonds, a retail jewelry store chain

Laura C. Kendall
President of Tanner Companies, LLC, which designs and manufactures women's high fashion luxury apparel

Dr. Charles D. Lein
Retired former President and Chief Operating Officer of Stuller, Inc., a manufacturer and distributor of jewelry and jewelry-related products

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:

Randall N. McCullough
President and Chief Executive Officer

Timothy L. Krist
Chief Financial Officer and Treasurer

Thomas G. Pautz
Vice President, Sales & Marketing

Available Information

Our corporate information is accessible through our Internet website at http://www.charlesandcolvard.com or http://www.moissanite.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 is available without charge upon written request to Investor Relations, Charles & Colvard, Ltd., 300 Perimeter Park Drive, Suite A, Morrisville, North Carolina 27560.

Risk Factors

Item
1A.

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.

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Our future financial performance depends upon increased consumer acceptance and growth of sales of our products. 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 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 are subject to a significant amount of uncertainty. Our future financial performance will depend, in part, upon greater consumer acceptance of moissanite jewels as an affordable, luxurious alternative to other gemstones, such as diamond, with exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market. In addition, consumer acceptance may be affected by retail jewelers' and jewelry manufacturers' acceptance of moissanite jewels. We primarily market loose jewels, which jewelry distributors, manufacturers, and retailers set in jewelry and in turn distribute or sell to consumers.

The quality, design, and workmanship of the jewelry settings selected by retail jewelers, which is not within our control, could affect both consumers' perception and acceptance of our jewels and costs incurred by returns and markdowns. Thus, our future financial performance may be affected by:

- the increasing interest and demand for moissanite jewelry at the consumer level;
- the willingness and ability of our jewelry distributors and other jewelry suppliers, manufacturers, and designers to market and promote moissanite jewels to the retail jewelry trade;
- the willingness of distributors, retailers, and others in the channel of distribution to purchase loose moissanite jewels and the willingness of manufacturers, designers, and retail jewelers to undertake setting of the loose jewels;
- the ability of manufacturers, designers, and retail jewelers to select jewelry settings that encourage consumer acceptance of and demand for our jewels;
- the ability of jewelry manufacturers and retail jewelers to set loose moissanite jewels in jewelry with high quality workmanship; and
- the ability of retail jewelers to effectively market and sell moissanite jewelry to consumers.

In addition, we are currently exploring opportunities in finished jewelry featuring our moissanite jewels that we would design, manufacture, and market under exclusive brands for sale to distributors and retailers in non-conflicting sales channels. Despite our efforts to pursue such a strategy in non-conflicting sales channels, some of our current customers may perceive us as a competitor and, in response, reduce their orders for our products. This reduction in orders could occur faster than our sales growth in this potential new sales initiative. We would also be dependent upon consumer acceptance of our finished jewelry designs and, should our products not receive greater market acceptance, our business, operating results, and financial condition would be materially and adversely affected.

Our company is in a state of flux and our success is contingent upon achieving multiple critical objectives. Our company has undergone significant changes in the past twelve months. On February 3, 2009, we entered into a management services agreement with Bird Capital Group, Inc., or BCG, that included the services of Richard A. Bird, a then current director, as our full-time non-employee Chief Executive Officer. On February 5, 2009, we ended our employment relationship with three executive officers: Dennis M. Reed, who had served as President and Chief Marketing Officer since March 2007 and principal executive officer since July 2008; Carl A. Mielke, Senior Vice President of Sales; and Steven L. Abate, Vice President of Operations. On June 7, 2009, Neil Boss, the Controller of our company since 2002, resigned as our principal financial officer and principal accounting officer effective on June 23, 2009, the date Timothy Krist was appointed our new Chief Financial Officer. On June 22, 2009, we dismissed Deloitte & Touche LLP as our independent registered public accounting firm and engaged FROST, PLLC, which subsequently merged with another firm to become Frazer Frost, LLP on January 1, 2010, as our independent registered public accounting firm for the fiscal year ending December 31, 2009. On June 26, 2009, the Board appointed Dr. Charles D. Lein to serve as a director of the Company. On July 2, 2009, we, BCG, and Richard A. Bird mutually agreed to terminate the management services agreement with BCG, including the resignation of Mr. Bird as our Chief Executive Officer and a member of our Board of Directors. Our current Chairman of the Board, George R.

Cattermole, was appointed our Interim Chief Executive Officer on July 17, 2009 while the search for a permanent Chief Executive Officer was being conducted by our Board. On October 12, 2009, we appointed Thomas G. Pautz as our Vice President, Sales and Marketing. On November 5, 2009, we appointed Randy N. McCullough as our new President and Chief Executive Officer and H. Marvin Beasley as a new member of our Board of Directors. These changes have been disruptive to our business as the new personnel and independent registered public accounting firm become acclimated to our processes and our unique business circumstances.

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Our business strategy is also currently being restructured under the new management team to more effectively position moissanite against diamonds and diamond substitutes in the highly competitive jewelry market while also continuing to identify opportunities to reduce operating expenses.

We believe our success to a significant extent is reliant upon on our new executive management team's ability to develop and implement a successful business strategy; to successfully lead and motivate our employees; and to work effectively with other members of our management team, our Board of Directors, and other stakeholders in our company. There can be no assurance that our changes in management will lead to an improvement in our results of operations. If the leadership transition is not successful, we may experience further disruption to our operations, which may have a material adverse affect on our business and financial condition.

A further decline in sales could continue to have a material adverse effect on us and our results of operations. We have experienced a declining trend in our annual sales in recent years: $40.7 million in 2006; $27.8 million in 2007; $14.7 million in 2008; and $8.3 million in 2009. These sales declines and the resulting operating losses in 2008 and 2009 have adversely impacted our relationships with our suppliers and customers, and they have affected our ability to retain key employees. Due to the large inventory position we currently have, we reduced our manufacturing levels in 2008 and, with the exception of custom orders, ceased manufacturing in 2009. We expect our make-to-stock manufacturing to be very limited until our inventory position is more in line with our sales. We made no raw material purchases in 2009, and deferred purchase commitments have resulted in significant price increases that will likely affect future gross margin percentages. We have no assurance that the quality of the raw material crystals we receive in the future will not be affected by the reduced purchase levels or that our raw material suppliers will be able to timely deliver increased quantities to us should we require a return to a higher level of purchases.

Our business and our results of operations could be materially adversely affected as a result of general economic and market conditions, including the current economic crisis. Global financial markets have been experiencing extreme disruptions, including severely diminished liquidity and credit availability, declines in consumer confidence, declines in economic growth, increases in unemployment rates, and uncertainty about economic stability. We are unable to predict the likely duration and severity of the current disruptions in the financial markets and the adverse global economic conditions, and if the current uncertainty continues or economic conditions further 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. The recent reduction in consumer discretionary spending, largely attributed to the conditions described above, has affected our industry more significantly than many other industries. Consumer discretionary spending is strongly affected by economic factors outside our control, including the condition of financial markets, consumer credit availability, prevailing interest rates, energy costs, employment levels, salary levels, and tax rates. A continued reduction in discretionary consumer spending could have a material adverse effect on our business and financial condition.

We expect to remain dependent upon Cree for the 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 jewel, 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 near-colorless SiC crystals. Under the Cree Exclusive Supply Agreement, we are obligated to buy from Cree, and Cree is obligated to sell to us, at least 50%, by dollar volume, of our requirements for SiC material for the production of gemstones in each calendar quarter through June 2015. In February 2005, in an attempt to diversify our supply base, we entered into the Norstel Exclusive Supply Agreement, which was amended in April 2008 and October 2008, as a secondary supplier of SiC crystals. However, Norstel has not demonstrated to date the ability to consistently grow high-quality SiC crystals that meet our requirements.

Cree is currently providing SiC crystals sufficient to meet our requirements. 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 purchase commitments at acceptable prices that enable us to manage our inventories and raw material costs effectively.

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Norstel may contest our position regarding our purchase obligations under the Norstel Exclusive Supply Agreement. As part of the Norstel Exclusive Supply Agreement, we advanced Norstel $400,000 in 2005 for the purchase of certain equipment. In December 2009, we received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. Though we did not consent to the composition offer, we received notice in January 2010 that the District Court of Norrköping had approved it, and we received a cash payment of $56,127 in February 2010. It is our position that, as a result of the failure of Norstel to repay the advance in full as stipulated in the Norstel Exclusive Supply Agreement, we have no further purchase obligations under the agreement. There can be no assurance that Norstel may not contest this, which may result in legal defense costs that could have an adverse effect on our business, results of operations, and financial condition.

We are currently substantially dependent on a limited number of distributors and jewelry manufacturers for the sale of our jewels in North America. We anticipate that the majority of the moissanite jewels that we sell in North America will be distributed through a limited number of manufacturers and distributors, and therefore, we are substantially dependent upon these companies for distribution of moissanite jewels in North America. During 2009, our five largest customers accounted for 51% of net sales, one of which represented 19% of net sales. In late 2007, we terminated our manufacturing agreement with K&G Creations (one of our largest customers in 2007), and in 2008, we terminated our manufacturing agreement with Reeves Park (one of our largest customers in 2007 and 2008). This disruption in our distribution model was significant and we have not yet replaced the sales volume lost as a result of these events.

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, and companies developing other synthetic jewelry technologies. A substantial number of companies supply products to the jewelry industry, many of which we believe have greater financial resources than we do. Competitors could develop new or improved technologies that may render the pricing point for moissanite noncompetitive, which would have an adverse effect on our business, results of operations, and financial condition.

The financial difficulties or insolvency of one or more of our major customers could adversely affect results. We are subject to a concentration of credit risk amongst our major customers 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. We estimate an allowance for accounts for which collectibility is at risk and this allowance adversely impacts profitability. In the event customers experience greater than anticipated financial difficulties or insolvency, we expect profitability to be adversely impacted by our failure to collect accounts receivable in excess of the estimated allowance. Given the current economic environment, constrained access to capital and general market contractions may heighten our exposure to customer default.

We are subject to certain risks due to our international distribution channels and vendors. We currently have approximately 25 international distributors for moissanite jewels covering portions of Western Europe, Australia, India, and certain countries in Southeast Asia and the Middle East. Our long-term strategy is to expand the number of international markets for our products. In addition, we expect to use certain companies based outside the United States 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 United States. These risks include the following:

- the adverse effects on United States-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 the 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; and
- the burdens of complying with a variety of foreign laws and other factors beyond our control.

Additionally, while the majority 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 these 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.

We rely upon our ability to protect our intellectual property. We have United States product and method patents for moissanite jewels under which we believe that we have broad, exclusive rights to manufacture, use, and sell moissanite jewels in the United States. We have these same patents in a number of foreign jurisdictions. We believe that these patents create substantial technological barriers to our potential competitors. At the present time, we are also 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 or Cree will provide any significant commercial protection, that we or Cree will have sufficient resources to protect our respective patents, 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 or Cree seek to enforce our respective rights against an infringer. 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. Our former South Korean patent is no longer valid as a result of a ruling by the South Korean Patent Court, and there can be no assurance that we will not incur similar outcomes in the future.

In addition, 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 patents owned or licensed by us or Cree.

As a result of the foregoing factors, 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, operating results, and financial condition.

Governmental regulation and oversight might adversely impact our operations. We are subject to governmental regulations in the manufacture and sale of moissanite jewels. In particular, the FTC has the power to restrict the offer and sale of products that could deceive or have the tendency or effect of misleading or deceiving purchasers or prospective purchasers with regard to their type, kind, quality, character, origin, or other characteristics. 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 jewel products. If our production or marketing of moissanite jewels is challenged by governmental agencies or competitors, or if regulations are issued that restrict our ability to market our products, our business, operating results, and financial condition could be materially adversely affected.

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. The majority of price increases in precious metals are passed on to the 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 2009, the price of gold has increased significantly (approximately 110%), 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.

Some anti-takeover provisions of our charter documents, agreements, and plans 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 the 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.

Under the terms of the Cree Exclusive Supply Agreement, we are prohibited from entering into an exclusive

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marketing or distribution agreement with DeBeers or its affiliates or any party whose primary business is the development, manufacture, marketing or sale of diamond gemstones or any non-gemstone and non-jewelry industry competitor of Cree. The agreement also prohibits us from entering into certain merger, acquisition, sale of assets or similar transactions with a prohibited party. These provisions of the agreement could limit the price that third parties might be willing to pay in the future for some or all of the shares of our common stock. In addition, this agreement could prevent us from entering into certain potentially profitable transactions with such prohibited parties.

On February 21, 1999, we adopted a Shareholder Rights Plan, or the Rights Plan, under which all shareholders of record as of March 8, 1999, received rights to purchase shares of a new series of preferred stock. Each share of common stock issued after March 8, 1999 has received the same rights. The Rights Plan, as modified by an amendment dated February 18, 2009, remains in full force and effect.

The Rights Plan is designed to enable all of our shareholders to realize the full value of their investment and to provide for fair and equal treatment for all shareholders in the event that an unsolicited attempt is made to acquire us. The adoption of the Rights Plan is intended as a means to guard against abusive takeover tactics and is not in response to any particular proposal. The rights, which expire in 2019, will be exercisable only if a person or group acquires 20% or more of our common stock or announces a tender offer for 20% or more of the common stock. If a person or group acquires 20% or more of our common stock, all shareholders except the purchaser will be entitled to acquire our common stock at a 50% discount. The effect will be to discourage acquisitions of more than 20% of our common stock without negotiations with our Board of Directors.

The rights will trade with our common stock, unless and until they are separated upon the occurrence of certain future events. Our Board of Directors may redeem the rights prior to the expiration of a specified period following the acquisition of more than 20% of our common stock.

If we fail to evaluate, implement, and integrate strategic 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, diversion of management attention, retention of existing customers of our current and 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.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

We lease approximately 16,500 square feet of mixed-use space (general office, light manufacturing, and laboratory) in the Research Triangle Park area of North Carolina from an unaffiliated third party. This lease expires in July 2011. This space houses the majority of all United States personnel, including our executive offices, sales offices, administrative personnel, and production facilities. This space is being fully utilized and management considers this space to be sufficient for our foreseeable needs over the next 12 months.

Item 3. Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or to which any of the Company's property is subject.

Item 4. (Removed and Reserved)

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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 Global Select Market under the symbol "CTHR." 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. As of March 25, 2010 there were 293 shareholders of record of our common stock.

	High	Low
Year Ended December 31, 2008:		
First Quarter	$2.26	$1.12
Second Quarter	$1.40	$1.06
Third Quarter	$1.17	$0.48
Fourth Quarter	$0.62	$0.18
Year Ended December 31, 2009:		
First Quarter	$0.55	$0.20
Second Quarter	$0.60	$0.29
Third Quarter	$0.96	$0.32
Fourth Quarter	$1.85	$0.44

We did not pay any dividends on our common stock during 2009 or 2008. We will regularly review and consider the best policies and practices for the Company, including the dividend policy. The payment of future dividends will be dependent on the facts and circumstances at the time of that review.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs (2)
October 1 – October 31, 2009	-	$ -	-	-
November 1 – November 30, 2009	148,708	$ 1.07	41,670	958,330
December 1 – December 31, 2009	53,541	$ 1.22	-	-
Total	202,249	$ 1.11	41,670	958,330

(1) This column includes 160,579 shares purchased by our executive officers and directors in open market transactions that were not made pursuant to our share repurchase program, as follows: H. Marvin Beasley, 10,000 shares; George R. Cattermole, 30,000 shares; Laura C. Kendall, 10,000 shares; Timothy L. Krist, 5,000 shares; Charles D. Lein, 16,537 shares; Randy N.

McCullough, 25,000 shares; and Ollin B. Sykes, 64,042 shares.

(2) On November 13, 2009, our Board of Directors authorized a share repurchase program of up to an aggregate 1 million shares of our common stock until August 12, 2010 in open market or private transactions. We have no obligation to repurchase shares under the program, and the program may be suspended or terminated at any time. On November 20, 2009 we made a block purchase on the open market of 41,670 shares at $1.21 per share.

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." Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

Overview

We manufacture, market, and distribute Charles & Colvard Created Moissanite® jewels (which we refer to as moissanite or moissanite jewels) for sale in the worldwide jewelry market. Moissanite, also known by its chemical name of silicon carbide, or 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 our advantage of being the sole source worldwide of lab-created moissanite jewels, our strategy is to establish Charles & Colvard with reputable, high-quality, and sophisticated brands and to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond. We believe this is possible due to moissanite's exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market.

We primarily sell loose moissanite jewels to some of the largest jewelry manufacturers and distributors in the world, which mount them into fine jewelry. We have also begun to wholesale a limited amount of finished moissanite jewelry. We have historically marketed moissanite to the self-purchasing woman as the perfect reward or indulgence to celebrate her achievements or milestones in life. However, in 2009, we expanded our marketing message beyond the self-purchasing woman, and with the assistance of our recently engaged marketing agency, we are revising our messaging to expand moissanite's global reach, increase market awareness of our moissanite jewels, develop additional marketing channels to the jewelry trade and the consumer, and help create a more compelling consumer value proposition that we believe will drive increased demand for our product.

The implementation of our strategy and corresponding messaging has been inhibited by several unfavorable conditions. The global economic recession resulted in a significant slowdown in the retail environment, with the impact on the jewelry industry particularly severe. We believe that market conditions are stabilizing, and we continue to receive feedback from channel partners that demand is improving. Despite this, a number of major retailers have excessive inventories of moissanite jewelry and have curtailed their purchases from jewelry manufacturers to which we sell our moissanite jewels. As a result, our 2009 net sales were 44% less than 2008 net sales. To reduce the impact of reduced sales to our net profit, we achieved a $10.0 million reduction in costs and expenses in 2009 as a result of decreased sales, very tight cost control, a reduction in headcount, and decreased expenses for sales and marketing programs, bad debt, and severance expenses, as well as a non-recurrence of subsidiary cessation expenses that we incurred in 2008. Net loss for 2009 was $3.4 million, or $0.18 per diluted common share, compared with a net loss of $6.2 million, or $0.34 per diluted common share, for 2008. Net loss for 2008 benefited from a $633,000 income tax benefit. We did not recognize an income tax benefit for our operating losses during 2009 due to the uncertainty of sufficient future taxable income to utilize our deferred tax assets.

Because of this difficult operating environment, our current priority is to generate positive cash flow and to strengthen our financial position through cost-cutting initiatives and selling down our inventory. We also have been working to expand our industry expertise at the Board and senior management levels. In the second quarter of 2009, we added Dr. Charles D. Lein to our Board of Directors, who has more than 27 years of experience in the jewelry, wholesale, and retail industries. In October 2009, we hired Thomas G. Pautz, who has more than 25 years of sales and marketing experience in the jewelry industry, as our Vice President, Sales and Marketing. In November 2009, we also added H. Marvin Beasley to our Board of Directors, who has more than 36 years of experience in the retail jewelry industry, and Randy McCullough as our new Chief Executive Officer, who we also expect to be nominated as a director candidate for election at our next annual meeting of shareholders. We believe Mr. McCullough's 36 years of diverse, progressive responsibilities in the jewelry industry will be a valuable resource as he leads us in defining new sales, marketing, and product placement strategies. Under Mr. McCullough's leadership, we evaluated the price sensitivity of moissanite and effected a price reduction in December 2009 to stimulate sales to a broader market. We also endeavor to become more consumer-centric and are working with our new marketing agency to help redefine our messaging to the consumer. We fully recognize the challenges of our business in the current economy, and our legacy issues divert resources from future strategic initiatives. It will take time to accomplish the

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improvements we seek. However, we believe that we have made much progress in building the right leadership team to define a strategic roadmap that can significantly improve our business.

2009 Summary

The following is a summary of key financial results and certain non-financial results achieved for the year ended December 31, 2009:

- Our total net sales for the year were $8.3 million, a decrease from 2008 of $6.4 million, or 44%. This overall decrease in revenues was primarily attributable to the ongoing economic recession, which has measurably affected the retail and jewelry industries, combined with the termination of our manufacturing agreement with Reeves Park during the fourth quarter of 2008 and reduced demand from major retailers who curbed purchases due to current levels of moissanite inventory and slow sell-through to consumers.

- Our costs and expenses for the year were $11.7 million, a decrease from 2008 of $10.0 million, or 46%. This decline was primarily attributable to lower sales as well as cost-control initiatives, including a reduction in headcount and decreased expenses for sales and marketing programs. Included in 2009 costs and expenses were $595,000 of management fees paid to BCG, $425,000 in severance expenses, a $146,000 loss on impairment of idle manufacturing equipment, and a $170,000 bad debt expense on a note receivable with Norstel, as discussed further below. We do not expect such extraordinary expenses in future periods.

- Our loss from operations for the year was $3.4 million, a decrease from 2008 of $3.5 million, or 51%. This amount includes the effects of the loss on impairment of long-lived assets of $146,000 and the bad debt expense of $170,000 discussed above. Net loss per basic and fully diluted share was $0.18 in 2009 compared to $0.34 in 2008.

- Cash and cash equivalents at December 31, 2009 were $7.4 million compared to $5.6 million at December 31, 2008. The primary reasons for this increase is a $1.9 million cash flow from operations that included receipt of a $2.1 million income tax refund from the Internal Revenue Service resulting from net operating loss carrybacks that we utilized after recognizing losses from the cessation of our Hong Kong subsidiary, a reduction in accounts receivable of $1.5 million, and a $3 million sell-down of inventory, partially offset by a $1.4 million decrease in accounts payable and our $3.4 million net loss.

- We made no SiC crystal raw material purchases in 2009 while maintaining our long-term exclusive supply agreements with our suppliers.

- We continue to carry no long-term debt.

- During 2009, we increased our jewelry industry experience by adding two directors to our Board and two members to our executive management team, including our new Chief Executive Officer, Randy N. McCullough, who most recently served as Chief Executive Officer at Samuel’s Jewelers and has more than 36 years of diverse, progressive responsibilities in the jewelry industry.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our financial statements, which we prepared in accordance with accounting principles generally accepted in the United States, or U.S. GAAP. The preparation of these 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 cooperative advertising. We also have other policies that we consider key accounting policies, the most significant

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of which is our policy for revenue recognition; however, this policy typically does not require us to make estimates or judgments that are difficult or subjective.

Inventories - Inventories are stated at the lower of cost or market determined on a first in, first out basis. Our finished goods inventory consists primarily of near-colorless moissanite jewels that meet rigorous grading criteria and are of cuts and sizes most commonly used in the jewelry industry. Any inventory in excess of our current requirements based on anticipated levels of sales is classified as long-term on our consolidated balance sheets. Our classification of long-term inventory requires us to estimate the portion of inventory that can be realized over the next 12 months. As of December 31, 2009, we carried only a limited amount of moissanite jewels in finished jewelry settings and the jewelry inventory that we do carry is valued at scrap value, or the amount we 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. Our moissanite jewel inventories do not degrade in quality over time and are not subject to fashion trends. We have very small market penetration in the worldwide jewelry market and have the exclusive right through 2015 to produce and sell lab-created SiC for use in jewelry applications. In view of the foregoing factors, we have concluded that no excess or obsolete loose jewel inventory reserve requirements existed as of December 31, 2009.

During 2002, we established a lower of cost or market reserve of $400,000 to allow for a portion of the finished goods inventory to be re-cut. There are certain jewels in inventory that can be re-cut to achieve higher quality standards. To determine this reserve, we estimated the amount of inventory that is anticipated to be re-cut and the amount of weight loss that will occur during the process. Since the establishment of this reserve, we have not yet re-cut any jewels and, therefore, at December 31, 2009 the reserve remained at $400,000.

Inventories are also shown net of a jewelry reserve of $1,348,000 and $245,000 at December 31, 2009 and 2008, respectively. All jewelry inventories are finished goods, the majority of which we do not actively market. As a result, a jewelry inventory reserve was established to reduce the majority of the jewelry inventory value to scrap value. The large increase in the reserve during 2009 was due to jewelry inventory received from Reeves Park as part of a settlement on its trade account receivable. To determine the amount of the jewelry reserve, we needed to estimate the amount of gold in each piece of jewelry, the price per ounce we will receive for the gold, and the amount of jewels that could be returned to finished goods inventory following a melt.

Accounts and Note Receivable Reserves - Estimates are used to determine the amount of two reserves against accounts receivable. The first reserve is an allowance for returns. At the time revenue is recognized, we estimate future returns and reduce sales and accounts receivable by this estimated amount. This amount is estimated using our historical return rate and considers any contractual return privileges granted to customers. The allowance for returns was $145,000 and $295,000 at December 31, 2009 and 2008, respectively. Second, an allowance for doubtful accounts is established to reduce accounts receivable to an amount expected to be collected. Based on our collection history, 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 receivables. Any increases or decreases to this allowance are charged or credited to general and administrative expenses. Any accounts with significant balances are reviewed separately to determine an appropriate allowance based on the facts and circumstances of the specific account. During our review for 2008, we specifically reviewed and recorded an allowance for the balances owed to us by Reeves Park and K&G Creations. It was not necessary to review any individual customers separately during our review for 2009. The total allowance for doubtful accounts was $90,000 and $3,915,000 at December 31, 2009 and 2008, respectively. The portion of the allowance for doubtful accounts at December 31, 2008 attributable to Reeves Park was $2,615,000 and the portion attributable to K&G Creations was $1,175,000. During 2009, we settled the outstanding balances with each of these customers and no portion of our allowance for doubtful accounts at December 31, 2009 was attributable to either customer.

We evaluate the need for reserves on notes receivable as facts and circumstances regarding their collectibility become known to us. Our only note receivable at December 31, 2009 was $224,627, which represents the unpaid portion of a $400,000 advance made to Norstel as part of the Norstel Exclusive Supply Agreement. In December 2009, we received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. As a result, we recorded a reserve of $170,000 on the advance in the fourth quarter of 2009.

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Deferred Tax Assets - U.S. GAAP guidance requires that all deferred tax assets of the company be assessed to determine if a valuation allowance is required. A valuation allowance is required if it is determined that it is more likely than not, or greater than a 50% probability, that some portion or all of the deferred tax assets will not be realized. The guidance states further that "forming a conclusion that a valuation allowance is not needed is difficult when there is negative evidence such as cumulative losses in recent years." Based on our significant losses during 2008 and the lack of verifiable positive evidence of sufficient future taxable income to fully use our net operating loss carryforward and other deferred tax assets, we established a valuation allowance during 2008 of $1.6 million against certain United States deferred tax assets. Due to the continued losses in 2009, the valuation allowance against U.S. deferred tax assets was increased to $4.9 million, which fully reserved all deferred tax assets at December 31, 2009. This assessment will continue to be addressed in all future periods. Our deferred tax assets in Hong Kong are fully reserved with a valuation allowance and have been fully reserved in all prior periods due to the uncertainty of future taxable income in this jurisdiction to utilize the deferred tax assets. Our Hong Kong subsidiary 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 will impact our future operating results.

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 accrued income tax liability under the provisions of this guidance was $1.1 million and $3.2 million at December 31, 2009 and 2008, 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. The large decrease in our accrued income tax liability during 2009 resulted from a deduction on our 2008 tax return related to unpaid obligations due to us from our Hong Kong subsidiary that ceased operating during 2008. We determined that this deduction qualified as an uncertain tax position at December 31, 2008. During 2009, our 2008 income tax returns were examined by the Internal Revenue Service and these returns were determined to be accepted as filed, with certain immaterial adjustments. As a result, we no longer consider this tax deduction an uncertain tax position and reversed the $2.2 million accrued income tax liability during the year ended December 31, 2009. Despite the reversal of this liability, there was not a material effect on our 2009 operating results as we have now established a full valuation allowance against the deferred tax assets generated by this deduction.

Cooperative Advertising - We offer a cooperative advertising program to many of our customers that reimburses a portion of their marketing costs based on their net purchases from us. At the end of any given period, we estimate the amount of cooperative advertising expense that has not yet been submitted for credit by our customers. These amounts were $173,000 and $401,849 at December 31, 2009 and 2008, respectively. We estimate this amount based on our historical experience with each customer, and the related contractual arrangements to provide certain levels of cooperative advertising for our customers. Any differences in actual amounts to our estimates will result in a charge or credit to sales and marketing expenses. We did have a $128,000 reduction in sales and marketing expenses in the first quarter of 2009 due to overestimating the amount of 2008 cooperative advertising used by customers.

Revenue Recognition - Revenue is recognized and title passes when products are shipped from our facility, excluding consignment, or memo, shipments as discussed below. Our standard payment terms are generally between 30 and 90 days. Some customers are required to prepay prior to shipment. 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 allows for the return of jewels for credit within 30 days of shipment and must be returned for a valid reason, such as quality problems or a shipment of the wrong jewels. Some customers have a contractual right to return a certain percentage of goods for any reason. In these instances, we only recognize revenue when the contractual right of return is exhausted. Periodically, we sell jewels to customers on memo terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Our customers are generally required to make payments on memo shipments within 60 days upon the customer informing us that it will keep the jewels. Accordingly, we do not recognize revenue on these memo transactions until the earlier of (1) the customer informing us that it will keep the jewels or (2) the expiration of the right of return period.

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.

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Results of Operations

The following table sets forth certain consolidated statements of operations data for the years ended December 31, 2009 and 2008.

	Year Ended December 31, 2009	2008
Net sales	$8,312,470	$14,727,054
Costs and expenses:		
Cost of goods sold	3,472,842	5,592,879
Sales and marketing	1,949,576	7,466,266
General and administrative	5,702,609	8,454,567
Research and development	401,496	113,621
Loss on impairment of long-lived assets	145,800	-
Total costs and expenses	11,672,323	21,627,333
Loss from operations	(3,359,853)	(6,900,279)
Interest income	38,194	116,484
Loss before income taxes	(3,321,659)	(6,783,795)
Income tax benefit (expense)	(77,710)	632,667
Net loss	$(3,399,369)	$(6,151,128)

Net Sales

Net sales for the years ended December 31, 2009 and 2008 comprise the following:

	Year Ended December 31, 2009	2008	Change Dollars	Percent
Loose jewels	$7,056,659	$13,481,442	$(6,424,783)	-48 %
Jewelry	1,223,607	1,136,819	86,788	8 %
Other	32,204	108,793	(76,589)	-70 %
Total net sales	$8,312,470	$14,727,054	$(6,414,584)	-44 %

Net sales were $8,312,000 for the year ended December 31, 2009 compared to $14,727,000 for the year ended December 31, 2008, a decrease of $6,415,000 or 44%. During 2009, carat sales of moissanite jewels and jewelry decreased 41% to approximately 48,000 carats from 81,000 carats in 2008. Sales of moissanite jewelry represented 15% of total net sales in 2009 compared to 8% of total net sales in 2008. The majority of our moissanite jewelry sales in 2009 were to JCPenney for sales at trunk show events. JCPenney canceled these events after September 2009 with no plans to run them again in the future. We are pursuing new opportunities in finished jewelry in 2010, but if these opportunities do not come to fruition, we may experience a significant decline in our jewelry sales in 2010. In 2009, the average selling price per carat for our sales of loose jewels decreased 7% from 2008 primarily as a result of a special pricing in the first quarter of 2009. U.S. net sales accounted for approximately 64% and 70% of net sales during the year ended December 31, 2009 and 2008, respectively.

Both U.S. net sales and carat shipments, which do not include shipments of consigned inventory, decreased by 48% for the year ended December 31, 2009 as compared to the year ended December 31, 2008. U.S. sales decreased primarily due to the ongoing significant slowdown in the retail environment, reduced sales and excessive inventory of moissanite jewelry at retailers, and reduced purchases from jewelry manufacturers serving major retailers that sell moissanite jewelry. Some of our retailers have indicated they are experiencing less than desired inventory turns for their moissanite jewelry. There continues to be a pullback in consumer spending that has negatively affected the jewelry industry and exacerbated the moissanite jewelry retail inventory turn issue. While the year-over-year trends were unfavorable, we did experience a 3% increase in domestic sales and a 24% increase in international sales in the fourth quarter of 2009 as compared to the third quarter of 2009, and a 10% increase in sales overall between the two quarters. This improvement in orders placed by a number of our existing domestic and international customers occurred as we worked to regain their confidence in us and to resolve legacy issues. As the new management team continues to reposition moissanite and explore new opportunities for our product, we anticipate orders and related sales will improve in 2010; however, as existing retailers evaluate their businesses, we are at risk that some retailers may not be able to achieve acceptable financial performance and may choose not to continue selling moissanite jewelry.

Also negatively impacting revenue during the year ended December 31, 2009 was the termination of our manufacturing agreement with Reeves Park during the fourth quarter of 2008 due to its repeated failure to make timely payments on its open payables to us. We assisted those retailers supplied by Reeves Park to find an alternate supplier of moissanite jewelry if they chose to stay in the moissanite jewelry business, but a few of these retailers decided not to continue carrying moissanite jewelry. One of these retailers returned to us a consignment of Reeves Park jewelry that we assumed as part of our settlement agreement with Reeves Park. This retailer is still currently selling moissanite jewelry but has consolidated its inventory into fewer stores in an attempt to achieve better inventory turn. We did not have any sales to Reeves Park during the year ended December 31, 2009, and it accounted for 9% of our sales during 2008. We will likely continue to see a negative impact on our results of operations, at least in the near-term, due to current inventory levels and the loss of sales to retailers who chose not to continue carrying moissanite jewelry.

Our largest customer during the year ended December 31, 2009 accounted for 19% of our sales compared to 21% during the year ended December 31, 2008. No additional customers accounted for more than 10% of sales in 2009 or 2008. We expect that we will remain dependent on our ability and that of our largest customers to maintain and enhance their 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. One of the retailers carrying moissanite jewelry filed for Chapter 11 bankruptcy protection in March 2009 and, as part of a July 2009 stipulation and consent order entered with this customer, we are recording approximately $35,000 per month of sales through July 2010 on inventory previously held on consignment. We do not expect to receive new orders from this customer for the foreseeable future.

International net sales and carat shipments, which do not include shipments of consigned inventory, decreased by 33% and 25%, respectively, for the year ended December 31, 2009 as compared to the year ended December 31, 2008. International sales decreased during the year ended December 31, 2009 primarily due to reduced sales to India, Thailand, and Taiwan. A portion of our international sales represents jewels sold internationally that will be re-imported to North American retailers. Our top three international distributors during the year ended December 31, 2009 were located in Hong Kong, Italy, and the United Kingdom.

Costs and Expenses

Cost of Goods Sold

Cost of goods sold for the years ended December 31, 2009 and 2008 are as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
Cost of goods sold	$3,472,842	$5,592,879	$(2,120,037)	-38 %

Cost of goods sold was $3,473,000 for the year ended December 31, 2009 compared to $5,593,000 for the year ended December 31, 2008, a decrease of $2,120,000 or 38%. Cost of goods sold primarily is composed of inventory sold during the period; inventory written off during the period due to ongoing quality reviews or through customer returns; salaries and benefits for personnel involved in preparing and shipping product to customers; an allocation of shared expenses such as rent, utilities, communication expenses, and depreciation related to preparing and shipping product to customers; and outbound freight charges.

Cost of goods sold decreased primarily due to the 44% decrease in sales for the year ended December 31, 2009. Other factors that contributed to the decrease in 2009 was that cost of goods sold for the year ended December 31, 2008 included a larger quantity of damaged jewel returns than in 2009, a $185,000 increase during 2008 in our reserve on consigned inventory to allow for non-return or damage of certain jewels on consignment with customers, and a $220,000 increase during 2008 in our jewelry reserve. These factors were partially offset during the year ended December 31, 2009 by a $248,000 increase in jewelry reserves primarily due to an adjustment of the value of consigned jewelry inventory with a retailer in Chapter 11 bankruptcy protection as well as an increased allocation of expenses, previously capitalized as a cost of inventory, to cost of goods sold as a result of reduced manufacturing activities.

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Sales and Marketing

Sales and marketing expenses for the years ended December 31, 2009 and 2008 are as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
Sales and marketing	$1,949,576	$7,466,266	$(5,516,690)	-74 %

Sales and marketing expenses were $1,950,000 for the year ended December 31, 2009 compared to $7,466,000 for the year ended December 31, 2008, a decrease of $5,517,000 or 74%.

The decrease in sales and marketing expenses is primarily due to a $2,838,000 decrease in advertising expenses and a $1,627,000 decrease in compensation costs for the year ended December 31, 2009 as compared to the year ended December 31, 2008. Our cooperative advertising program reimburses a portion of our customers' marketing costs based on the amount of their purchases from us and is subject to the customer providing us documentation of all advertising copy that includes our products. Cooperative advertising expenses decreased by $1,032,000 in 2009 compared to 2008 primarily due to lower sales. Our direct advertising costs decreased by $1,805,000 in 2009 compared to 2008 because we reduced marketing activities as we assessed the effectiveness of our sales and marketing strategies. The decrease in compensation costs is primarily attributable to headcount reductions and reduced severance expense in our continuing effort to reduce costs.

General and Administrative

General and administrative expenses for the years ended December 31, 2009 and 2008 are as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
General and administrative	$5,702,609	$8,454,567	$(2,751,958)	-33 %

General and administrative expenses were $5,703,000 for the year ended December 31, 2009 compared to $8,455,000 for the year ended December 31, 2008, a decrease of $2,752,000 or 33%.

The decrease in general and administrative expenses is primarily due to a $2,386,000 reduction in bad debt expense, a $289,000 decrease in professional fees, and a $267,000 decrease in compensation costs during 2009 as compared to 2008. During the year ended December 31, 2008, we increased our allowance for bad debts by $2,100,000 for uncollectible accounts for Reeves Park and $475,000 to fully reserve the outstanding balance from K&G Creations. During 2009, bad debt expense totaled $297,000, primarily due to a $170,000 reserve established against our note receivable due from Norstel resulting from its composition offer to its creditors to accept 25% of outstanding debts as payment in full. Professional fees decreased primarily due to lower legal fees, offset in part by $595,000 in fees paid to BCG under its February 2009 management services agreement with us. The decrease in compensation costs is primarily attributable to headcount reductions in our continuing effort to reduce costs.

Research and Development

Research and development expenses for the years ended December 31, 2009 and 2008 are as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
Research and development	$401,496	$113,621	$287,875	253 %

Research and development expenses were $401,000 for the year ended December 31, 2009 compared to $114,000 for the year ended December 31, 2008, an increase of $288,000 or 253%.

The increase in research and development expenses during the year ended December 31, 2009 is primarily attributable to our December 2008 research and development agreement that required us to pay $50,000 per month for six months and concluded in May 2009.

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Loss on Impairment of Long-lived Assets

On a periodic basis, we review our long-lived assets for possible impairment. Loss on impairment of long-lived assets for the years ended December 31, 2009 and 2008 are as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
Loss on impairment of long-lived assets	$145,800	$-	$145,800	-

During 2009, we determined that certain of our idled manufacturing equipment was impaired because its carrying value of $183,300 exceeded future net undiscounted cash flows expected to be generated by the equipment due to the current large finished goods inventory position. As a result, a fair value adjustment in the amount of $145,800 was recorded as a loss on impairment, representing the carrying value less the estimated salvage value of $37,500. There was no impairment of long-lived assets in 2008.

Interest Income

Interest income for the years ended December 31, 2009 and 2008 is as follows:

	Year Ended December 31,		Change	
	2009	2008	Dollars	Percent
Interest income	$38,194	$116,484	$(78,290)	-67%

Interest income was $38,000 for the year ended December 31, 2009 compared to $116,000 for the year ended December 31, 2008, a decrease of $78,000 or 67%. This decrease resulted primarily from a lower interest rate earned on our cash balances.

Provision for Income Taxes

During 2008, we recorded a valuation allowance against certain deferred tax assets. Due to continued uncertainty over sufficient future taxable income to fully use these deferred tax assets, we did not record an income tax benefit for the losses incurred during the year ended December 31, 2009. During the year ended December 31, 2009, we recorded $78,000 of income tax expense primarily due to interest and penalties accrued under U.S. GAAP for uncertain tax positions. During 2008, we recorded an income tax benefit of $633,000 as a result of losses generated in 2008, partially offset by $80,000 in interest and penalties accrued under U.S. GAAP for uncertain tax positions. Our statutory tax rate is 38.5% and consists of the federal income tax rate of 34% and the North Carolina state income tax rate of 4.5%, net of the federal benefit.

During 2008, we ceased operations of our Hong Kong subsidiary and as a result, we had a significant tax deduction on our 2008 tax returns resulting from unpaid obligations of the subsidiary to us. At December 31, 2008, we determined that this deduction qualified as an uncertain tax position under U.S. GAAP and recorded a long-term accrued income tax liability of $2.2 million. During 2009, our 2008 income tax returns were examined by the Internal Revenue Service, and these returns were determined to be accepted as filed, with certain immaterial adjustments. As a result, we no longer consider this tax deduction an uncertain tax position and reversed the $2.2 million accrued income tax liability during the year ended December 31, 2009. Despite the reversal of this liability, there was not a material effect on our 2009 results of operations as we have now established a full valuation allowance against the deferred tax assets generated by this deduction.

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, 2009, our principal sources of liquidity were cash and cash equivalents totaling $7.4 million, trade accounts receivable of $1.0 million, and inventory of $3.5 million, as compared to cash and cash equivalents totaling $5.6 million, trade accounts receivable of $3.8 million, and inventory of $8.3 million as of December 31, 2008. Of the $3.8 million trade accounts receivable balance at December 31, 2008, $2.3 million related to Reeves Park with whom we completed a settlement agreement to eliminate the outstanding balance in 2009.

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During the year ended December 31, 2009, our working capital decreased by approximately $7.2 million to $11.6 million from $18.8 million at December 31, 2008. As described more fully below, the decrease in working capital at December 31, 2009 is primarily attributable to decreases in trade accounts receivable, continuing sales declines, and reclassifications of inventory between short-term and long-term.

During the year ended December 31, 2009, $1.9 million of cash was provided by operations primarily as a result of a $1.5 million decrease in accounts receivable (excluding the impact of the change in reserves and the non-cash purchase of inventory under the Reeves Park settlement), receipt of a $2.1 million income tax receivable from the Internal Revenue Service, and a $3.0 million decrease in inventory (excluding the impact of the non-cash purchase of inventory under the Reeves Park settlement), partially offset by a $1.4 million decrease in accounts payable and our $3.4 million net loss. Accounts receivable were down primarily due to cash collections, lower sales, and the impact of our settlement with Reeves Park. Our accounts payable are typically at their highest level at December 31 of each year due to our increased expenses for sales and marketing during the fourth quarter holiday season, and our decrease in accounts payable is due to payments made on these expenses as well as the overall reduction in expenses and inventory purchase commitments consistent with our efforts to reduce costs and inventory while conserving cash.

We did not make any purchases of raw material inventory during the year ended December 31, 2009. During 2008, we significantly reduced our raw material inventory purchase commitments from prior years to improve cash flow from operations. Further, in the fourth quarter of 2008, we were able to negotiate with our two leading raw material suppliers to defer purchases while keeping in place our long-term supply agreements. We expect our reduced and deferred purchase commitments to help us convert inventory into cash at a faster rate. Our raw material inventories of SiC crystals have been purchased under exclusive supply agreements with a limited number of suppliers. Because the supply agreements restrict the sale of these crystals exclusively to us, the suppliers have negotiated minimum purchase commitments with us that, combined with our reduced sales, have resulted in levels of inventories that are higher than we might otherwise maintain. Our current rate of sales and our high level of inventory resulted in $37.9 million of our inventories being classified as long-term assets at December 31, 2009.

The Cree Exclusive Supply Agreement for the supply of SiC crystals had an initial term of ten years that was extended in January 2005 to July 2015. In connection with the Cree Exclusive Supply Agreement, we have committed to purchase from Cree a minimum of 50%, by dollar volume, of our raw material SiC crystal requirements. If our orders require Cree to expand beyond specified production levels, we must commit to purchase certain minimum quantities. In September 2008, we entered into an agreement with Cree to delay our commitment to purchase $710,000 of SiC crystals during the fourth quarter of 2008. Effective March 22, 2010, we entered into a letter agreement with Cree in connection with the Cree Exclusive Supply Agreement under which we agreed to purchase approximately $1.2 million of SiC crystals over a period of approximately eight months in 2010 to satisfy this existing purchase commitment and to preserve the exclusivity terms of the Cree Exclusive Supply Agreement.

The Norstel Exclusive Supply Agreement for the supply of raw material SiC crystals was amended in April 2008 due to an update of Norstel’s delivery schedule and capability and also due to our desire to limit our purchase of raw materials. Under this amendment, our minimum purchase commitment from Norstel was to continue until (i) we have purchased an aggregate amount of approximately $7.9 million of SiC crystals, or (ii) September 26, 2011, whichever occurs first. As of December 31, 2009, we have purchased $550,000 of SiC crystals since inception of the Norstel Exclusive Supply Agreement. In October 2008, we entered into a new letter agreement with Norstel that suspended our commitment to purchase SiC crystals from Norstel during the fourth quarter of 2008.

In addition, as part of the Norstel Exclusive Supply Agreement, we advanced $400,000 to Norstel in 2005 for the purchase of certain equipment. This advance, which was in the form of a note receivable, began to be repaid in January 2007 through a 20% reduction on each invoice for subsequent purchases of SiC crystals. Effective March 1, 2008, pursuant to the April 2008 amendment, we began receiving a 30% reduction on each invoice for subsequent purchases of SiC crystals. The balance on the advance as of December 31, 2008 was $224,627. In December 2009, we received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. As a result, we recorded a reserve of $170,000 on the advance in the fourth quarter of 2009. Though we did not consent to the composition offer, we received notice in January 2010 that the District Court of Norrköping had approved it, and we received a cash payment of $56,127 in February 2010. It is our position that, as a result of the failure of Norstel to repay the advance in full as stipulated in the Norstel Exclusive Supply Agreement, we have no further purchase

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obligations under the agreement.

As of December 31, 2009, we had no trade accounts receivable from Reeves Park. As of December 31, 2008, we had trade accounts receivable from Reeves Park of $4.9 million, or 62% of receivables (not considering our allowances for uncollectible accounts or returns). In January 2009, we entered into a settlement agreement with Reeves Park to settle its outstanding balance by accepting a return of inventory, the receipt of certain cash payments due to Reeves Park from its customers, and the payment by Reeves Park of a settlement fee to us. Based on the $2.3 million estimated net realizable value of the transactions under the settlement agreement, we increased our allowance for uncollectible accounts at December 31, 2008 for Reeves Park to $2.6 million. The transactions under the settlement agreement are complete as of December 31, 2009 and the underlying allowance for uncollectible accounts is zero.

We received payment in April 2009 of a $2.1 million income tax receivable. We did not make any income tax payments during the year ended December 31, 2009 due to our loss position, and we have $434,000 of remaining federal income tax credits, $102,000 of which expire between 2014 and 2016 and the balance without an expiration, that can be carried forward to offset future income tax. As of December 31, 2009, we also had a federal operating loss carryforward of approximately $5.3 million expiring between 2028 and 2029, which can be used to offset against future federal taxable income, and a North Carolina tax net operating loss carryforward of approximately $9.8 million expiring between 2015 and 2024, which can be offset against future state taxable income.

In November 2009, our Board of Directors authorized a repurchase program for up to 1,000,000 shares of our common stock through August 12, 2010. Repurchases can be made in the open market or in privately negotiated transactions. We expect to use available cash to finance these purchases and will determine the timing and amount of stock repurchases based on our evaluation of market conditions and other factors. During the three months ended December 31, 2009, we repurchased 41,670 shares at $1.21 per share. As of December 31, 2009, there remained 958,330 shares of our common stock approved for repurchase under the repurchase program.

Our future capital requirements and the adequacy of available funds will depend on many factors, including the risk factors described in more detail in “Risk Factors” in Part I, Item 1A of this Annual Report on Form 10-K. Based on our cash and cash equivalents and other working capital, management believes that our existing capital resources are adequate to satisfy our capital requirements for at least the next 12 months, provided that there are no extraordinary events and that economic conditions impacting consumer spending do not further deteriorate and adversely affect the demand for moissanite. There can be no assurance that the efforts taken to date and future actions will be able to withstand the impact of any economic downturn that extends deeper or longer than we currently anticipate. Under these conditions, our operations and other sources of funds may not be sufficient to fund our operations, and we may be required to seek alternative sources of funding. There is no assurance, however, that we will be able to obtain financing on acceptable terms, or at all, especially in light of the ongoing turmoil in the financial markets.

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, 2009, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

We have entered into an operating lease for approximately 16,500 square feet of mixed-use space 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.

Quantitative and Qualitative Disclosures About Market Risk

Item
7A.

Not applicable.

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Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheet of Charles & Colvard, Ltd. and subsidiaries as of December 31, 2009, and the related consolidated statements of operations, shareholders' equity and comprehensive loss, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of Charles & Colvard, Ltd. and subsidiaries as of December 31, 2008, were audited by other auditors whose report dated March 31, 2009, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, 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. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Charles & Colvard, Ltd. and subsidiaries as of December 31, 2009, and the consolidated results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ FRAZER FROST, LLP
Certified Public Accountants

Little Rock, Arkansas
March 26, 2010

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheet of Charles & Colvard, Ltd. and subsidiaries (the "Company") as of December 31, 2008, and the related consolidated statements of operations, shareholders' equity and comprehensive loss, and of cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, 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. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Charles & Colvard, Ltd. and subsidiaries as of December 31, 2008, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

Raleigh, North Carolina
March 31, 2009

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CHARLES & COLVARD, LTD.
CONSOLIDATED BALANCE SHEETS

	December 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$7,405,685	$5,587,144
Accounts receivable, net	1,043,296	3,754,657
Interest receivable	65	2,747
Income tax receivable	-	2,074,420
Note receivable, net	54,627	142,000
Inventory, net	3,470,136	8,291,847
Prepaid expenses and other assets	188,812	500,643
Deferred income taxes	-	1,231,071
Total current assets	12,162,621	21,584,529
Property and equipment, net	218,418	412,234
Patent and license rights, net	260,548	279,315
Inventory, non-current, net	37,888,622	34,727,841
Note receivable, non-current	-	82,627
Deferred income taxes, non-current	-	940,903
Other assets, non-current	1,990	-
TOTAL ASSETS	$50,532,199	$58,027,449
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$265,439	$1,631,074
Deferred revenue	-	171,181
Accrued cooperative advertising	173,000	401,849
Accrued expenses and other liabilities	157,954	623,584
Total current liabilities	596,393	2,827,688
Long-term liabilities:		
Accrued income taxes	1,058,659	3,154,110
Total liabilities	1,655,052	5,981,798
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 50,000,000 shares authorized; 19,013,749 and 18,334,136 shares issued and outstanding at December 31, 2009 and 2008, respectively	52,906,459	52,910,075
Additional paid-in capital – share-based compensation	6,411,727	6,177,246
Accumulated deficit	(10,441,039)	(7,041,670)
Total shareholders' equity	48,877,147	52,045,651
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$50,532,199	$58,027,449

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31,	
	2009	2008
Net sales	$8,312,470	$14,727,054
Costs and expenses:		
Cost of goods sold	3,472,842	5,592,879
Sales and marketing	1,949,576	7,466,266
General and administrative	5,702,609	8,454,567
Research and development	401,496	113,621
Loss on impairment of long-lived assets	145,800	-
Total costs and expenses	11,672,323	21,627,333
Loss from operations	(3,359,853)	(6,900,279)
Interest income	38,194	116,484
Loss before income taxes	(3,321,659)	(6,783,795)
Income tax benefit (expense)	(77,710)	632,667
Net loss	$(3,399,369)	$(6,151,128)
Net loss per common share:		
Basic and fully diluted	$(0.18)	$(0.34)
Weighted average number of shares used in computing net loss per common share:		
Basic and fully diluted	18,720,850	18,240,853

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
AND COMPREHENSIVE LOSS

	Common Stock						
	Number of Shares	Amount	Additional Paid-in Capital – Share-Based Compensation	Accumulated Other Comprehensive Gain (Loss)	Accumulated Deficit	Total Shareholders' Equity	Total Comprehensive Loss
Balance at December 31, 2007	18,106,526	$52,910,075	$ 5,892,730	$ 881	$(892,686)	$57,911,000	
Share-based compensation	-	-	471,098	-	-	471,098	
Tax effect of share-based compensation	-	-	(186,582)	-	-	(186,582)	
Issuance of restricted stock	227,610	-	-	-	-	-	
Foreign currency translation	-	-	-	(881)	2,144	1,263	$ 1,263
Net loss	-	-	-	-	(6,151,128)	(6,151,128)	(6,151,128)
Total comprehensive loss							(6,149,865)
Balance at December 31, 2008	18,334,136	52,910,075	6,177,246	-	(7,041,670)	52,045,651	
Share-based compensation	-	-	233,909	-	-	233,909	
Tax effect of share-based compensation	-	-	1,390	-	-	1,390	
Issuance of restricted stock	679,408	-	-	-	-	-	
Stock option exercises	41,875	46,810	(818)	-	-	45,992	
Share repurchases	(41,670)	(50,426)	-	-	-	(50,426)	
Net loss	-	-	-	-	(3,399,369)	(3,399,369)	(3,399,369)
Total comprehensive loss							$ (3,399,369)
Balance at December 31, 2009	19,013,749	$52,906,459	$ 6,411,727	-	$(10,441,039)	$48,877,147	

See Notes to Consolidated Financial Statements.

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CHARLES & COLVARD, LTD.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(3,399,369)	$(6,151,128)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	168,881	216,028
Share-based compensation	233,909	467,104
Provision for uncollectible accounts	297,014	2,675,000
Provision for sales returns	(150,000)	130,000
Consignment inventory reserve	(138,000)	185,000
Jewelry reserve	116,000	220,000
Provision (benefit) for deferred income taxes	2,171,974	(662,775)
Loss on impairment of long-lived assets	145,800	-
Loss on disposal of assets	-	385,082
Changes in assets and liabilities:		
Accounts receivable	1,460,107	2,822,062
Income tax receivable	2,074,420	(1,992,229)
Inventory	2,957,170	(238,851)
Other assets, net	312,523	263,694
Accounts payable	(1,365,635)	(1,717,699)
Deferred revenue	(171,181)	171,181
Accrued cooperative advertising	(228,849)	(50,943)
Accrued income taxes	(2,095,451)	2,242,504
Other accrued liabilities, net	(465,630)	98,267
Net cash provided by (used in) operating activities	1,923,683	(937,703)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(75,792)	(28,910)
Patent and license rights costs	(26,306)	(308,968)
Proceeds from sale of equipment	-	898
Net cash used in investing activities	(102,098)	(336,980)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock option exercises	45,992	-
Excess tax benefit (cost) from share-based payment arrangements	1,390	(186,582)
Share repurchases	(50,426)	-
Net cash used in financing activities	(3,044)	(186,582)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,818,541	(1,461,265)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	5,587,144	7,048,409
CASH AND CASH EQUIVALENTS, END OF PERIOD	$7,405,685	$5,587,144
Supplemental schedule of non-cash operating activities:		
Inventory acquired from settlement of accounts receivable	$1,274,240	$-
Supplemental schedule of non-cash investing activities:		
Reduction of note receivable	$-	$140,763

See Notes to 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® jewels (hereinafter referred to as moissanite or moissanite jewels) 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 the Company's advantage of being the sole source worldwide of lab-created moissanite jewels, the Company's strategy is to establish itself as a reputable, high-quality, and sophisticated brand and to position moissanite as an affordable, luxurious alternative to other gemstones, such as diamond, with exceptional brilliance, fire, luster, durability, and rarity like no other jewel available on the market. The Company primarily sells loose moissanite jewels to jewel distributors and jewelry manufacturers, although it has begun to wholesale a limited amount of finished moissanite jewelry.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation and Principles of Consolidation - The accompanying consolidated financial statements as of and for the years ended December 31, 2009 and 2008 include the accounts of the Company and its wholly owned subsidiary in Hong Kong, Charles & Colvard (HK) Ltd., which became a dormant entity in the second quarter of 2009. The 2008 consolidated financial statements also include the accounts of a Chinese corporation, Guangzhou Charles & Colvard Trading Limited, controlled by the Company as beneficial owner of the entire interest. All intercompany accounts have been eliminated. During the year ended December 31, 2008, the Company ceased operations of both its Hong Kong subsidiary and the controlled company in China.

All of the Company's activities are within a single reportable segment. The following presents certain data by geographic area:

	Year Ended December 31,	
	2009	2008
Net sales		
United States	$5,324,212	$10,286,568
International	2,988,258	4,440,486
Total	$8,312,470	$14,727,054

	December 31, 2009	December 31, 2008
Property and equipment, net		
United States	$218,418	$412,234
International	-	-
Total	$218,418	$412,234

	December 31, 2009	December 31, 2008
Patent and license rights, net		
United States	$85,496	$100,397
International	175,052	178,918
Total	$260,548	$279,315

Fiscal Year - The Company’s fiscal year ends December 31. References to fiscal 2009, for example, refer to the fiscal year ending December 31, 2009.

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

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classification of inventories, accounts receivable reserves, deferred tax assets, uncertain tax positions, and cooperative advertising. Actual results could differ materially from those estimates.

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

Cash and Cash Equivalents - All highly liquid investments with an original maturity of three months or less 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. The Company maintains cash and cash equivalents with high quality financial institutions and invests in low risk securities, primarily money market funds. At times, cash balances may exceed the Federal Deposit Insurance Corporation ("FDIC") insurable limits.

Trade receivables potentially subject the Company to credit risk. The Company's standard payment terms on trade receivables are generally between 30 and 90 days. 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, the customer's payment history with the Company, the customer's reputation in the trade, and an evaluation of the Company's opportunity to introduce its moissanite jewels 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.

See Note 11, "Major Customers and Concentration of Credit Risk," for further discussion of risk within accounts receivable.

Allowance for Doubtful Accounts and Notes Receivable - The Company maintains an allowance for doubtful accounts for estimated losses resulting from the inability, failure, or refusal of its customers or noteholders to make required payments. The Company analyzes accounts receivable, historical percentages of uncollectible accounts, changes in payment history, and facts and circumstances that become known to management when evaluating the adequacy of the allowance for doubtful accounts. The Company generally uses an internal collection effort, which may include its sales personnel as it deems appropriate. Although the Company believes that its reserves are adequate, if the financial condition of its customers deteriorates, resulting in an impairment of their ability to make payments, or if it underestimates the allowances required, additional allowances may be necessary, which will result in increased expense in the period in which such determination is made.

Based on these criteria, management determined that allowances for doubtful accounts receivable of $90,000 and $3,915,000 at December 31, 2009 and 2008, respectively, were required.

At December 31, 2009, the Company had a note receivable of $224,627, which represented the unpaid portion of a $400,000 advance made to Norstel AB ("Norstel") as part of Norstel's exclusive supply agreement with the Company. In December 2009, the Company received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. As a result, the Company recorded a reserve of $170,000 on the advance in the fourth quarter of 2009.

Inventories - Inventories are stated at the lower of cost or market determined on a first-in, first-out basis. Inventory costs include direct material and labor, inbound freight, purchasing and receiving costs, inspection costs, and warehousing costs. Any inventory on hand in excess of the Company's current requirements based on historical and anticipated levels of sales is classified as non-current on the Company’s consolidated balance sheets.

The Company currently sells one grade of jewel with limited exceptions to test market acceptance. The grade is classified as very good (“VG”) and consists of near-colorless jewels that meet certain standards. Only VG jewels are valued in inventory. Currently, jewels that have not met the Company’s quality standards, including colored jewels, are not valued in inventory.

Obsolescence is not a factor in the Company’s loose jewel inventory valuation. The Company’s jewels do not

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degrade over time and inventory generally consists of the cuts 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 United States through mid-2015 and in many other countries through mid-2016 to produce and sell lab-created SiC for use in jewelry applications. In view of the foregoing factors, management has concluded that no excess or obsolete inventory reserve requirements exist as of December 31, 2009.

All inventories are carefully reviewed for quality standards before they are entered into finished goods. As conditions warrant, the Company’s grading standards change. The Company reviews the inventory on an ongoing basis to ensure its inventory meets current quality standards. The Company has provided a reserve to allow for certain jewels of a slightly lesser quality in its finished goods inventory to be possibly re-cut to increase their quality. The need for adjustments to this reserve is evaluated on a period-by-period basis.

All jewelry inventories are finished goods, the majority of which the Company does not actively market. As a result, 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.

Property and Equipment - Property and equipment are stated at cost and are depreciated over their estimated useful lives using the straight-line method as follows:

Machinery and equipment	5 to 12 years
Computer hardware	3 to 5 years
Computer software	3 years
Furniture and fixtures	5 to 10 years
Leasehold improvements	Shorter of the estimated useful life or the lease term

Patents and License Rights - The Company capitalizes costs associated with obtaining or defending patents issued or pending for inventions and license rights related to the manufacture of moissanite jewels. Such costs are amortized over the life of the patent, generally 17 years. The Company also capitalizes licenses it obtains for the use of certain advertising images. Such costs are amortized over the period of the license.

Impairment of Long-Lived Assets - The Company evaluates the recoverability of its long-lived assets by reviewing them for possible impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of the asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment is measured as the amount by which the carrying amount exceeds the fair value and is recognized as an operating expense in the period in which the determination is made. Assets to be disposed are reported at the lower of the carrying amount or fair value less costs to sell.

In addition to the recoverability assessment, the Company routinely reviews the remaining estimated useful lives of its long-lived assets. Any reduction in the useful-life assumption will result in increased depreciation and amortization expense in the period when such determinations are made, as well as in subsequent periods.

In 2009, management determined that certain manufacturing equipment was impaired because its carrying value exceeded future net undiscounted cash flows expected to be generated by the equipment due to the current large finished goods inventory position. As a result, a loss on impairment of long-lived assets in the amount of $145,800, representing the carrying value less estimated salvage value, was recognized as an operating expense in 2009.

Foreign Currency Translation - All non-U.S. operations were ceased during 2008. The assets and liabilities of the Company's non-U.S. operations, whose local currency was the functional currency, were translated into U.S. dollars at exchange rates in effect on the balance sheet dates. Revenues and expenses were translated using the average exchange rates in effect during the year. Prior to 2008, foreign currency translation adjustments were reflected as a separate component of shareholders' equity as accumulated other comprehensive gain (loss). In 2008, the net amount was reclassified into accumulated deficit.

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Revenue Recognition - Revenue is recognized and title passes when products are shipped from the Company's facility, excluding consignment, or "memo," shipments as discussed below. 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. The Company's return policy allows for the return of jewels for credit within 30 days of shipment and must be returned for a valid reason, such as quality problems or a shipment of the wrong jewels. Some customers have a contractual right to return a certain percentage of goods for any reason. In these instances, the Company only recognizes revenue when the contractual right of return is exhausted. Periodically, the Company sells jewels to customers on memo terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. The Company's customers are generally required to make payments on memo shipments within 60 days upon the customer informing the Company that it will keep the jewels. Accordingly, the Company does not recognize revenue on these memo transactions until the earlier of (1) the customer informing the Company that it will keep the jewels or (2) the expiration of the right of return period.

Cost of Goods Sold - Cost of goods sold primarily is composed of inventory sold during the period; inventory written off during the period due to ongoing quality reviews or through customer returns; salaries and benefits for personnel involved in preparing and shipping product to customers; an allocation of shared expenses such as rent, utilities, communication expenses, and depreciation related to preparing and shipping product to customers; and outbound freight charges.

Advertising Costs - Advertising production costs are expensed as incurred. Media placement costs are expensed the first time the advertising appears.

The Company also offers a cooperative advertising program to its customers that reimburses a portion of their marketing costs based on the customers' net purchases from the Company and is subject to the customer providing documentation of all advertising performed that includes the Company's product. For the years ended December 31, 2009 and 2008, these amounts were approximately $286,000 and $1,318,000, respectively, and are included as a component of sales and marketing expenses.

Advertising expenses, inclusive of the cooperative advertising program, for the years ended December 31, 2009 and 2008 were approximately $422,000 and $3,260,000, respectively.

Sales and Marketing - Sales and marketing expenses are expensed as incurred. These costs include all expenses of promoting and selling the Company's product and include such items as the salaries, payroll-related expenses, and travel of sales and marketing personnel; advertising; trade shows; market research; and sales commissions.

General and Administrative - General and administrative expenses are expensed as incurred. These costs include the salaries and payroll-related expenses of executive, finance, information technology, and administrative personnel; legal, investor relations, and professional fees; Board of Directors fees; insurance; bad debts; and rent.

Research and Development - All research and development costs are expensed as incurred.

Share-Based Compensation - The Company recognizes compensation expense for share-based awards based on estimated fair values on the date of grant. The Company uses the Black-Scholes-Merton option pricing model to determine the fair value of stock options. The fair value of other stock compensation awards is determined by the market price of the Company's common stock on the date of grant. The expense associated with share-based compensation is recognized on a straight line basis over the service period of each award.

Fair value of stock options using the Black-Scholes-Merton valuation model is estimated on the date of grant utilizing certain assumptions for dividend yield, expected volatility, risk-free interest rate, and expected lives of the awards, as follows:

Dividend yield – Although the Company issued dividends in prior years, a dividend yield is not used due to the uncertainty of future dividend payments.

Expected volatility – 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.

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Risk-free interest rate – 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 option.

Expected lives – The expected lives of the options represent the estimated period of time until exercise or forfeiture and are based on historical experience of similar awards.

The assumptions used in calculating the fair value of share-based payment awards represent management's best estimates, but these estimates involve inherent uncertainties and the application of management's judgment. As a result, if factors change and the Company uses different assumptions, the Company's share-based compensation expense could be materially different in the future. In addition, the Company is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. In estimating the Company's forfeiture rate, the Company analyzed its historical forfeiture rate, the remaining lives of unvested options, and the amount of vested options as a percentage of total options outstanding. If the Company's actual forfeiture rate is materially different from its estimate, or if the Company reevaluates the forfeiture rate in the future, the share-based compensation expense could be significantly different from what the Company has recorded in the current period.

Income Taxes - Deferred income taxes are recognized for the income tax consequences of "temporary" differences by applying enacted statutory income tax rates applicable to future years to differences between the financial statement carrying amounts and the income tax bases of existing assets and liabilities. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount that is more likely than not to be realized.

Net Loss per Common Share - Basic net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding during the periods. Diluted net loss per common share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the periods. Common equivalent shares consist of stock options that are computed using the treasury stock method.

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

	Year Ended December 31,	
	2009	2008
Numerator:		
Net loss	$(3,399,369)	$(6,151,128)
Denominator:		
Weighted average common shares outstanding		
Basic	18,720,850	18,240,853
Stock options	-	-
Diluted	18,720,850	18,240,853
Net loss per common share:		
Basic	$(0.18)	$(0.34)
Diluted	$(0.18)	$(0.34)

For the years ended December 31, 2009 and 2008, stock options to purchase approximately 790,000 and 739,000 shares, respectively, were excluded from the computation of diluted net loss per common share because the exercise price of the options was greater than the average market price of the common shares or the effect of inclusion of such amounts would be anti-dilutive to net loss per common share.

Recently Adopted/Issued Accounting Pronouncements - Accounting for Business Combinations. In December 2007, the Financial Accounting Standards Board ("FASB") issued new U.S. GAAP guidance related to business combinations that establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, and the goodwill acquired. The guidance also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination and was effective for business combinations occurring on or after January 1, 2009. The adoption of this guidance did not have an effect on the Company's consolidated financial statements.

Noncontrolling Interests in Consolidated Financial Statements. In December 2007, the FASB issued new U.S. GAAP guidance related to noncontrolling interests in consolidated financial statements that establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The guidance also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners and was effective for the Company beginning January 1, 2009. The adoption of this guidance did not have an effect on the Company's consolidated financial statements.

Determination of the Useful Life of Intangible Assets. In April 2008, the FASB issued new U.S. GAAP guidance related to the determination of the useful life of intangible assets that requires entities to consider their own historical experience in renewing or extending similar arrangements when developing assumptions regarding the useful lives of intangible assets and also mandates certain related disclosure requirements. The guidance is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The adoption of this guidance did not have an effect on the Company's consolidated financial statements.

Interim Disclosures About Fair Value of Financial Instruments. In April 2009, the FASB issued new U.S. GAAP guidance that requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This guidance also requires those disclosures in summarized financial information at interim reporting periods and is effective for interim and annual reporting periods ending after June 15, 2009. The adoption of this guidance did not have an effect on the Company's consolidated financial statements.

Subsequent Events. In May 2009, the FASB issued new U.S. GAAP guidance that establishes the accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. The Company adopted this guidance in the second quarter of 2009, and it did not have an effect on the Company's consolidated financial statements.

FASB Accounting Standards Codification. In June 2009, the FASB issued new U.S. GAAP guidance concerning the organization of authoritative guidance under U.S. GAAP. This new guidance created the FASB Accounting Standards Codification (the "Codification"). The Codification has become the source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. Rules and interpretive releases of the Securities and Exchange Commission ("SEC") under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. The Codification became effective for the Company in its third quarter of 2009. As the Codification is not intended to change or alter existing U.S. GAAP, it did not have any impact on the Company's consolidated financial statements. On its effective date, the Codification superseded all then-existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification has become non-authoritative.

Multiple-Deliverable Revenue Arrangements. In October 2009, the FASB issued new U.S. GAAP guidance that requires an entity to allocate revenue arrangement consideration at the inception of an arrangement to all of its deliverables based on their relative selling prices (the relative-selling-price method). The guidance eliminates the use of the residual method of allocation, in which the undelivered element is measured at its estimated selling price and the delivered element is measured as the residual of the arrangement consideration, and requires the relative-selling-price method in all circumstances in which an entity recognizes revenue for an arrangement with multiple deliverables. The new guidance must be adopted no later than the beginning of the first fiscal year beginning on or after June 15, 2010, with early adoption permitted through either prospective application for revenue arrangements entered into, or materially modified, after the effective date or through retrospective application to all revenue arrangements for all periods presented. The Company does not expect the adoption of this guidance to have an effect on its consolidated financial statements.

Improving Disclosures About Fair Value Measurements. In January 2010, the FASB issued new U.S. GAAP guidance to enhance the usefulness of fair value measurements that requires both the disaggregation of information

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in certain existing disclosures, as well as the inclusion of more robust disclosures about valuation techniques and inputs to recurring and non-recurring fair value measurements. The amended guidance is effective for interim and annual reporting periods beginning after December 15, 2009. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

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

3. FAIR VALUE MEASUREMENTS

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

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

The Company evaluates assets and liabilities subject to fair value measurements on a recurring and non-recurring basis to determine the appropriate level to classify them for each reporting period. This determination requires significant judgments to be made by the Company. The instruments identified as subject to fair value measurements on a recurring basis are cash and cash equivalents, trade accounts receivable, trade accounts payable, and accrued expenses that are reflected in the consolidated balance sheets at carrying value, which approximates fair value due to the short-term nature of these instruments.

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

During the year ended December 31, 2009, management determined that certain idled manufacturing equipment was impaired based on Level 3 inputs because its carrying value of $183,300 exceeded future net undiscounted cash flows expected to be generated by the equipment due to the current large finished goods inventory position. As a result, a fair value adjustment in the amount of $145,800 was recorded as a loss on impairment, representing the carrying value less estimated salvage value of $37,500.

4. INVENTORIES

The Company’s total inventories consisted of the following as of December 31, 2009 and 2008:

	December 31,	
	2009	2008
Raw materials	$6,736,677	$6,755,863
Work-in-process	1,900,266	1,969,806

Finished goods	31,582,988	32,851,411
Finished goods on consignment	1,138,827	1,442,608
Totals	$41,358,758	$43,019,688
Current portion	$3,470,136	$8,291,847
Non-current portion	37,888,622	34,727,841
Totals	$41,358,758	$43,019,688

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Periodically, the Company ships finished goods inventory to customers on consignment, or “memo,” terms. For shipments on memo terms, the customer assumes the risk of loss and has an absolute right of return for a specified period. Finished goods on consignment at December 31, 2009 and 2008 are net of reserves of $147,000 and $285,000, respectively, to allow for certain jewelry on consignment at a customer that has filed for Chapter 11 bankruptcy protection and to allow for certain jewels on consignment with customers that may not be returned or may be returned damaged.

Total loose-jewel inventories at December 31, 2009 and 2008, net of a reserve of $400,000 and including inventory on consignment net of reserves, were $39,624,694 and $41,822,227, respectively. This reserve was established to allow for the carat weight loss associated with the possible future re-cutting of a portion of the loose-jewel inventory to achieve higher quality standards. The need for adjustments to this reserve is evaluated on a period-by-period basis. To date, no such jewels have been re-cut.

All jewelry inventories are finished goods, the majority of which the Company does not actively market. As a result, a jewelry inventory reserve of $1,348,000 and $245,000 was established at December 31, 2009 and 2008, respectively, 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. Total jewelry inventory at December 31, 2009 and 2008, net of reserves and including net inventory on consignment, was $1,634,049 and $1,058,872 respectively. As part of the Company’s January 2009 settlement agreement with Reeves Park, Inc. (“Reeves Park”), the Company received jewelry inventory to reduce its outstanding receivable from that customer. The majority of the jewelry received pursuant to this agreement was reserved to scrap value due to the lack of a plan to market this inventory.

5. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	December 31,	
	2009	2008
Machinery and equipment	$572,810	$532,188
Computer hardware	465,184	427,497
Computer software	319,400	281,295
Furniture and fixtures	209,366	209,366
Leasehold improvements	126,030	126,030
Construction in progress	-	40,622
Total	1,692,790	1,616,998
Less accumulated depreciation	(1,474,372)	(1,204,764)
Property and equipment, net	$218,418	$412,234

Depreciation expense for the years ended December 31, 2009 and 2008 was $123,808 and $150,994, respectively.

6. INTANGIBLE ASSETS

Intangible assets consist of the following:

	December 31,		
	2009	2008	Weighted Average Amortization

			Period (in Years)
Patents	$546,540	$520,234	6.3
License rights	20,200	20,200	1.0
Trademarks	5,000	5,000	-
Total	571,740	545,434	
Less accumulated amortization	(311,192)	(266,119)	
Patent and license rights, net	$260,548	$279,315	

Amortization expense for the years ended December 31, 2009 and 2008 was $45,073 and $65,034, respectively.

Amortization expense on existing patents and license rights is estimated to be $47,000 for 2010 and $41,000 per year for 2011 through 2014.

Since 2006, the Company had been party to a lawsuit in South Korea defending its gemstone patent in that jurisdiction. Based on successful court decisions in 2007 and early in 2008, the Company capitalized $349,000 of legal fees, most of which were incurred during 2008, as patent and license rights. However, based on a negative decision received in December 2008 in this matter, the Company recorded a loss on disposal of $322,000 in 2008.

7. ACCRUED EXPENSES

During the year ended December 31, 2008, the Company reduced staffing levels, resulting in severance expense of approximately $659,000 that was included in operating expenses. Staffing levels were further reduced during the year ended December 31, 2009, resulting in severance expense of approximately $425,000 that was included in operating expenses. As of December 31, 2009 and 2008, there were $38,000 and $227,000, respectively, of remaining severance expenses included in accrued expenses and other liabilities on the Company's consolidated balance sheets.

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 of $11,727 per month, plus additional common-area expenses based on the Company's proportionate share of the lessor's operating costs. Terms of the lease provide for escalations of the base monthly rent throughout the lease term, up to $13,546 at August 1, 2010. The lease also provided for two rent holidays (August 2004 through September 2004 and August 2005 through May 2006) throughout the term during which no rent was payable and a $74,000 moving allowance that was paid to the Company in September 2004. The Company recognizes rent expense on a straight-line basis, giving consideration to the rent holidays and the moving allowance paid to the Company. At the Company's option, the lease can be extended for three successive five-year periods.

The future minimum lease payments of the Company are $160,000 in 2010 and $95,000 in 2011, totaling $255,000. Rent expense for the years ended December 31, 2009 and 2008 was approximately $187,000 and $298,000, 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. In September 2008, the Company entered into an agreement with Cree to delay the Company's commitment to purchase $710,000 of SiC crystals during the fourth quarter of 2008. Effective March 22, 2010, the Company entered into a letter agreement with Cree in connection with the amended and restated exclusive supply agreement under which the Company agreed to purchase approximately $1.2 million of SiC crystals over a period of approximately eight months in 2010 to satisfy this existing purchase commitment and to preserve the exclusivity terms of the amended and restated exclusive supply agreement.

In February 2005, the Company entered into an exclusive supply agreement with Norstel for the supply of raw material SiC crystals for use in the manufacture of moissanite jewels. In April 2008, the Company entered into an amendment to the exclusive supply agreement with Norstel due to an update of Norstel’s delivery schedule and capability and also due to the Company’s desire to limit its purchase of raw materials. Under this amendment, the Company’s minimum purchase commitment from Norstel was to continue until (i) the Company has purchased an aggregate amount of approximately $7.9 million of SiC crystals, or (ii) September 26, 2011, whichever occurs first. This purchase commitment was contingent upon Norstel being able to deliver SiC crystals of acceptable quality in the amount committed. In October 2008, the Company entered into a new letter agreement with Norstel that suspended the Company’s commitment to purchase SiC crystals from Norstel during the fourth quarter of 2008.

In addition, as part of the exclusive supply agreement, the Company advanced $400,000 to Norstel in 2005 for the purchase of certain equipment. This advance, which is in the form of a note receivable, began to be repaid in January 2007 through a 20% reduction on each invoice for subsequent purchases of SiC crystals. Effective March 1, 2008, pursuant to the April 2008 amendment, the Company began receiving a 30% reduction on each invoice for subsequent purchases of SiC crystals. The balance on the advance as of December 31, 2008 was $224,627. In December 2009, the Company received notification from Norstel that it had reached an agreement in principle with a new investor. This agreement was conditioned upon Norstel initiating a company reorganization that would involve unsecured creditors' acceptance of a composition offer to receive 25% of outstanding debts as payment in full. As a result, the Company recorded a reserve of $170,000 on the advance in the fourth quarter of 2009. Though the Company did not consent to the composition offer, it received notice in January 2010 that the District Court of Norrköping had approved it, and the Company received a cash payment of $56,127 in February 2010. It is the Company's position that, as a result of the failure of Norstel to repay the advance in full as stipulated in the exclusive supply agreement, it has no further purchase obligations under the agreement.

Legal Proceedings

There are no material pending legal proceedings to which the Company is a party or to which any of the Company's property is subject.

9. SHAREHOLDERS' EQUITY AND SHARE-BASED COMPENSATION

Common Stock

The Company is authorized to issue 50,000,000 shares of common stock, no par value. As of December 31, 2009 and 2008, it had 19,013,749 and 18,334,136 shares of common stock outstanding, respectively. Holders of common stock are entitled to one vote for each share held.

In November 2009, the Board of Directors authorized a repurchase program for up to 1,000,000 shares of the Company's common stock through August 12, 2010. Repurchases can be made in the open market or in privately negotiated transactions. The Company expects to use available cash to finance these purchases and will determine the timing and amount of stock repurchases based on its evaluation of market conditions and other factors. During the three months ended December 31, 2009, the Company repurchased 41,670 shares at $1.21 per share. As of December 31, 2009, there remained 958,330 shares of the Company's common stock approved for repurchase under the repurchase program.

Preferred Stock

The Board of Directors is authorized, without further shareholder approval, to issue up to 10,000,000 shares of preferred stock, no par value. The preferred stock may be issued from time to time in one or more series. No shares of preferred stock have been issued as of December 31, 2009.

On February 21, 1999, the Company adopted, as a means to guard against abusive takeover tactics a Shareholder Rights Plan under which all common shareholders of record as of March 8, 1999 received a dividend distribution of one right for each outstanding share of the Company's common stock to purchase shares of a new series of preferred stock (the "Rights Plan"). One right will also be distributed for each share of common stock issued after March 8, 1999 until the distribution date, which will occur upon the earlier of (i) 10 business days following a public announcement that a person or group of affiliated or associated persons has acquired beneficial ownership of 20% or more of the outstanding shares of the Company's common stock, or (ii) 10 business days following the commencement of a tender offer or exchange offer that would, if consummated, result in a person or group beneficially owning 20% or more of such outstanding shares of the Company’s common stock, subject to certain limitations. The rights will be exercisable only if a person or group acquires or announces a tender offer to acquire 20% or more of the Company’s common stock. If a person or group acquires 20% or more of the Company’s common stock, all shareholders except the purchaser will be entitled to acquire the Company’s common stock at a 50% discount. The rights will trade with the Company’s common stock, unless and until they are separated upon the occurrence of certain future events. The Rights Plan, as modified by an amendment dated February 18, 2009, remains in full force and effect.

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Equity Compensation Plans

1996 Stock Option Plan

In 1996, the Company adopted the 1996 Stock Option Plan of Charles & Colvard, Ltd. (the "1996 Option Plan"), under which options to acquire 1,020,402 common shares, reduced by the number of options granted outside the 1996 Option Plan, could be granted to key employees, directors, and independent consultants. Under the 1996 Option Plan, both incentive and non-qualified options could be granted under terms and conditions established by the Compensation Committee of the Board of Directors. The exercise price for incentive options was the fair market value of the related common stock on the date the option was granted. Options granted under the 1996 Option Plan generally vested equally over a three-year period and had terms of 10 years. As of December 31, 2008, there were no outstanding options under the 1996 Option Plan, and the Company currently has no plans to award additional options under this plan.

1997 Omnibus Stock Plan

In 1997, the Company adopted the 1997 Omnibus Stock Plan of Charles & Colvard, Ltd. (the "1997 Omnibus Plan"). The 1997 Omnibus Plan authorized the Company to grant stock options, stock appreciation rights, and restricted awards (collectively, "awards") to selected employees, independent contractors, and directors of the Company and related corporations in order to promote a closer identification of their interests with those of the Company and its shareholders. The maximum number of shares of common stock for which awards could be granted under the 1997 Omnibus Plan could be increased from time to time to a number of shares equal to 20% of the shares of common stock outstanding as of that time less the number of shares of common stock subject to outstanding options under the 1996 Option Plan. The number of shares reserved for issuance under the 1997 Omnibus Plan could also be adjusted upon certain events affecting the Company's capitalization. All options granted under the 1997 Omnibus Plan have an exercise price equal to the market price of the Company's common stock on the date the option is granted. Options granted to employees under the 1997 Omnibus Plan generally vest over three years and have terms of up to 10 years, with the exception of options granted in 2005 under the Executive Compensation Plan (which is governed by and subject to the 1997 Omnibus Plan) that vested immediately and options granted in 2006 under the Executive Compensation Plan that vested at the end of three years. Options granted to the Board of Directors under the 1997 Omnibus Plan generally vest over one year and have terms of up to 10 years. The terms of options granted to outside consultants vary depending on the specific grant, but the terms are no longer than 10 years. Restricted stock awards granted to members of the Board of Directors vested at the end of one year. The 1997 Omnibus Plan expired (with respect to future grants) on September 30, 2007. As of December 31, 2009 and 2008, there were 400,257 and 739,164 options outstanding under this plan, respectively.

2008 Stock Incentive Plan

On May 27, 2008, at the 2008 Annual Meeting of Shareholders, the shareholders of the Company approved the adoption of the Charles & Colvard, Ltd. 2008 Stock Incentive Plan (the "2008 Plan"), which replaced the 1997 Omnibus Plan. The 2008 Plan authorizes the Company to grant stock options, stock appreciation rights, restricted stock, and other equity awards to selected employees, directors, and independent contractors. The aggregate number of shares of the Company's common stock that may be issued pursuant to awards granted under the 2008 Plan shall not exceed the sum of 3,000,000 plus any shares of common stock subject to an award granted under the 1997 Omnibus Plan or any other stock incentive plan maintained by the Company prior to the 2008 Plan (each, a "Prior Plan") that is forfeited, cancelled, terminated, expires, or lapses for any reason without the issuance of shares pursuant to the award, or shares subject to an award granted under a Prior Plan which shares are forfeited to, or repurchased or reacquired by, the Company. As of December 31, 2009, there were 389,752 options outstanding under this plan. As of December 31, 2008, no stock option awards were issued under the 2008 Plan.

Stock Options

The following is a summary of the stock option activity for the years ended December 31, 2009 and 2008:

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	Shares	Weighted Average Exercise Price
Outstanding, December 31, 2007	963,781	$6.18
Granted	-	$-
Exercised	-	$-
Canceled	(224,617)	$6.98
Outstanding, December 31, 2008	739,164	$5.94
Granted	422,252	$0.57
Exercised	(41,875)	$1.09
Canceled	(329,532)	$7.71
Outstanding, December 31, 2009	790,009	$2.88

The fair value of each option grant is estimated on the grant date using the Black-Scholes-Merton option pricing model. The valuations of options granted during the year ended December 31, 2009 were based on the following weighted average assumptions:

Dividend yield	0.0%
Expected volatility	84.2%
Risk-free interest rate	2.61%
Expected lives (years)	6.0

There were no stock options granted during the year ended December 31, 2008.

The following table summarizes information about stock options outstanding at December 31, 2009:

Options Outstanding			Options Exercisable			Options Vested or Expected to Vest		
Balance as of 12/31/2009	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 12/31/2009	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Balance as of 12/31/2009	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
790,009	6.26	$2.88	503,145	4.25	$4.19	767,278	6.16	$2.95

As of December 31, 2009, the unrecognized share-based compensation expense related to unvested stock options is approximately $113,722, which is expected to be recognized over a weighted average period of approximately 33 months.

The aggregate intrinsic value of options outstanding, exercisable, and vested or expected to vest at December 31, 2009 was $249,511, $83,184, and $236,543, respectively. This amount is before applicable income taxes and represents the closing market price of the Company's common stock at December 31, 2009 less the grant price, multiplied by the number of options that have a grant price that is less than the closing market price. This amount represents the amount that would have been received by the optionees had these options been exercised on that date. During the year ended December 31, 2009, the aggregate intrinsic value of options exercised was $3,972. There were no options exercised during the year ended December 31, 2008.

Restricted Stock

The following is a summary of the restricted stock activity for the years ended December 31, 2009 and 2008:

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	Shares	Weighted Average Grant Date Fair Value
Unvested, December 31, 2007	63,806	$4.78
Granted	227,610	$1.34
Vested	(63,806)	$4.78
Canceled	-	$-
Unvested, December 31, 2008	227,610	$1.34
Granted	679,408	$0.49
Vested	(270,110)	$1.22
Canceled	-	$-
Unvested, December 31, 2009	636,908	$0.48

On May 30, 2008, the Company granted its non-employee Board members an aggregate of 227,610 shares of restricted stock. The restrictions on these shares lapsed on the date of the annual meeting in May 2009. The aggregate fair value of the restricted stock granted was $305,000 based on the closing market price of the Company's common stock on May 30, 2008.

On February 23, 2009, the Company granted five of its non-employee Board members (excluding Richard A. Bird) an aggregate of 103,262 shares of restricted stock in connection with the negotiation between the Company and Bird Capital Group, Inc. ("BCG") of a management services agreement ("the BCG Agreement"). The restrictions on these shares lapsed on February 23, 2010. The aggregate fair value of the restricted stock granted was $47,500 based on the closing market price of the Company's common stock on February 19, 2009.

On May 18, 2009, the Company granted its non-employee Board members (excluding Richard A. Bird) an aggregate of 329,787 shares of restricted stock. The restrictions on these shares will lapse on the date of the annual meeting in May 2010, subject to continued service on the Board. The aggregate fair value of the restricted stock granted was $155,000 based on the closing market price of the Company's common stock on May 18, 2009.

On June 23, 2009, the Company granted its newly appointed Chief Financial Officer 60,000 shares of restricted stock. The restrictions on these shares will lapse on June 15, 2010, subject to the Chief Financial Officer's continued employment or service to the Company. The fair value of the restricted stock granted was $30,000 based on the closing market price of the Company's common stock on June 23, 2009.

On June 26, 2009, the Board appointed Dr. Charles D. Lein to serve as a director of the Company, and he was granted 98,039 shares of restricted stock. The restrictions on these shares will lapse on the date of the annual meeting in May 2010, subject to continued service on the Board. The fair value of the restricted stock granted was $50,000 based on the closing market price of the Company's common stock on June 26, 2009.

Pursuant to the terms of the compensation arrangement with George R. Cattermole, the Company's Chairman of the Board, to serve in the role of Interim Chief Executive Officer until a permanent chief executive officer was appointed, the Company was accruing 30% of Mr. Cattermole's compensation, or $1,800 per week, to be paid as restricted stock, with all restrictions lapsing at the time of such issuance, upon the appointment of a new chief executive officer. On November 5, 2009, 42,500 shares of stock were granted under this compensation arrangement. The fair value of the stock granted was $24,650 based on the closing market price of the Company's common stock on November 5, 2009.

On November 5, 2009, the Board appointed H. Marvin Beasley to serve as a director of the Company, and he was granted 45,820 shares of restricted stock. The restrictions on these shares will lapse on the date of the annual meeting in May 2010, subject to continued service on the Board. The fair value of the restricted stock granted was $26,576 based on the closing market price of the Company's common stock on November 5, 2009.

As of December 31, 2009, the unrecognized share-based compensation expense related to unvested restricted stock was approximately $116,000, which is expected to be recognized over a weighted average period of approximately five months.

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Share-Based Compensation

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

	Year Ended December 31, 2009	2008
Employee stock options	$(108,339)	$169,252
Consultant stock options	-	(154)
Restricted stock awards	342,248	298,006
Income tax benefit	(88,119)	(141,213)
Total	$145,790	$325,891

Due to the Company’s valuation allowance against deferred tax assets as discussed further in Note 10, “Income Taxes,” some or all of the above income tax benefit was reserved.

No share-based compensation was capitalized as a cost of inventory during the year ended December 31, 2009, and $3,993 of share-based compensation was capitalized as a cost of inventory during the year ended December 31, 2008. There was a $180,000 decrease in compensation costs on employee stock options during the year ended December 31, 2009 due to the February 2009 termination of three executive officers.

Dividends

The Company has not paid any cash dividends during the years ended December 31, 2009 and 2008.

10. INCOME TAXES

The Company accounts for income taxes under the liability method. Under the liability method, deferred income taxes are recognized for the income tax consequences of “temporary differences” by applying enacted statutory income tax rates applicable to future years to differences between the financial statement carrying amounts and the income tax bases of existing assets and liabilities.

Income tax expense (benefit) comprises the following:

	Year Ended December 31, 2009	2008
Current		
Federal	$(2,157,865)	$72,056
State	63,601	(41,948)
Total	(2,094,264)	30,108
Deferred		
Federal	2,171,974	(511,686)
State	-	(151,089)
Total	2,171,974	(662,775)
Income tax expense (benefit)	$77,710	$(632,667)

Significant components of the Company’s deferred income tax assets are as follows:

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	December 31, 2009	December 31, 2008
Current		
Reserves and accruals	$1,804,379	$2,116,949
Prepaid expenses	(36,586)	(136,878)
Valuation allowance	(1,767,793)	(749,000)
Total	-	1,231,071
Noncurrent		
Federal net operating loss ("NOL") carryforwards	1,818,415	-
State NOL carryforwards	446,120	353,429
Hong Kong and China NOL carryforwards	1,056,000	1,287,000
Federal benefit on state taxes under uncertain tax positions	275,111	253,486
Share-based compensation	73,515	196,570
Investment loss	43,715	43,554
Research tax credit	102,443	525,151
Alternative minimum tax credit	331,471	447,544
Depreciation	(36,910)	(57,831)
Loss on impairment of long-lived assets	52,697	-
Valuation allowance	(4,162,577)	(2,108,000)
Total	-	940,903
Total deferred income tax assets, net	$-	$2,171,974

A reconciliation between expected income taxes, computed at the statutory federal income tax rate of 34% applied to pretax accounting income, and the income tax expense included in the statements of operations for each of the years ended December 31, 2009 and 2008 is as follows:

	Year Ended December 31, 2009	Year Ended December 31, 2008
Anticipated income tax benefit at statutory rate	$(1,129,365)	$(2,306,490)
State income tax benefit, net of federal tax effect	(71,054)	(244,851)
Effect of foreign operations	231,000	(63,358)
Income tax effect of uncertain tax positions	(2,117,075)	2,223,877
U.S. tax deduction due to cessation of operations at Hong Kong subsidiary	-	(2,051,033)
Other	(17,473)	(2,812)
Increase in valuation allowance	3,181,677	1,812,000
Income tax expense (benefit)	$77,710	$(632,667)

During 2009, the Company did not recognize an income tax benefit for operating losses due to the uncertainty of sufficient future taxable income to utilize its deferred tax assets. The valuation allowance increased during 2009 to fully offset all deferred tax assets generated during 2009. These increases in the valuation allowance were partially offset by a $231,000 decrease in the deferred tax assets related to the losses associated with the controlled company in China that ceased operations in 2008. Due to legal requirements with respect to controlled companies under Chinese law, the Company reversed the assets associated with the tax losses and valuation allowance in 2009.

During 2008, $1.6 million of the increase in the valuation allowance was due to the establishment of a reserve against certain United States deferred tax assets due to the Company's 2008 net loss and uncertainty over sufficient future taxable income to fully use the Company's deferred tax assets. The remaining $238,000 of the increase in the valuation allowance during 2008 was due to establishment of reserves for the income tax benefit of losses in Hong Kong and China.

Due to the carryback of 2008 taxable loss against taxes paid in prior years, the Company has $434,000 of remaining federal income tax credits, $102,000 of which expire between 2014 and 2016 and the balance without an expiration, that can be carried forward to offset future income tax. As of December 31, 2009, the Company also has a federal operating loss carryforward of approximately $5.3 million expiring between 2028 and 2029, which can be used to

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offset against future federal taxable income, and a North Carolina tax NOL carryforward of approximately $9.8 million expiring between 2015 and 2024, which can be offset against future state taxable income.

As of December 31, 2008, there was approximately $6.0 million in NOL carryforwards in Hong Kong. In accordance with the Hong Kong tax code, these amounts can be carried forward indefinitely to offset future taxable income in Hong Kong.

Uncertain Tax Positions

During 2008, the Company ceased operations of its Hong Kong subsidiary and, as a result, took a significant tax deduction on its 2008 tax returns resulting from unpaid obligations of the subsidiary to the Company. At December 31, 2008, the Company determined that this deduction qualified as an uncertain tax position under U.S. GAAP and recorded a long-term accrued income tax liability of $2.2 million. During 2009, the 2008 income tax returns were examined by the Internal Revenue Service and determined to be accepted as filed, with certain immaterial adjustments. As a result, the Company no longer considers the tax deduction an uncertain tax position and reversed the $2.2 million accrued income tax liability during the year ended December 31, 2009. Despite the reversal of this liability, there was not a material effect on the Company’s 2009 results of operations as it has established a full valuation allowance against the deferred tax assets generated by this deduction.

The liability for income taxes associated with uncertain tax positions at December 31, 2009 was $1.1 million. This amount, if recognized, would favorably affect the Company’s effective tax rate. A federal income tax benefit for state income taxes and timing differences of $275,000 resulting from the uncertain tax positions was fully reserved by a valuation allowance consistent with the full valuation allowance on the Company’s other deferred tax assets. The total 2009 income tax benefit attributable to uncertain tax positions was $2.1 million. The decrease in the accrued income tax liability for uncertain tax positions was primarily due to the $2.2 million reversal of the liability booked for the tax deduction associated with the closing of the Company’s Hong Kong subsidiary as discussed above. There was no additional liability for new uncertain tax positions during 2009.

The liability for income taxes associated with uncertain tax positions at December 31, 2008 was $3.2 million. This liability was reduced by $253,000 of offsetting tax benefits associated with the federal income tax benefit for state income taxes and timing differences. The net amount of $2.9 million, if recognized, would favorably affect the Company’s effective tax rate. The total 2008 income tax expense attributable to uncertain tax positions was $2.2 million. The increase in the accrued income tax liability for uncertain tax positions was primarily due to the $2.2 million liability booked for the tax deduction associated with the closing of the Company’s Hong Kong subsidiary as discussed above.

The Company’s policy for recording interest and penalties associated with tax audits is to record such items as a component of the provision for income taxes. During 2009 and 2008, the Company accrued interest and penalties associated with uncertain tax positions of $68,000 and $80,000, respectively. Including the interest and penalties recorded for uncertain tax positions, there is a total of $296,000 and $228,000 of interest and penalties included in the accrued income tax liability for uncertain tax positions at December 31, 2009 and 2008, respectively. To the extent interest and penalties are not ultimately incurred with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision.

In all of the significant federal and state jurisdictions where it is required to file income tax returns, the Company has analyzed filing positions for all tax years in which the statute of limitations is open. The only periods subject to examination by the major tax jurisdictions where the Company does business are the 2005 through 2009 tax years. The Company does not believe that the outcome of any examination will have a material impact on its financial statements and does not expect settlement on any uncertain tax positions within the next 12 months.

The following summarizes the activity related to the Company's gross liability for uncertain tax positions from January 1, 2008 through December 31, 2009:

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Balance as of January 1, 2008	$911,606
Increases related to prior year tax positions	70,202
Increases related to current year tax positions	2,172,302
Balance as of December 31, 2008	3,154,110
Increases related to prior year tax positions	76,851
Decreases related to settlements with taxing authorities	(2,172,302)
Balance as of December 31, 2009	$1,058,659

11. MAJOR CUSTOMERS AND CONCENTRATION OF CREDIT RISK

As of December 31, 2009, the Company had no trade accounts receivable from Reeves Park. This reduction in receivables from $4.9 million or 62% of receivables at December 31, 2008 is the result of the Company entering into a settlement agreement with Reeves Park in January 2009 to settle its outstanding balance. Under the terms of the settlement agreement, the Company accepted a return of inventory, received directly certain cash payments due to Reeves Park from its customers, and received a settlement fee payment from Reeves Park. Based on the $2.3 million estimated net realizable value of the transactions under the settlement agreement, the Company increased its allowance for uncollectible accounts at December 31, 2008 for Reeves Park to $2.6 million. The transactions under the settlement agreement are complete as of December 31, 2009 and the underlying allowance for uncollectible accounts is zero.

As of December 31, 2009, two customers accounted for 18% and 13% of trade accounts receivable, respectively. As of December 31, 2008, two different customers accounted for 62% and 15% of trade accounts receivable, respectively.

For the year ended December 31, 2009, one customer accounted for 19% of the Company’s total gross sales. This same customer accounted for 21% of total gross sales during the year ended December 31, 2008. No other customers accounted for more than 10% of the Company’s gross sales during these periods.

12. EMPLOYEE BENEFIT PLAN

All full time employees who meet certain age and length of service requirements are eligible to participate in the Company’s 401(k) Plan. The plan provides for matching contributions by the Company in such amounts as the Board of Directors may annually determine, as well as a 401(k) option under which eligible participants may defer a portion of their salaries. The Company contributed a total of $21,000 and $76,000 to the plan during 2009 and 2008, respectively.

13. SUBSEQUENT EVENTS

The Company has performed an evaluation of subsequent events through March 26, 2010, which is the date the financial statements were issued.

On March 24, 2010, the Company entered into a letter agreement (the “Letter Agreement”), effective March 22, 2010, with Cree under which the Company agreed to purchase approximately $1.2 million of SiC crystals over a period of approximately eight months in 2010 to satisfy the outstanding purchase commitment from the fourth quarter of 2008 and to preserve the exclusivity terms of the amended and restated exclusive supply agreement. The Letter Agreement amended the letter agreement dated November 12, 2007 (as amended by the letter agreement dated September 18, 2008) between the parties and provides a framework for the Company’s purchases of SiC crystals from Cree under the amended and restated exclusive supply agreement, dated as of June 6, 1997, between the Company and Cree. Pursuant to the terms of the Letter Agreement, the Company is obligated to purchase a minimum quantity of previously manufactured “usable material,” as previously graded and approved by the Company, on a monthly basis until the full amount of such material has been purchased by the Company. After the previously manufactured material has been purchased, each new order by the Company must equal or exceed a set minimum order quantity. Beginning with the fourth quarter of 2010, the Company must submit quarterly rolling forecasts of its projected requirements for SiC crystals.

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Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Not applicable.

Item 9A(T). Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2009. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, as ours are designed to do, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2009, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting. We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. During the three months ended December 31, 2009, we made no changes to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management’s Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control system was designed to provide reasonable assurance to our management and Board of Directors regarding the preparation and fair presentation of published financial statements.

Our internal control over financial reporting includes those policies and procedures that:

(i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

(ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

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All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

In making the assessment of internal control over financial reporting, our management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on that assessment and those criteria, management determined that our internal control over financial reporting was effective as of December 31, 2009.

This Annual Report on Form 10-K does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's report in this Annual Report on Form 10-K.

Item 9B. Other Information

On March 24, 2010, we entered into a letter agreement, or the Letter Agreement, effective March 22, 2010, with Cree under which we agreed to purchase approximately $1.2 million of SiC crystals over a period of approximately eight months in 2010 to satisfy the ous (continued)

Impairment of long-lived assets (continued)

The table below provides, as of the date indicated, the number of communities in which the Company recognized impairment charges, the fair value of those communities at such date (net of impairment charges), and the amount of impairment charges recognized ($ in millions):

	2009			2008		
Quarter Ended	Number of Communities Impaired	Fair Value of Communities Impaired, Net of Impairment Charges	Impairment Charges	Number of Communities Impaired	Fair Value of Communities Impaired, Net of Impairment Charges	Impairment Charges
March 31	116	$ 351.2	$ 358.6	150	$ 597.8	$ 598.8
June 30	43	82.4	109.2	48	198.9	153.5
September 30	48	163.9	132.6	96	232.4	250.4
December 31	40	66.2	150.8	88	223.5	204.6
			$ 751.2			$ 1,207.3

The Company recorded these valuation adjustments in its Consolidated Statements of Operations within Homebuilding home cost of revenues. In 2009, the Company reviewed each of its land positions for potential impairment indicators and performed detailed impairment calculations for approximately 300 communities. The discount rate used in the Company s determination of fair value for the impaired communities ranged from 12% to 22%, with an aggregate average of 15%. If conditions in the homebuilding industry or the Company s local markets worsen in the future, the current difficult market conditions extend beyond the Company s expectations, or the Company s strategy related to certain communities changes, the Company may be required to evaluate its assets, including additional projects, for future impairments or write-downs, which could result in future charges that might be significant.

Net realizable value adjustments land held for sale

The Company acquires land primarily for the construction of homes for sale to customers but periodically sells select parcels of land to third parties for commercial or other development. Additionally, the Company may determine that certain of its land assets no longer fit into its strategic operating plans. In such instances, the Company classifies the land asset as land held for sale, assuming the criteria in ASC 360-10 are met. During 2009, a significant portion of land previously classified as land held for sale was reclassified to either land under development or land held for future development as a result of either a change in strategy related to the land or a change in market conditions.

In accordance with ASC 360-10, the Company values land held for sale at the lower of carrying value or fair value less costs to sell. In determining the fair value of land held for sale, the Company considers recent legitimate offers received, prices for land in recent comparable sales transactions, and other factors. As a result of changing market conditions in the real estate industry, a portion of the Company s land held for sale was written down to net realizable value. During 2009, 2008, and 2007, the Company recognized net realizable value adjustments related to land held for sale of $113.7 million, $271.1 million, and $199.2 million, respectively. The Company records these net realizable value adjustments in its Consolidated Statements of Operations within Homebuilding land cost of revenues. During 2009, the amount of land held for sale and related net realizable value reserves decreased primarily as the result of the completion of certain land sale transactions.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

5. Inventory and land held for sale (continued)

Land valuation adjustments and write-offs (continued)

Net realizable value adjustments land held for sale (continued)

The Company s land held for sale at December 31, 2009 and 2008 was as follows ($000 s omitted):

	2009	2008
Land held for sale, gross	$ 84,495	$ 314,112
Net realizable value reserves	(25,850)	(149,158)
Land held for sale, net	$ 58,645	$ 164,954

Write-off of deposits and pre-acquisition costs

From time to time, the Company writes off certain deposits and pre-acquisition costs related to land option contracts the Company no longer plans to pursue. Such decisions take into consideration changes in national and local market conditions, the willingness of land sellers to modify terms of the related purchase agreement, the timing of required land takedowns, the availability and best use of necessary incremental capital, and other factors. The Company wrote off (net of recoveries) deposits and pre-acquisition costs in the amount of $54.3 million, $33.3 million, and $239.7 million, during 2009, 2008, and 2007, respectively. The Company records these write-offs of deposits and pre-acquisition costs in its Consolidated Statements of Operations within other expense (income), net.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Segment information

The Company s Homebuilding operating segments are engaged in the acquisition and development of land primarily for residential purposes within the continental United States and the construction of housing on such land targeted for first-time, first and second move-up, and active adult home buyers. Home sale revenues for detached and attached homes were $3.0 billion and $851.9 million in 2009, $4.6 billion and $1.3 billion in 2008, and $6.9 billion and $2.0 billion in 2007, respectively.

The Company has determined that its Homebuilding operating segments are its Areas. In the third quarter of 2009, in connection with the Centex merger, the Company realigned the organizational structure for certain of its markets. The operating data by segment provided in this note have been reclassified to conform to the current presentation. Accordingly, the Company s reportable Homebuilding segments are as follows:

Northeast:	Northeast Area includes the following states: *Connecticut, Delaware, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, Rhode Island, Virginia*
Southeast:	Southeast Area includes the following states: *Georgia, North Carolina, South Carolina, Tennessee*
Gulf Coast:	Gulf Coast Area includes the following states: *Florida, Texas*
Midwest:	Midwest Area includes the following states: *Colorado, Illinois, Indiana, Missouri, Michigan, Minnesota, Ohio*
Southwest:	Southwest Area includes the following states: *Arizona, Nevada, New Mexico*
*West:	West Area includes the following states: *California, Oregon, Washington*

** The Company s homebuilding operations located in Reno, Nevada are reported in the West segment, while its remaining Nevada homebuilding operations are reported in the Southwest segment. Also, our Hawaii and Puerto Rico operations are included in Other homebuilding, which does not represent a reportable segment.*

The Company also has one reportable segment for its financial services operations, which consist principally of mortgage banking and title operations. The Company s Financial Services segment operates generally in the same markets as the Company s Homebuilding segments.

Evaluation of segment performance is based on operating earnings from continuing operations before provision for income taxes which, for the Homebuilding segments, is defined as home sales (settlements) and land sale revenues less home cost of sales, land cost of sales, and certain selling, general, and administrative and other expenses, plus equity income from unconsolidated entities, which are incurred by or allocated to the Homebuilding segments. Operating earnings for the Financial Services segment is defined as revenues less costs associated with the Company s mortgage and title operations and certain selling, general, and administrative expenses incurred by or allocated to the Financial Services segment. Each reportable segment generally follows the same accounting policies described in Note 1 Summary of Significant Accounting Policies to the consolidated financial statements.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Segment information (continued)

	Operating Data by Segment ($000 s omitted) Years Ended December 31,		
	2009	**2008**	**2007**
Revenues:			
Northeast	$ 653,211	$ 910,886	$ 1,121,636
Southeast	561,194	929,113	1,175,467
Gulf Coast	947,637	1,225,849	1,791,554
Midwest	445,339	732,451	1,189,638
Southwest	669,338	1,486,016	2,367,597
West	627,065	827,723	1,475,838
Other homebuilding *(a)*	62,805	-	-
	3,966,589	6,112,038	9,121,730
Financial Services	117,800	151,016	134,769
Consolidated revenues	$ 4,084,389	$ 6,263,054	$ 9,256,499
Income (loss) before income taxes:			
Northeast	$ (207,461)	$ (129,552)	$ (149,793)
Southeast	(52,930)	(14,968)	72,799
Gulf Coast	(276,164)	(244,900)	(468,938)
Midwest	(66,554)	(103,202)	(339,193)
Southwest	(308,358)	(555,756)	(249,173)
West	(109,554)	(284,048)	(545,369)
Other homebuilding *(a)*	(832,276)	(362,285)	(829,825)
	(1,853,297)	(1,694,711)	(2,509,492)
Financial Services *(b)*	(55,038)	28,045	42,980
Total segment income (loss) before income taxes	(1,908,335)	(1,666,666)	(2,466,512)
Other non-operating *(c)*	(66,784)	(15,933)	(30,391)
Consolidated loss before income taxes *(d)*	$ (1,975,119)	$ (1,682,599)	$ (2,496,903)

(a) Other homebuilding includes the Company s operations in Hawaii and Puerto Rico, certain wind down operations, amortization of intangible assets, goodwill impairment, and amortization of capitalized interest. Capitalized interest amortization totaled $165.4 million, $210.7 million, and $315.0 million for 2009, 2008, and 2007, respectively. Goodwill impairment totaled $563.0 million, $5.0 million, and $370.0 million in 2009, 2008, and 2007, respectively.

(b) Financial Services income (loss) before income taxes includes interest expense of $2.3 million, $6.1 million, and $16.5 million for 2009, 2008, and 2007, respectively; interest income of $7.7 million, $13.3 million, and $21.8 million for 2009, 2008, and 2007, respectively; and goodwill impairment of $0.7 million in 2008.

(c) *Other non-operating includes the costs of certain shared services that benefit all operating segments, a portion of which are not allocated to the operating segments reported above. Other non-operating also includes a gain (loss) of ($31.6) million, ($1.6) million, and $0.5 million, respectively, related to the redemption of debt.*

(d) *Consolidated loss before income taxes includes selling, general, and administrative expenses of $672.4 million, $814.5 million, and $1.1 billion for 2009, 2008, and 2007, respectively.*

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Segment information (continued)

	Valuation Adjustments and Write-Offs by Segment ($000 s omitted) Years Ended December 31,		
	2009	2008	2007
Land and community valuation adjustments:			
Northeast	$ 150,407	$ 58,553	$ 116,418
Southeast	52,660	53,739	17,089
Gulf Coast	180,107	172,384	381,534
Midwest	44,897	79,029	240,380
Southwest	177,051	519,405	335,044
West	77,892	238,984	398,717
Other homebuilding *(a)*	68,192	85,237	114,473
	$ 751,206	$ 1,207,331	$ 1,603,655
Net realizable value adjustments (NRV) - land held for sale:			
Northeast	$ 19,310	$ 89,950	$ 16,051
Southeast	310	1,747	6,652
Gulf Coast	29,464	74,809	46,773
Midwest	699	20,295	103,374
Southwest	45,451	53,269	14,859
West	18,503	31,041	11,538
	$ 113,737	$ 271,111	$ 199,247
Write-off of deposits and pre-acquisition costs *(b)*:			
Northeast	$ 1,026	$ 12,618	$ 60,863
Southeast	1,235	4,032	3,114
Gulf Coast	51,711	555	52,065
Midwest	139	795	10,940
Southwest	15	15,328	54,870
West	130	(19)	57,864
	$ 54,256	$ 33,309	$ 239,716
Impairments of investments in unconsolidated joint ventures:			
Northeast	$ 31,121	$ -	$ -
Southwest	19,305	-	59,075
West	1,236	15,386	128,303
Other homebuilding *(c)*	2,428	3,088	2,485
	$ 54,090	$ 18,474	$ 189,863
Total valuation adjustments and write-offs	$ 973,289	$ 1,530,225	$ 2,232,481

(a) *Includes write-offs of capitalized interest related to land and community valuation adjustments of $68.2 million, $84.8 million, and $110.8 million, recorded during 2009, 2008, and 2007, respectively. Also includes a $0.4 million valuation adjustment related to a non-strategic land parcel recorded during 2008 and $3.7 million of land and community valuation adjustments related to the Company s Puerto Rico operations recorded during 2007.*

(b) *Includes settlements related to costs previously in dispute and considered non-recoverable.*

(c) *Includes impairments related to joint ventures located in Puerto Rico.*

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Segment information (continued)

	Operating Data by Segment ($000 s omitted) Years Ended December 31,		
	2009	2008	2007
Depreciation and amortization:			
Northeast	$ 2,718	$ 3,431	$ 4,170
Southeast	4,750	6,558	5,255
Gulf Coast	6,003	9,987	14,827
Midwest	1,763	2,790	5,068
Southwest	6,152	13,432	15,531
West	2,385	7,359	10,547
Other homebuilding *(a)*	14,601	8,802	8,817
	38,372	52,359	64,215
Financial Services	4,766	7,938	9,559
Other non-operating *(b)*	11,108	13,683	10,078
Consolidated depreciation and amortization	$ 54,246	$ 73,980	$ 83,852

(a) Other homebuilding includes the Company s operations in Hawaii, Puerto Rico, certain wind down operations, and amortization of intangible assets.

(b) Other non-operating includes depreciation of corporate fixed assets.

	Operating Data by Segment ($000 s omitted) Years Ended December 31,		
	2009	2008	2007
Equity income (loss) *(a)*:			
Northeast	$ (28,011)	$ (139)	$ 30
Southeast	-	-	-
Gulf Coast	(68)	-	-
Midwest	(31)	-	-
Southwest	(16,365)	1,231	(56,941)
West	(1,630)	(11,883)	(131,254)
Other homebuilding	(3,563)	(2,133)	(2,218)
	(49,668)	(12,924)	(190,383)
Financial Services	16	111	361
Consolidated equity income (loss)	$ (49,652)	$ (12,813)	$ (190,022)

(a) Includes impairments related to investments in unconsolidated joint ventures totaling $54.1 million, $18.5 million, and $189.9 million in 2009, 2008, and 2007, respectively.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

6. Segment information (continued)

Operating Data by Segment ($000 s omitted)

December 31, 2009

	Homes Under Construction	Land Under Development	Land Held for Future Development	Total Inventory	Total Assets
Northeast	$ 273,238	$ 256,486	$ 382,828	$ 912,552	$ 1,169,059
Southeast	213,216	356,295	68,408	637,919	788,289
Gulf Coast	318,598	684,598	229,251	1,232,447	1,427,229
Midwest	172,900	241,069	28,760	442,729	468,192
Southwest	191,145	522,709	165,604	879,458	951,346
West	239,613	166,948	126,262	532,823	634,012
Other homebuilding *(a)*	84,184	142,771	75,475	302,430	1,463,359
	1,492,894	2,370,876	1,076,588	4,940,358	6,901,486
Financial Services	-	-	-	-	250,828
Other non-operating *(b)*	-	-	-	-	2,898,908
	$ 1,492,894	$ 2,370,876	$ 1,076,588	$ 4,940,358	$ 10,051,222

December 31, 2008

	Homes Under Construction	Land Under Development	Land Held for Future Development	Total Inventory	Total Assets
Northeast	$ 190,287	$ 279,711	$ 146,580	$ 616,578	$ 897,526
Southeast	146,381	205,152	36,506	388,039	585,450
Gulf Coast	275,584	464,830	224,469	964,883	1,168,368
Midwest	157,347	209,640	27,323	394,310	430,110
Southwest	335,999	531,543	298,421	1,165,963	1,261,163
West	198,225	208,393	96,083	502,701	612,783
Other homebuilding *(a)*	21,849	102,770	44,196	168,815	288,773
	1,325,672	2,002,039	873,578	4,201,289	5,244,173
Financial Services	-	-	-	-	360,774
Other non-operating *(b)*	-	-	-	-	2,103,511
	$ 1,325,672	$ 2,002,039	$ 873,578	$ 4,201,289	$ 7,708,458

December 31, 2007

	Homes Under Construction	Land Under Development	Land Held for Future Development	Total Inventory	Total Assets
Northeast	$ 277,647	$ 530,792	$ 211,342	$ 1,019,781	$ 1,245,240
Southeast	232,013	326,242	30,251	588,506	835,085
Gulf Coast	416,635	740,734	208,488	1,365,857	1,649,655
Midwest	270,094	321,781	30,904	622,779	678,638

Southwest	495,488	1,044,641	492,689	2,032,818	2,173,718
West	394,199	452,860	202,468	1,049,527	1,190,970
Other homebuilding *(a)*	29,026	124,519	3,132	156,677	312,301
	2,115,102	3,541,569	1,179,274	6,835,945	8,085,607
Financial Services	-	-	-	-	566,373
Other non-operating *(b)*	-	-	-	-	1,573,723
	$ 2,115,102	$ 3,541,569	$ 1,179,274	$ 6,835,945	$ 10,225,703

(a) *Other homebuilding primarily includes operations in Hawaii, Puerto Rico, certain wind down operations, capitalized interest, goodwill, and intangibles.*

(b) *Other non-operating primarily includes cash and equivalents, income taxes receivable, and corporate items that are not allocated to the operating segments.*

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

7. Investments in unconsolidated entities

The Company participates in a number of joint ventures with independent third parties. Many of these joint ventures purchase, develop, and/or sell land and homes in the United States and Puerto Rico. A summary of the Company s joint ventures is presented below ($000 s omitted):

	December 31, 2009	December 31, 2008
Number of joint ventures with limited recourse guaranties	3	2
Number of joint ventures with debt non-recourse to Pulte	5	3
Number of other active joint ventures	19	11
Total number of active joint ventures	27	16
Investments in joint ventures with limited recourse guaranties	$ 19,611	$ 17,258
Investments in joint ventures with debt non-recourse to Pulte	12,859	14,317
Investments in other active joint ventures	41,345	103,311
Total investments in unconsolidated entities	$ 73,815	$ 134,886
Total joint venture debt	$ 69,488	$ 84,033
Pulte proportionate share of joint venture debt:		
Joint venture debt with limited recourse guaranties	$ 18,970	$ 32,130
Joint venture debt non-recourse to Pulte	6,357	7,690
Pulte s total proportionate share of joint venture debt	$ 25,327	$ 39,820

The total number of active joint ventures increased significantly in the year ended December 31, 2009 as a result of the Centex merger. The consolidation of two joint ventures in which the Company and Centex were partners was the primary cause for the decrease in investments in other active joint ventures as reflected in the above table.

In 2009, 2008, and 2007, the Company recognized a loss from its unconsolidated joint ventures of $49.7 million, $12.8 million, and $190.0 million, respectively. The equity loss recognized during 2009, 2008, and 2007 includes impairments totaling $54.1 million, $18.5 million, and $189.9 million, respectively. During 2009, 2008, and 2007, the Company made capital contributions of $35.1 million, $54.6 million, and $217.5 million, respectively, to its joint ventures and received capital and earnings distributions of $9.5 million, $11.2 million, and $64.6 million, respectively, from its joint ventures.

The timing of cash obligations under the joint venture and related financing agreements varies by agreement and in certain instances is contingent upon the joint venture s sale of its land holdings. If additional capital infusions are required and approved, the Company would need to contribute its pro rata portion of those capital needs in order not to dilute its ownership in the joint ventures. While future capital contributions may be required, the Company believes the total amount of such contributions will be limited. The Company s maximum financial loss exposure related to joint ventures is unlikely to exceed the combined investment and limited recourse guaranty totals.

The Company has committed through a limited recourse guaranty that one of the joint ventures will maintain specified loan to value ratios. While such debt is scheduled to be repaid in 2010, the Company and its joint venture partners agreed with the lender to make an early repayment of a portion of the debt, which resulted in the Company making a capital contribution of $14.2 million during the year ended December 31, 2009.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

7. Investments in unconsolidated entities (continued)

Another joint venture agreement providing limited recourse guaranties requires the Company and other members of the joint venture to guarantee for the benefit of the lender the completion of the project if the joint venture does not perform the required development and an increment of interest on the loan. This joint venture defaulted under its debt agreement, and the lender has foreclosed on the joint venture s property that served as collateral. During 2008, the lender also filed suit against the majority of the members of the joint venture, including the Company, in an effort to enforce the completion guaranty. While the Company believes it has meritorious defenses against the lawsuit, there is no assurance that the Company will not be required to pay damages under the completion guaranty. The Company s maximum exposure should be limited to its proportionate share of the amount, if any, determined to be owed under such guaranties. Accordingly, the amount of any potential loss the Company might incur as a result of resolving this matter should not exceed the Company s proportionate share of the joint venture s outstanding principal plus accumulated interest as of the date the lender foreclosed on the property, the Company s proportionate share of which totaled approximately $52.2 million at December 31, 2009, representing 12% of the total pre-foreclosure debt of the joint venture, and which is excluded from the above table.

Additionally, the Company has agreed to indemnify the lenders for the three joint ventures with limited recourse guaranties for certain environmental contingencies, and the guaranty arrangements provide that the Company is responsible for its proportionate share of the outstanding debt if the joint venture voluntarily files for bankruptcy. The Company would not be responsible under these guaranties unless the joint venture was unable to meet its contractual borrowing obligations or in instances of fraud, misrepresentation, or other bad faith actions by the Company. To date, the Company has not been requested to perform under the bankruptcy or environmental guaranties described above.

In addition to the joint ventures with limited recourse guaranties, the Company has investments in other unconsolidated entities, some of which have debt. These investments include the Company s joint ventures in Puerto Rico, which are in the final stages of liquidation, as well as other entities. The Company does not have any significant financing exposures related to these entities.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

8. Debt

The Company s senior notes are summarized as follows ($000 s omitted):

	December 31, 2009	December 31, 2008
4.875% unsecured senior notes, issued by Pulte Homes, Inc. due 2009 *(a)*	$ -	$ 25,405
4.55% unsecured senior notes, issued by Centex Corp. due 2010 *(b)*	48,082	-
7.875% unsecured senior notes, issued by Centex Corp. due 2011 *(b)*	90,046	-
8.125% unsecured senior notes, issued by Pulte Homes, Inc. due 2011, *(a)*	13,892	199,736
7.875% unsecured senior notes, issued by Pulte Homes, Inc. due 2011 *(c)*	131,995	497,388
7.50% unsecured senior notes, issued by Centex Corp. due 2012 *(b)*	117,249	-
5.45% unsecured senior notes, issued by Centex Corp. due 2012 *(b)*	128,916	-
6.25% unsecured senior notes, issued by Pulte Homes, Inc. due 2013 *(c)*	224,542	298,816
5.125% unsecured senior notes, issued by Centex Corp. due 2013 *(b)*	258,874	-
5.25% unsecured senior notes, issued by Pulte Homes, Inc. due 2014 *(c)*	463,865	499,824
5.70% unsecured senior notes, issued by Centex Corp. due 2014 *(b)*	336,299	-
5.2% unsecured senior notes, issued by Pulte Homes, Inc. due 2015 *(c)*	292,586	349,602
5.25% unsecured senior notes, issued by Centex Corp. due 2015 *(b)*	415,262	-
6.50% unsecured senior notes, issued by Centex Corp. due 2016 *(b)*	464,139	-
7.625% unsecured senior notes, issued by Pulte Homes, Inc. due 2017 *(a)*	149,156	149,048
7.875% unsecured senior notes, issued by Pulte Homes, Inc. due 2032 *(c)*	299,021	298,978
6.375% unsecured senior notes, issued by Pulte Homes, Inc. due 2033 *(c)*	398,271	398,197
6.0% unsecured senior notes, issued by Pulte Homes, Inc. due 2035 *(c)*	299,337	299,311
7.375% unsecured senior notes, issued by Pulte Homes, Inc. due 2046 *(d)*	150,000	150,000
Total senior notes - carrying value	$ 4,281,532	$ 3,166,305
Estimated fair value	$ 4,087,269	$ 2,136,628

(a) Not redeemable prior to maturity, guaranteed on a senior basis by certain wholly-owned subsidiaries

(b) Redeemable prior to maturity, assumed by Pulte Homes, Inc., and guaranteed on a senior basis by certain wholly-owned subsidiaries

(c) Redeemable prior to maturity, guaranteed on a senior basis by certain wholly-owned subsidiaries

(d) Callable at par on or after June 1, 2011, guaranteed on a senior basis by certain wholly-owned subsidiaries

Refer to Note 17 for supplemental consolidating financial information of the Company.

Total senior note maturities during the five years after 2009 are as follows: 2010 - $47.4 million; 2011 - $231.7 million; 2012 - $237.0 million; 2013 - $495.1 million; 2014 - $814.0 million; and thereafter - $2.5 billion.

The Company retired a significant amount of its outstanding senior notes during 2009 through a number of separate transactions. The Company repurchased $1.5 billion of senior notes during a tender offer completed in September 2009 that resulted in a loss of $47.5 million. Also in September 2009, the Company retired at their scheduled maturity date the remaining $211.0 million of the 5.800% senior notes due 2009 assumed with the Centex merger. In July 2009, the Company retired at their scheduled maturity date the remaining $25.4 million of the 4.875% senior notes due 2009. In May and June 2009, the Company repurchased a total of $192.9 million of senior notes that resulted in a net gain of $15.9 million. As a net result of these transactions, other expense (income), net as reflected in the Consolidated Statements of Operations includes losses on debt repurchases of $31.6 million for 2009.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

8. Debt (continued)

In June 2008, the Company repurchased $313.4 million of its 4.875% senior notes due 2009 by means of a tender offer. These repurchases resulted in a loss of $1.6 million, which is included in the Consolidated Statements of Operations within other expense (income), net.

During 2007, the Company repurchased $61.2 million of its 4.875% senior notes due 2009. These repurchases resulted in a gain of $0.5 million, which is included in the Consolidated Statements of Operations within other expense (income), net.

9. Other financing arrangements

Corporate/Homebuilding

As of September 30, 2009, the Company was not in compliance with the tangible net worth covenant under its revolving credit facility. The Company subsequently requested and received a limited waiver from its banks until December 15, 2009, permitting the Company to utilize letters of credit under the credit facility during the term of the waiver. On December 11, 2009, the Company entered into the Fourth Amendment and Waiver to Third Amended and Restated Credit Agreement, which decreased the Company s borrowing capacity from $1.0 billion to $750.0 million, reduced the credit facility s uncommitted accordion feature from $1.75 billion to $1.0 billion, replaced the maximum debt to capitalization ratio with a maximum debt to tangible capital limit, reduced the tangible net worth minimum, and waived any default under the previous credit facility resulting from failure to comply with the tangible net worth financial covenant. As a result of the December 2009 amendment and previous amendments to the credit facility, the Company recognized expense of $2.9 million and $3.7 million in 2009 and 2008, respectively, which is included in the Consolidated Statements of Operations within selling, general and administrative expenses.

Under the terms of the credit facility, the Company has the capacity to issue letters of credit totaling up to $750 million. Borrowing availability is reduced by the amount of letters of credit outstanding. The credit facility includes a borrowing base limitation when the Company does not have an investment grade senior unsecured debt rating from at least two of Fitch Ratings, Moody s Investor Service, and Standard and Poor s Corporation (the Rating Agencies). The Company currently does not have investment grade ratings from any of the Rating Agencies and is therefore subject to the borrowing base limitation. Under the borrowing base limitation, the sum of the Company s senior debt and the amount drawn on the credit facility may not exceed an amount based on certain percentages of various categories of the Company s unencumbered inventory and other assets. As of December 31, 2009, the Company had no borrowings outstanding and full availability of the remaining $249.4 million under the credit facility after consideration of $500.6 million of outstanding letters of credit.

The Company is also required under the terms of the credit facility to maintain certain liquidity reserve accounts in the event the Company fails to satisfy an interest coverage test. Specifically, if the interest coverage ratio (as defined in the credit facility) is less than 2.0 to 1.0, the Company is required to maintain cash and equivalents in designated accounts with certain banks. While the Company s access to and utilization of cash and equivalents maintained in liquidity reserve accounts is not restricted, failure to maintain sufficient balances within the liquidity reserve accounts restricts the Company s ability to utilize the credit facility. The Company maintained the required cash and equivalents of $415.1 million and $393.3 million within the liquidity reserve accounts at December 31, 2009 and 2008, respectively, calculated under the credit facility as two times the amount by which the interest incurred over the last four fiscal quarters exceeds interest income over the last four fiscal quarters, excluding Financial Services. Additionally, failure to satisfy the interest coverage test can also result in an increase to LIBOR margin and letter of credit pricing.

The credit facility contains certain financial covenants. The Company is required to not exceed a debt to tangible capital ratio as well as to meet a tangible net worth covenant each quarter. Violations of the financial covenants in the credit facility, if not waived by the lenders or cured, could result in an optional maturity date acceleration by the lenders, which might require repayment of any borrowings and replacement or cash collateralization of any letters of credit outstanding under the credit facility. In the event these violations were not waived by the lenders or cured, the violations could also result in a default under the Company s $4.3 billion of senior notes.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

9. Other financing arrangements (continued)

Corporate/Homebuilding (continued)

As of December 31, 2009, the Company was in compliance with all of the covenants under the credit facility. However, in the event market conditions deteriorate in the future or the Company incurs additional land-related charges, the Company s compliance with the required covenant levels may be adversely impacted. Additionally, the Company s ability to utilize the full capacity of the credit facility may be limited under the terms of the borrowing base.

The following is a summary of aggregate borrowing information related to this facility ($000 s omitted):

	2009	2008	2007
Available credit lines at year-end	$ 750,000	$ 1,200,000	$ 1,860,000
Unused credit lines at year-end *(a)*	$ 249,418	$ 846,700	$ 1,412,600
Maximum indebtedness outstanding at the end of any month *(b)*	$ -	$ -	$ 200,000
Average monthly indebtedness *(c)*	$ -	$ -	$ 52,000
Range of interest rates during the year	N/A	N/A	5.56 to 8.25%
Weighted-average rate at year-end	N/A	N/A	6.51%

(a) Reduced by letters of credit outstanding of $500.6 million, $353.3 million, and $447.4 million at December 31, 2009, 2008, and 2007, respectively.

(b) Excludes letters of credit outstanding of $582.1 million for 2009, $446.5 million for 2008, and $486.1 million for 2007.

(c) Excludes letters of credit outstanding, which averaged $407.1 million, $392.1 million, and $484.6 million for 2009, 2008, and 2007, respectively.

At December 31, 2009, other financing included limited recourse collateralized financing arrangements totaling $2.0 million. These financing arrangements have maturities ranging primarily from one to three years, a weighted-average interest rate of 7.7%, are collateralized by certain of the Company s land positions, and have no recourse to any other assets of the Company. These arrangements have been classified as accrued and other liabilities in the Consolidated Balance Sheets.

In June 2009, the Company entered into a five-year, unsecured letter of credit facility (the LOC Agreement) with Deutsche Bank AG, New York Branch, which permits the issuance of up to $200.0 million of letters of credit (LOCs) by the Company. This credit facility supplements the Company s existing letter of credit capacity included in the Company s unsecured revolving credit facility. The LOCs will be used for general corporate purposes of the Company and its subsidiaries. LOCs may be issued to support the obligations of any wholly-owned subsidiary of the Company. At December 31, 2009, $28.6 million of letters of credit were outstanding under this facility.

Financial Services

Pulte Mortgage provides mortgage financing for many of the Company s home sales and uses its own funds and borrowings made available pursuant to certain repurchase agreements. Pulte Mortgage uses these resources to finance its lending activities until the mortgage loans are sold to third party investors. As of December 31, 2009, Pulte Mortgage had a combination of repurchase agreements in place that provided borrowing capacity totaling $175.0 million:

In May 2009, Pulte Mortgage entered into a master repurchase agreement with Comerica Bank, which was subsequently amended in September 2009. The repurchase agreement provides for advances of up to $70.0 million, subject to certain sublimits, and includes an accordion feature under which Pulte Mortgage may request that the aggregate commitments be increased to an amount up to $140.0 million. The repurchase agreement expires on May 14, 2010 and replaced Pulte Mortgage s previous revolving credit agreement, which expired on May 15, 2009. The repurchase agreement contains various affirmative and negative covenants, including the following financial covenants: (i) adjusted tangible net worth shall not be less than $52.8 million, (ii) the leverage ratio shall not be more than 10.0 to 1.0, (iii) quarterly net income shall not be less than $1, and (iv) liquidity shall be no less than $15.0 million.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

9. Other financing arrangements (continued)

Financial Services (continued)

In July 2009, Pulte Mortgage entered into a master repurchase agreement with Bank of America, N.A., which expires on July 30, 2010 and provides advances for up to $35.0 million, subject to certain sublimits. The other terms and conditions of the repurchase agreement with Bank of America, N.A., including the financial covenants, are substantially similar to those under the repurchase agreement with Comerica Bank.

In September 2009, Pulte Mortgage entered into a master repurchase agreement with JPMorgan Chase Bank, N.A., which provides for loan purchases of up to $70.0 million, subject to certain sublimits. The repurchase agreement expires on September 29, 2010. The repurchase agreement contains various affirmative and negative covenants, including the following financial covenants: (i) the leverage ratio should not exceed 10.0 to 1.0; (ii) the minimum adjusted tangible net worth shall not be less than $57.0 million; (iii) the minimum special current ratio shall not be less than 1.05 to 1.0; (iv) liquidity shall be greater than or equal to 3% of actual total assets, as defined within the repurchase agreement; (v) the available warehouse facility under the repurchase agreement should constitute no more than 50% of Pulte Mortgage s aggregate available warehouse facilities; (vi) commencing with the quarter ending March 31, 2010, Pulte Mortgage shall not permit its net income before taxes, for such quarter and each calendar quarter thereafter, to be less than $1; and (vii) the maximum warehouse capacity ratio shall not exceed 20.0 to 1.0.

At December 31, 2009, Pulte Mortgage had $18.4 million outstanding under its repurchase arrangements. During the three years ended December 31, 2009, Pulte Mortgage provided compensating balances, in the form of escrows and other custodial funds, in order to further reduce interest rates.

The following is aggregate borrowing information for the Company s mortgage operations ($000 s omitted):

	2009		2008		2007	
Available credit lines at year-end	$	175,000	$	405,000	$	705,000
Unused credit lines at year-end	$	157,000	$	167,000	$	264,000
Maximum amount outstanding at the end of any month	$	79,422	$	262,000	$	441,000
Average monthly indebtedness	$	44,522	$	174,000	$	291,000
Range of interest rates during the year		0.53% to 4.75%		0.53% to 6.62%		0.53% to 6.66%
Weighted-average rate at year-end		4.29%		0.95%		5.47%

Borrowings under Pulte Mortgage s credit lines are secured by residential mortgage loans available-for-sale. The carrying amounts of such borrowings approximate fair value.

CTX Mortgage Company LLC (CTX Mortgage), which was acquired with the Centex merger, also had a master repurchase agreement in place with JP Morgan Chase Bank, N.A. that provided for advances of up to $50 million, subject to certain sublimits, and was scheduled to expire on January 31, 2010. The Company terminated this agreement in December 2009.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

10. Shareholders equity

Pursuant to the two $100.0 million stock repurchase programs authorized by the Board of Directors in October 2002 and 2005, and the $200.0 million stock repurchase authorization in February 2006 (for a total stock repurchase authorization of $400 million), the Company has repurchased a total of 9,688,900 shares for a total of $297.7 million. At December 31, 2009, the Company had remaining authorization to purchase $102.3 million of common stock.

On November 24, 2008, the Board of Directors discontinued the regular quarterly dividend on the Company s common stock effective in the first quarter of 2009.

Under its stock-based compensation plans, the Company accepts shares as payment under certain conditions related to stock option exercises and vesting of restricted stock, generally related to the payment of minimum tax obligations. During 2009 and 2008, the Company repurchased $7.4 million and $5.3 million, respectively, of shares from employees under these plans. Such repurchases are excluded from the $400 million stock repurchase authorization.

Accumulated other comprehensive income (loss)

The accumulated balances related to each component of other comprehensive income (loss) are as follows ($000 s omitted):

	December 31, 2009	December 31, 2008
Foreign currency translation adjustments:		
Mexico	$ 45	$ (1,091)
Fair value of derivatives, net of income taxes of $2,086 in 2009 and 2008	(2,294)	(3,008)
	$ (2,249)	$ (4,099)

11. Stock compensation plans

The Company has fixed stock option plans for both employees and for non-employee directors. Information related to the active plans as of December 31, 2009 is as follows:

Plan Name	Shares Authorized	Shares Available for Grant
Employee Plans		
Pulte Homes, Inc. 2004 Stock Incentive Plan	22,000,000	11,023,997
Pulte Homes, Inc. 2002 Stock Incentive Plan	12,000,000	64,830
Pulte Homes, Inc. 2000 Stock Incentive Plan for Key Employees	10,000,000	123,272

The plans provide for the grant of options (both non-qualified options and incentive stock options as defined in each respective plan), stock appreciation rights, restricted stock, and restricted stock units to key employees of the Company or its subsidiaries (as determined by the Compensation Committee of the Board of Directors) for periods not exceeding ten years. Options granted to employees vest incrementally in periods ranging from six months to four years. Non-employee directors are entitled to an annual distribution of shares of common stock, restricted stock units, and stock options. All options granted to non-employee directors are non-qualified, vest immediately, and are exercisable on the date of grant. Options granted to non-employee directors are exercisable for ten years from the grant date. Restricted stock units are converted into shares of the Company s common stock at distribution. Restricted stock units represent the right to receive an equal number of shares of the Company s common stock at the time the award is paid and were fully vested upon issuance.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

11. Stock compensation plans (continued)

A summary of the Company s stock option activity for the years ended December 31, 2009, 2008, and 2007 is presented below (000 s omitted except per share data):

	2009		2008		2007	
	Shares	Weighted-Average Per Share Exercise Price	Shares	Weighted-Average Per Share Exercise Price	Shares	Weighted-Average Per Share Exercise Price
Outstanding, beginning of year	20,059	$ 19	19,884	$ 20	18,237	$ 21
Granted *(a)*	8,235	$ 27	1,430	$ 11	2,884	$ 12
Exercised	(756)	$ (6)	(528)	$ (8)	(683)	$ (10)
Forfeited	(1,345)	$ (45)	(727)	$ (23)	(554)	$ (33)
Outstanding, end of year	26,193	$ 21	20,059	$ 19	19,884	$ 20
Options exercisable at year end	20,336	$ 23	14,857	$ 20	13,471	$ 17
Weighted-average per share fair value of options granted during the year	$ 2.19		$ 5.72		$ 4.32	

(a) Includes 5.3 million options issued in 2009 in conjunction with the Centex merger.

The following table summarizes information about the weighted-average remaining contractual lives of stock options outstanding and exercisable at December 31, 2009:

	Options Outstanding			Options Exercisable	
	Number Outstanding (000 s omitted)	Weighted-Average Remaining Contract Life (in years)	Weighted-Average Per Share Exercise Price	Number Exercisable (000 s omitted)	Weighted-Average Per Share Exercise Price
$0.01 to $11.00	6,624	3.7	$ 10	5,470	$ 10
$11.01 to $18.00	7,627	6.5	$ 12	3,394	$ 12
$18.01 to $25.00	3,852	4.0	$ 22	3,852	$ 22
$25.01 to $35.00	4,600	5.2	$ 31	4,134	$ 31
$35.01 to $60.00	3,490	4.4	$ 45	3,486	$ 45

The fair value of each option grant is estimated on the date of grant using primarily the Black-Scholes option pricing model with the following weighted-average assumptions:

	Weighted-Average Assumptions Year Ended December 31,		
	2009	2008	2007
Expected life of options in years	3.1	5.6	5.5
Expected stock price volatility	60%	54%	40%
Expected dividend yield	0.0%	0.1%	1.5%
Risk-free interest rate	1.2%	1.8%	3.4%

The Company has estimated the expected life of its share options using employees historical exercise behavior and the contractual term of these instruments in determining the fair value of its share options. Volatility is estimated using a combination of implied volatility and historical volatility.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

11. Stock compensation plans (continued)

In connection with stock option awards, the Company recognized compensation expense of $22.1 million, $15.8 million, and $28.2 million for the years ended December 31, 2009, 2008, and 2007, respectively. Total compensation cost related to non-vested stock option awards not yet recognized was $13.9 million at December 31, 2009. These costs will be expensed over a weighted-average period of approximately three years. The aggregate intrinsic value of both stock options outstanding and exercisable at December 31, 2009 was $1.8 million. The aggregate intrinsic value of stock options that were exercised during 2009, 2008, and 2007 was $3.3 million, $2.4 million, and $8.8 million, respectively. The aggregate intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option.

The Company s stock option participant agreements provide continued vesting for certain eligible employees who have achieved a predetermined level of service based on their combined age and years of service. For awards granted prior to January 1, 2006, the Company recognizes the related compensation cost ratably over the nominal vesting period. For awards granted after the adoption of SFAS No. 123(R) (codified within ASC 718, Compensation Stock Compensation), the Company records the related compensation cost over the period through the date the employee first achieves the minimum level of service that would no longer require them to provide services to earn the award. For the years ended December 31, 2009, 2008, and 2007, the Company recorded $5.6 million, $3.9 million, and $4.5 million, respectively, of compensation expense related to stock option grants made to employees that have achieved this level of service, as well as those who will achieve this level of service during the vesting period.

A summary of the Company s restricted stock activity for the three years ended December 31, 2009 is presented below (000 s omitted, except per share data):

	2009		2008		2007	
	Shares	Weighted-Average Per Share Grant Date Fair Value	Shares	Weighted-Average Per Share Grant Date Fair Value	Shares	Weighted-Average Per Share Grant Date Fair Value
Non-vested at beginning of year	3,932	$ 23	4,335	$ 31	3,717	$ 35
Granted	2,182	$ 12	1,490	$ 13	1,616	$ 20
Vested	(1,957)	$ 25	(1,268)	$ 36	(689)	$ 27
Forfeited	(618)	$ 14	(625)	$ 28	(309)	$ 35
Non-vested at end of year	3,539	$ 16	3,932	$ 23	4,335	$ 31

The Company awarded 2,181,997, 1,490,511, and 1,615,612 shares of restricted stock to certain key employees during 2009, 2008, and 2007, respectively. During 2009, 2008, and 2007, the total fair value of shares vested during the year was $48.1 million, $46.2 million, and $18.9 million, respectively. In connection with the restricted stock awards, of which a majority cliff vest at the end of three years, the Company recorded compensation expense of $24.2 million, $23.3 million, and $42.5 million during 2009, 2008, and 2007, respectively. Total compensation cost related to restricted stock awards not yet recognized was $20.2 million at December 31, 2009. These costs will be expensed over a weighted-average period of approximately two years.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

11. Stock compensation plans (continued)

A summary of the Company s restricted stock unit activity for the year ended December 31, 2009 is presented below (000 s omitted, except per share data):

	2009	
	Shares	Weighted-Average Grant-Date Fair Value
Outstanding, beginnning of year	-	$ -
Granted	632	$ 12
Forfeited	(269)	$ 12
Distributed	(240)	$ 12
Outstanding, end of year	123	$ 12
Vested, end of year	123	$ 12

The restricted stock units granted during 2009 were done so in conjunction with the Centex merger. The fair value of each restricted stock unit was calculated using the closing stock price on the date of grant and was included within the calculation of consideration transferred. At December 31, 2009, there were 123,319 restricted stock units outstanding that had vested but had not yet been paid out because the payout date had been deferred by the holder.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

12. Income taxes

Components of current and deferred income tax expense (benefit) for continuing operations are as follows ($000 s omitted):

	2009	2008	2007
Current provision (benefit)			
Federal	$ (812,744)	$ (346,699)	$ (261,921)
State and other	(17,395)	31,307	(33,729)
	$ (830,139)	$ (315,392)	$ (295,650)
Deferred provision (benefit)			
Federal	$ 37,587	$ 95,668	$ 61,043
State and other	-	10,238	12,121
	$ 37,587	$ 105,906	$ 73,164
Income tax benefit	$ (792,552)	$ (209,486)	$ (222,486)

The following table reconciles the statutory federal income tax rate to the effective income tax rate for continuing operations:

	2009	2008	2007
Income taxes at federal statutory rate	35.0%	35.0%	35.0%
Effect of state and local income taxes, net of federal tax	3.0	3.0	3.0
Deferred tax asset valuation allowance	18.4	(24.9)	(25.0)
Tax contingencies	(4.7)	(1.4)	0.2
Goodwill impairment	(9.7)	-	(4.2)
Other	(1.9)	0.7	(0.1)
Effective rate	40.1%	12.4%	8.9%

The Company s net deferred tax asset (liability) is as follows ($000 s omitted):

	At December 31,	
	2009	2008
Deferred tax assets:		
Non-deductible reserves and other	$ 531,237	$ 230,159
Inventory valuation reserves	1,504,815	836,145
Net operating loss carryforwards:		
Federal	150,267	16,897
State	256,257	94,100
Alternative minimum tax credits	22,784	22,856
Energy credits and charitable contribution carryforward	39,053	17,715

	2,504,413	1,217,872
Deferred tax liabilities:		
Capitalized items, including real estate basis differences, deducted for tax, net	(83,880)	(127,228)
Trademarks and tradenames	(75,218)	(38,971)
	(159,098)	(166,199)
Valuation allowance	(2,345,315)	(1,051,673)
Net deferred tax asset	$ -	$ -

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

12. Income taxes (continued)

The Company s income tax benefit for the year ended December 31, 2009 was $792.6 million compared with a benefit of $209.5 million for the year ended December 31, 2008. These amounts represent effective tax rates of 40.1% and 12.4% for the tax years ended December 31, 2009 and 2008, respectively.

On November 6, 2009, the Worker, Homeownership, and Business Assistance Act of 2009 (the Act) was enacted into law. The Act amended Section 172 of the Internal Revenue Code to allow net operating losses realized in either tax year 2008 or 2009 to be carried back up to five years (previously limited to two years). The Company expects to realize $867.3 million from the carryback of 2009 net operating losses pursuant to the Act. No state in which the Company operates has adopted the Act and as such no state benefits will be realized from the extended carryback provision.

The Company had income taxes receivable of $955.2 million and $373.6 million at December 31, 2009 and 2008, respectively. Income taxes receivable at December 31, 2009 included $867.3 million related to the carryback of 2009 federal net operating losses under the Act. The Company expects to receive these federal income tax refunds in the first half of 2010. The remaining income taxes receivable relate to state net operating loss carrybacks and other federal and state tax refunds.

At December 31, 2009, the Company had deferred tax assets totaling $150.3 million for federal and $256.3 million for state net operating loss carryforwards. The Company s gross federal net operating loss carryforward is approximately $426.0 million. The Company also has significant gross state net operating losses in various tax jurisdictions. These net operating losses may be carried forward from 5 to 20 years, depending on the tax jurisdiction, with losses expiring between 2010 and 2029.

Deferred tax assets primarily represent the deferred tax benefits arising from temporary differences between book and tax income which will be recognized in future years as an offset against future taxable income. In accordance with SFAS No. 109, Accounting for Income Taxes (codified in ASC 740-10), the Company evaluates its deferred tax assets, including net operating losses, to determine if a valuation allowance is required. ASC 740-10 requires that companies assess whether a valuation allowance should be established based on the consideration of all available evidence using a more likely than not standard. In making such judgments, significant weight is given to evidence that can be objectively verified. ASC 740-10 provides that a cumulative loss in recent years is significant negative evidence in considering whether deferred tax assets are realizable and also restricts the amount of reliance on projections of future taxable income to support the recovery of deferred tax assets. In the fourth quarter of 2007, the Company determined that it would be in a cumulative loss position in 2008. Accordingly, a $621.9 million valuation allowance was recorded. Given the continued downturn in the homebuilding industry during 2008 and 2009, resulting in additional inventory impairments and losses, the Company continues to be in a cumulative pre-tax loss position.

At December 31, 2009 and 2008, the Company had net deferred tax assets of $2.3 billion and $1.1 billion, respectively, which were offset by valuation allowances, due to the uncertainty of realizing such deferred tax assets. The increase in the net deferred tax assets and valuation allowance is principally due to the merger with Centex. The ultimate realization of these deferred tax assets is dependent upon the generation of taxable income during future periods. Changes in existing tax laws could also affect actual tax results and the valuation of deferred tax assets over time. The accounting for deferred taxes is based upon an estimate of future results. Differences between the anticipated and actual outcomes of these future tax consequences could have a material impact on the Company s consolidated results of operations or financial position.

As a result of the Company s merger with Centex, the Company s ability to use certain of Centex s pre-ownership change net operating losses and built-in losses or deductions will be limited by Section 382 of the Internal Revenue Code. The Company s Section 382 limitation is approximately $68 million per year for net operating losses, losses realized on built-in loss assets that are sold within five years of the ownership change, and certain deductions. The limitation may result in a significant portion of Centex s pre-ownership change net operating loss carryforwards and future recognized built-in losses or deductions not being available for use by the Company.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

12. Income taxes (continued)

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48 , codified within ASC 740-10), effective January 1, 2007. FIN 48 created a single model to address accounting for uncertainty in tax positions and clarifies accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The January 1, 2007 adoption of FIN 48 resulted in a $31.4 million increase in income tax liabilities and a corresponding charge to beginning retained earnings.

At December 31, 2009 the Company had $326.1 million of gross unrecognized tax benefits, of which $291 million would affect the effective tax rate if recognized. At December 31 2008, the Company had $126.3 million of gross unrecognized tax benefits, of which $96.3 million would affect the effective rate if recognized. Additionally, the Company had $80.6 million and $36.1 million of accrued interest and penalties at December 31, 2009 and 2008, respectively. In 2009 and 2008, the Company s income tax expense included tax related interest and penalties. Such amounts totaled $3.4 million in 2009 and $10.2 million in 2008. The 2009 increase in unrecognized tax benefits and accrued interest and penalties is largely due to the merger with Centex.

The Company is currently under examination by the IRS and various state taxing jurisdictions and anticipates finalizing certain of the examinations within the next twelve months. The final outcome of these examinations is not yet determinable. It is reasonably possible, within the next twelve months, that the Company s unrecognized tax benefits may decrease by approximately $116 million, excluding interest and penalties, primarily due to expirations of certain statutes of limitations and potential settlements. The statute of limitations for the Company s major tax jurisdictions remains open for examination for tax years 1998 to 2009.

A reconciliation of the change in the unrecognized tax benefits is as follows ($000 s omitted):

	2009	2008
Unrecognized tax benefits, beginning of period	$ 126,299	$ 86,209
Assumed with Centex merger	121,667	-
Decreases related to tax positions taken during the current period	(10,029)	-
Increases related to tax positions taken during a prior period	37,303	57,647
Decreases related to tax positions taken during a prior period	(10,414)	(10,951)
Increases related to tax positions taken during the current period	82,973	6,678
Decreases related to settlements with taxing authorities	(1,389)	(4,078)
Reductions as a result of a lapse of the applicable statute of limitations	(20,322)	(9,206)
Unrecognized tax benefits, end of period	$ 326,088	$ 126,299

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

13. Fair value disclosures

ASC 820, Fair Value Measurements and Disclosures, provides a framework for measuring fair value in generally accepted accounting principles and establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The fair value hierarchy can be summarized as follows:

Level 1 Fair value determined based on quoted prices in active markets for identical assets or liabilities.

Level 2 Fair value determined using significant observable inputs, generally either quoted prices in active markets for similar assets or liabilities or quoted prices in markets that are not active.

Level 3 Fair value determined using significant unobservable inputs, such as pricing models, discounted cash flows, or similar techniques.

The Company s financial instruments measured at fair value on a recurring basis are summarized below ($000 s omitted):

Financial Instrument	Level 1	Level 2	Level 3	Fair Value at December 31, 2009
Residential mortgage loans available-for-sale	$ -	$ 166,817	$ -	$ 166,817
Whole loan commitments	-	910	-	910
Interest rate lock commitments	-	1,915	-	1,915
Forward contracts	-	2,475	-	2,475
	$ -	$ 172,117	$ -	$ 172,117

See Note 1 of the Consolidated Financial Statements regarding the fair value of mortgage loans available-for-sale and derivative instruments and hedging activities.

In addition, certain of the Company s assets are required to be recorded at fair value on a non-recurring basis when events and circumstances indicate that the carrying value may not be recoverable. The Company s assets measured at fair value on a non-recurring basis are summarized below ($000 s omitted):

	Level 1	Level 2	Level 3	Fair Value at December 31, 2009
Loans held for investment	$ -	$ 5,384	$ 10,333	$ 15,717
Real estate owned	-	13,515	-	13,515
House and land inventory	-	-	66,226	66,226
	$ -	$ 18,899	$ 76,559	$ 95,458

The fair values included in the table above represent only those assets whose carrying values were adjusted to fair value in the current quarter. The Company measured certain of its loans held for investment at fair value since the cost of the loans exceeded their fair value. Fair value of the loans was determined based on the fair value of the underlying collateral. The Company values real estate acquired through foreclosure, or real estate owned, at fair value less cost to sell. Fair values are determined through appraisals and market analyses. For house and land inventory, see Note 5 of these Consolidated Financial Statements for a more detailed discussion of the valuation methods used.

The carrying amounts of cash and equivalents approximate their fair values due to their short-term nature. The fair values of senior notes are based on quoted market prices, when available. If quoted market prices are not available, fair values are based on quoted market prices of similar issues. At December 31, 2009, the fair value of the senior notes outstanding approximated $4.1 billion. The carrying values of the senior notes are presented in Note 8. Borrowings under Financial Services repurchase agreements are secured by residential mortgage loans available-for-sale. The carrying amounts of such borrowings approximate fair value.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

14. Other assets and accrued and other liabilities

The Company s other assets are presented below ($000 s omitted):

	December 31, 2009	December 31, 2008
Deposits and pre-acquisition costs	$ 143,502	$ 225,292
Accounts and notes receivable	196,622	115,918
Prepaid expenses	124,790	102,737
Property and equipment, net	82,419	69,297
Other	157,707	81,854
	$ 705,040	$ 595,098

The Company s accrued and other liabilities are presented below ($000 s omitted):

	December 31, 2009	December 31, 2008
Self insurance liabilities	$ 566,693	$ 347,631
Community development district obligations	224,294	15,256
Liabilities for land, not owned, under option agreements	174,132	171,101
Compensation-related	108,088	172,524
Loan origination liabilities	100,768	3,240
Warranty	96,110	58,178
Accrued interest	67,906	67,878
Lease exit liabilities	38,591	7,771
Other	466,963	235,616
	$ 1,843,545	$ 1,079,195

15. Leases

The Company leases certain property and equipment under non-cancelable leases. The future minimum lease payments required under operating leases that have initial or remaining non-cancelable terms in excess of one year are as follows ($000 s omitted):

Years Ending December 31,	
2010	$ 54,162
2011	42,153
2012	34,383
2013	26,666
2014	22,326
After 2014	76,402

Total minimum lease payments	$	256,092

Net rental expense for 2009, 2008, and 2007 was $48.7 million, $67.1 million, and $70.7 million, respectively. Certain leases contain renewal or purchase options and generally provide that the Company shall pay for insurance, taxes, and maintenance.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

16. Commitments and contingencies

Loan origination liabilities

The Company s mortgage operations have established liabilities for anticipated losses associated with mortgage loans originated and sold to investors that may result from borrower fraud, borrower early payment defaults, or loans that have not been underwritten in accordance with the investor guidelines. In the normal course of business, the Company s mortgage operations also provide limited indemnities for certain loans sold to investors. The Company establishes the liabilities for such anticipated losses based upon, among other things, historical loss rates, current trends in loan originations, and the geographic location of the underlying collateral. Effective with the Centex merger, we assumed loan origination liabilities totaling $52.6 million. Also during 2009, the Company has experienced a significant increase in actual and anticipated losses as a result of the high level of loan defaults and related losses in the mortgage industry and increasing aggressiveness by investors in presenting such claims to the Company. Given the volatility in the mortgage industry, it is reasonably possible that future losses may exceed the Company s current estimates. Changes in these liabilities are as follows ($000 s omitted):

	2009	2008	2007
Liabilities, beginning of period	$ 3,240	$ 2,107	$ 395
Provision for losses	60,896	2,370	1,787
Settlements	(15,983)	(1,237)	(75)
Liabilities assumed with Centex merger	52,615	-	-
Liabilities, end of period	$ 100,768	$ 3,240	$ 2,107

Mortgage reinsurance liabilities

A subsidiary of Pulte Mortgage operates as a re-insurer for a portion of the mortgage insurance written on loans originated by Pulte Mortgage. Such reinsurance programs were discontinued effective January 1, 2009. At December 31, 2009 and 2008, reserves for potential claims under this program totaled $9.1 million and $11.7 million, respectively, and are reflected in accrued and other liabilities.

Community development and other special district obligations

A community development district or similar development authority (CDD) is a unit of local government created under various state statutes that utilizes the proceeds from the sale of bonds to finance the construction or acquisition of infrastructure assets of a development. A portion of the liability associated with the bonds, including principal and interest, is assigned to each parcel of land within the development. This debt is typically paid by subsequent special assessments levied by the CDD on the landowners. Generally, the Company is only responsible for paying the special assessments for the period in which it is the landowner of the applicable parcels. However, in certain limited instances the Company records a liability for future assessments that are fixed or determinable for a fixed or determinable period in accordance with ASC 970-470, Real Estate Debt . At December 31, 2009 and 2008, the Company had recorded $224.3 million and $15.3 million, respectively, in accrued liabilities for outstanding CDD obligations. The increase in the liability as of December 31, 2009 resulted from CDD obligations for certain communities acquired with the Centex merger.

Surety bonds

In the normal course of business, the Company posts surety bonds pursuant to certain performance related obligations. At December 31, 2009 and 2008, the Company had outstanding letters of credit and performance bonds totaling $2.0 billion and $1.4 billion, respectively.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

16. Commitments and contingencies (continued)

Surety bonds (continued)

In addition, the Company is subject to approximately $1.4 billion of surety bonds related to certain construction obligations of Centex s previous commercial construction business, which was sold by Centex on March 30, 2007. The Company estimates that less than $200.0 million of work remains to be performed on these commercial construction projects. No event has occurred that has led the Company to believe that these bonds will be drawn upon. Additionally, the purchaser of the Centex commercial construction business has indemnified the Company against potential losses relating to such surety bond obligations. As additional security, the Company has purchased for its benefit a back-up indemnity provided by a financial institution with an investment grade credit rating. The obligation of such financial institution under the back-up indemnity is limited to $400.0 million and terminates in 2016, if not previously terminated by the Company.

Litigation

The Company is involved in various litigation incidental to its continuing business operations. While the outcome of such contingencies cannot be predicted with certainty, management does not believe that the resolution of such matters will have a material adverse impact on the results of operations, financial position, or cash flows of the Company.

Self-insured risks

The Company has, and requires the majority of its subcontractors to have, general liability, property, errors and omissions, workers compensation, and other business insurance. These insurance policies protect the Company against a portion of its risk of loss from claims, subject to certain self-insured retentions, deductibles, and other coverage limits.

In certain instances in which the Company believes it is too difficult or expensive for its subcontractors to obtain general liability insurance, the Company may waive its traditional subcontractor general liability insurance requirements and purchase insurance policies from either third party carriers or one of the Company s wholly-owned captive insurance subsidiaries, and name certain subcontractors as additional insureds. The policies issued by the captive insurance subsidiary represent self insurance of these risks by the Company. As compensation for assuming such additional risks, the Company either collects premiums or receives lower pricing from the subcontractors, depending on the program s structure.

The Company reserves for costs to cover its self-insured and deductible amounts under these policies, some of which are maintained in its wholly-owned captive insurance subsidiaries, and for any costs of claims and related lawsuits, based on an analysis of the Company s historical claims, which includes an estimate of claims incurred but not yet reported. These estimates are subject to a high degree of uncertainty due to a variety of factors, including extended lag times in the reporting and resolution of claims, which generally occur over several years and can occur in excess of ten years, and trends or changes in claim settlement patterns, insurance industry practices, and legal interpretations. As a result, actual costs could differ significantly from the estimated amounts. Adjustments to estimated reserves are recorded in the period in which the change in estimate occurs. The Company s reserves for such items totaled $566.7 million and $347.6 million at December 31, 2009 and 2008, respectively. The balance at December 31, 2009 includes $271.0 million acquired with the Centex merger. Expenses, including estimates for claims not yet reported, totaled $34.9 million, $103.5 million, and $141.2 million, in 2009, 2008, and 2007, respectively. The Company experienced a high level of insurance-related expenses in 2009, 2008, and 2007, primarily due to the adverse development of general liability product claims, the frequency and severity of which have increased significantly in recent years, including several very large claims. In certain instances, the Company has the ability to recover a portion of its costs under various insurance policies or from its subcontractors or other third parties. Estimates of such amounts are recorded when recovery is considered probable.

The Company is self-insured for certain of its medical and dental claims and reserves for costs to cover its liability for such claims, based on analysis of historical claims, which include an estimate of claims incurred but not yet reported. The Company s reserves for such items totaled $5.5 million and $3.8 million at December 31, 2009 and 2008, respectively.

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information

All of the Company s senior notes are guaranteed jointly and severally on a senior basis by each of the Company s wholly-owned Homebuilding subsidiaries and certain other wholly-owned subsidiaries (collectively, the Guarantors). Such guaranties are full and unconditional. Supplemental consolidating financial information of the Company, including such information for the Guarantors, is presented below. Investments in subsidiaries are presented using the equity method of accounting. Separate financial statements of the Guarantors are not provided as the consolidating financial information contained herein provides a more meaningful disclosure to allow investors to determine the nature of the assets held by, and the operations of, the combined groups.

PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING BALANCE SHEET

DECEMBER 31, 2009

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
ASSETS					
Cash and equivalents	$ -	$ 1,501,684	$ 356,550	$ -	$ 1,858,234
Restricted cash	-	3,414	28,962	-	32,376
Unfunded settlements	-	5,085	(2,932)	-	2,153
House and land inventory	-	4,935,821	4,537	-	4,940,358
Land held for sale	-	58,645	-	-	58,645
Land, not owned, under option agreements	-	174,132	-	-	174,132
Residential mortgage loans available-for-sale	-	-	166,817	-	166,817
Investments in unconsolidated entities	1,511	64,578	7,726	-	73,815
Goodwill	-	895,918	-	-	895,918
Intangible assets, net	-	188,548	-	-	188,548
Other assets	36,007	599,795	69,238	-	705,040
Income taxes receivable	955,186	-	-	-	955,186
Deferred income tax assets	(30,149)	31	30,118	-	-
Investments in subsidiaries and intercompany accounts, net	6,993,438	3,770,005	4,352,881	(15,116,324)	-
	$ 7,955,993	$ 12,197,656	$ 5,013,897	$ (15,116,324)	$ 10,051,222
LIABILITIES AND SHAREHOLDERS EQUITY					
Liabilities:					
Accounts payable, customer deposits, accrued and other liabilities	$ 119,100	$ 1,570,406	$ 506,429	$ -	$ 2,195,935
Collateralized short-term debt, recourse solely to applicable non-guarantor subsidiary assets	-	-	18,394	-	18,394
Income tax liabilities	360,921	-	-	-	360,921
Senior notes	4,281,532	-	-	-	4,281,532
Total liabilities	4,761,553	1,570,406	524,823	-	6,856,782
Total shareholders equity	3,194,440	10,627,250	4,489,074	(15,116,324)	3,194,440
	$ 7,955,993	$ 12,197,656	$ 5,013,897	$ (15,116,324)	$ 10,051,222

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING BALANCE SHEET

DECEMBER 31, 2008

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
ASSETS					
Cash and equivalents	$ -	$ 1,288,200	$ 367,064	$ -	$ 1,655,264
Unfunded settlements	-	11,191	797		11,988
House and land inventory	-	4,196,488	4,801	-	4,201,289
Land held for sale	-	164,954	-	-	164,954
Land, not owned, under option agreements	-	171,101	-	-	171,101
Residential mortgage loans available-for-sale	-	-	297,755	-	297,755
Investments in unconsolidated entities	1,348	127,541	5,997	-	134,886
Intangible assets, net	-	102,554	-	-	102,554
Other assets	38,273	508,815	48,010	-	595,098
Income taxes receivable	373,569	-	-	-	373,569
Deferred income tax assets	(26,977)	37	26,940	-	-
Investments in subsidiaries and intercompany accounts, net	5,874,166	1,818,530	4,711,055	(12,403,751)	-
	$ 6,260,379	$ 8,389,411	$ 5,462,419	$ (12,403,751)	$ 7,708,458
LIABILITIES AND SHAREHOLDERS EQUITY					
Liabilities:					
Accounts payable, customer deposits, accrued and other liabilities	$ 127,761	$ 821,342	$ 389,177	$ -	$ 1,338,280
Collateralized short-term debt, recourse solely to applicable non-guarantor subsidiary assets	-	-	237,560	-	237,560
Income tax liabilities	130,615	-	-	-	130,615
Senior notes	3,166,305	-	-	-	3,166,305
Total liabilities	3,424,681	821,342	626,737	-	4,872,760
Total shareholders equity	2,835,698	7,568,069	4,835,682	(12,403,751)	2,835,698
	$ 6,260,379	$ 8,389,411	$ 5,462,419	$ (12,403,751)	$ 7,708,458

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF OPERATIONS

For the year ended December 31, 2009

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Revenues:					
Homebuilding					
Home sale revenues	$ -	$ 3,869,297	$ -	$ -	$ 3,869,297
Land sale revenues	-	97,292	-	-	97,292
	-	3,966,589	-	-	3,966,589
Financial Services	-	9,859	107,941	-	117,800
	-	3,976,448	107,941	-	4,084,389
Homebuilding Cost of Revenues:					
Home cost of revenues	-	4,274,474	-	-	4,274,474
Land cost of revenues	-	211,170	-	-	211,170
	-	4,485,644	-	-	4,485,644
Financial Services expenses	716	6,794	165,344	-	172,854
Selling, general and administrative expenses	77,227	542,622	52,585	-	672,434
Other expense, net	31,353	650,728	3,748	-	685,829
Interest income	(2)	(7,782)	(1,383)	-	(9,167)
Interest expense	1,810	537	(85)	-	2,262
Intercompany interest	237,492	(237,492)	-	-	-
Equity loss from unconsolidated entities	-	46,065	3,587	-	49,652
Loss before income taxes and equity in income of subsidiaries	(348,596)	(1,510,668)	(115,855)	-	(1,975,119)
Income tax benefit	(139,828)	(625,250)	(27,474)	-	(792,552)
Loss before equity in income of subsidiaries	(208,768)	(885,418)	(88,381)	-	(1,182,567)
Equity in income (loss) of subsidiaries	(973,799)	(80,196)	(191,763)	1,245,758	-
Net income (loss)	$ (1,182,567)	$ (965,614)	$ (280,144)	$ 1,245,758	$ (1,182,567)

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF OPERATIONS

For the year ended December 31, 2008

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Revenues:					
Homebuilding					
Home sale revenues	$ -	$ 5,980,289	$ -	$ -	$ 5,980,289
Land sale revenues	-	131,749	-	-	131,749
	-	6,112,038	-	-	6,112,038
Financial Services	-	15,607	135,409	-	151,016
	-	6,127,645	135,409	-	6,263,054
Homebuilding Cost of Revenues:					
Home cost of revenues	-	6,585,177	-	-	6,585,177
Land cost of revenues	-	393,998	-	-	393,998
	-	6,979,175	-	-	6,979,175
Financial Services expenses	676	7,101	115,305	-	123,082
Selling, general and administrative expenses	72,754	678,156	63,598	-	814,508
Other expense, net	1,594	36,370	1,607	-	39,571
Interest income	(100)	(17,012)	(9,292)	-	(26,404)
Interest expense	2,901	57	(50)	-	2,908
Intercompany interest	219,508	(219,508)	-	-	-
Equity loss from unconsolidated entities	-	10,747	2,066	-	12,813
Loss before income taxes and equity in income of subsidiaries	(297,333)	(1,347,441)	(37,825)	-	(1,682,599)
Income tax benefit	(35,631)	(161,753)	(12,102)	-	(209,486)
Loss before equity in income of subsidiaries	(261,702)	(1,185,688)	(25,723)	-	(1,473,113)
Equity in income (loss) of subsidiaries	(1,211,411)	11,758	(982,519)	2,182,172	-
Net income (loss)	$ (1,473,113)	$ (1,173,930)	$ (1,008,242)	$ 2,182,172	$ (1,473,113)

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF OPERATIONS

For the year ended December 31, 2007

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Revenues:					
Homebuilding					
Home sale revenues	$ -	$ 8,881,509	$ -	$ -	$ 8,881,509
Land sale revenues	-	240,221	-	-	240,221
	-	9,121,730	-	-	9,121,730
Financial Services	-	20,802	113,967	-	134,769
	-	9,142,532	113,967	-	9,256,499
Homebuilding Cost of Revenues:					
Home cost of revenues	-	9,329,354	-	-	9,329,354
Land cost of revenues	-	418,177	-	-	418,177
	-	9,747,531	-	-	9,747,531
Financial Services expenses	634	8,543	82,973	-	92,150
Selling, general and administrative expenses	98,820	925,607	70,056	-	1,094,483
Other expense, net	942	624,674	6,331	-	631,947
Interest income	(12)	(3,178)	(3,405)	-	(6,595)
Interest expense	21,663	247	(18,046)	-	3,864
Intercompany interest	164,933	(164,933)	-	-	-
Equity loss from unconsolidated entities	-	187,805	2,217	-	190,022
Loss from continuing operations before income taxes and equity in income of subsidiaries	(286,980)	(2,183,764)	(26,159)	-	(2,496,903)
Income tax benefit	(20,294)	(194,240)	(7,952)	-	(222,486)
Loss from continuing operations before equity in income of subsidiaries	(266,686)	(1,989,524)	(18,207)	-	(2,274,417)
Income from discontinued operations	18,662	-	-	-	18,662
Loss before equity income (loss) of subsidiaries	(248,024)	(1,989,524)	(18,207)	-	(2,255,755)
Equity in income (loss) of subsidiaries:					
Continuing operations	(2,007,731)	19,013	(1,567,843)	3,556,561	-

Net income (loss)	$ (2,255,755)	$ (1,970,511)	$ (1,586,050)	$ 3,556,561	$ (2,255,755)

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF CASH FLOWS

For the year ended December 31, 2009

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Net cash provided by operating activities	$ 44,747	$ 515,775	$ 178,331	$ -	$ 738,853
Distributions from unconsolidated entities	-	8,612	-	-	8,612
Investments in unconsolidated entities	-	(35,144)	-	-	(35,144)
Dividends received from subsidiaries	8,359	33,000	-	(41,359)	-
Investment in subsidiaries	(30,540)	(10,904)	(17,297)	58,741	-
Cash acquired with Centex merger, net of cash used	(50)	1,723,120	25,672	-	1,748,742
Net change in loans held for investment	-	-	8,802	-	8,802
Proceeds from the sale of fixed assets		1,960	91	-	2,051
Capital expenditures	-	(30,432)	(8,820)	-	(39,252)
Net cash provided by (used in) investing activities	(22,231)	1,690,212	8,448	17,382	1,693,811
Cash flows from financing activities:					
Net repayments under Financial Services credit arrangements	-	-	(219,166)	-	(219,166)
Repayment of other borrowings	(2,000,732)	(4,473)	-		(2,005,205)
Capital contributions from parent	-	30,540	28,201	(58,741)	-
Advances (to) from affiliates	1,983,876	(2,015,211)	31,335	-	-
Dividends paid	-	(3,359)	(38,000)	41,359	-
Issuance of common stock	4,782	-	-	-	4,782
Stock repurchases	(7,384)	-	-	-	(7,384)
Debt issuance costs	(3,058)	-	-	-	(3,058)
Net cash used in financing activities	(22,516)	(1,992,503)	(197,630)	(17,382)	(2,230,031)

Effect of exchange rate changes on cash and equivalents	-	-	337	-	337
Net increase (decrease) in cash and equivalents	-	213,484	(10,514)	-	202,970
Cash and equivalents at beginning of year	-	1,288,200	367,064	-	1,655,264
Cash and equivalents at end of year	$ -	$ 1,501,684	$ 356,550	$ -	$ 1,858,234

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF CASH FLOWS

For the year ended December 31, 2008

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Net cash provided by (used in) operating activities	$ (125,416)	$ 1,121,263	$ 224,545	$ -	$ 1,220,392
Distributions from unconsolidated entities	-	6,777	-	-	6,777
Investments in unconsolidated entities	-	(54,619)	-	-	(54,619)
Dividends received from subsidiaries	-	23,000	11,400	(34,400)	-
Investment in subsidiaries	(215,280)	(3,234)	(71,987)	290,501	-
Net change in loans held for investment	-	-	5,462	-	5,462
Proceeds from the sale of fixed assets	-	5,304	10	-	5,314
Capital expenditures	-	(16,404)	(2,474)	-	(18,878)
Net cash provided by (used in) investing activities	(215,280)	(39,176)	(57,589)	256,101	(55,944)
Cash flows from financing activities:					
Net repayments under Financial Services credit arrangements	-	-	(203,051)	-	(203,051)
Repayment of other borrowings	(313,384)	(3,696)	-	-	(317,080)
Capital contributions from parent	-	194,425	96,076	(290,501)	-
Advances (to) from affiliates	701,603	(688,627)	(12,976)	-	-
Dividends paid	(41,119)	(11,400)	(23,000)	34,400	(41,119)
Issuance of common stock	4,543	-	-	-	4,543
Stock repurchases	(5,260)	-	-	-	(5,260)
Debt issuance costs	(5,687)	-	-	-	(5,687)
Net cash provided by (used in) financing activities	340,696	(509,298)	(142,951)	(256,101)	(567,654)
	-	-	(1,841)	-	(1,841)

Effect of exchange rate changes on cash and equivalents									
Net increase in cash and equivalents		-		572,789		22,164		-		594,953
Cash and equivalents at beginning of year		-		715,411		344,900		-		1,060,311
Cash and equivalents at end of year	$	-	$	1,288,200	$	367,064	$	-	$	1,655,264

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PULTE HOMES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

17. Supplemental Guarantor information (continued)

CONSOLIDATING STATEMENT OF CASH FLOWS

For the year ended December 31, 2007

($000 s omitted)

	Pulte Homes, Inc.	Unconsolidated Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminating Entries	Consolidated Pulte Homes, Inc.
Net cash provided by (used in) operating activities	$ (747,713)	$ 1,501,969	$ 463,999	$ -	$ 1,218,255
Distributions from unconsolidated entities	-	57,154	3,047	-	60,201
Investments in unconsolidated entities	-	(217,541)	-	-	(217,541)
Dividends received from subsidiaries	51	24,000	-	(24,051)	-
Investment in subsidiaries	(219,304)	(4,510)	(127,093)	350,907	-
Net change in loans held for investment	-	-	(13,728)	-	(13,728)
Proceeds from the sale of fixed assets	-	19,758	9	-	19,767
Capital expenditures	-	(66,551)	(3,565)	-	(70,116)
Net cash provided by (used in) investing activities	(219,253)	(187,690)	(141,330)	326,856	(221,417)
Cash flows from financing activities:					
Net repayments under Financial Services credit arrangements	-	-	(374,096)	-	(374,096)
Repayment of other borrowings	(61,189)	(13,498)	-	-	(74,687)
Excess tax benefits from share-based awards	523	-	-	-	523
Capital contributions from parent	-	153,294	197,613	(350,907)	-
Advances (to) from affiliates	1,067,012	(1,056,922)	(10,090)	-	-
Dividends paid	(40,997)	(51)	(24,000)	24,051	(40,997)
Issuance of common stock	7,862	-	-	-	7,862
Stock repurchases	(6,245)	-	-	-	(6,245)
Net cash provided by (used in) financing activities	966,966	(917,177)	(210,573)	(326,856)	(487,640)

Effect of exchange rate changes on cash and equivalents	-	-	(179)	-	(179)
Net increase in cash and equivalents	-	397,102	111,917	-	509,019
Cash and equivalents at beginning of year	-	318,309	232,983	-	551,292
Cash and equivalents at end of year	$ -	$ 715,411	$ 344,900	$ -	$ 1,060,311

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders

of Pulte Homes, Inc.

We have audited the accompanying consolidated balance sheets of Pulte Homes, Inc. (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2009. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pulte Homes, Inc. at December 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Pulte Homes, Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 19, 2010 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Detroit, Michigan

February 19, 2010

PULTE HOMES, INC.

UNAUDITED QUARTERLY INFORMATION

(000 s omitted, except per share data)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2009					
Homebuilding:					
Revenues	$ 565,343	$ 657,882	$ 1,056,791	$ 1,686,573	$ 3,966,589
Cost of revenues *(a)*	898,842	736,255	1,092,748	1,757,799	4,485,644
Loss before income taxes *(b)*	(507,433)	(187,483)	(291,605)	(866,776)	(1,853,297)
Financial Services:					
Revenues	$ 18,549	$ 20,698	$ 34,303	$ 44,250	$ 117,800
Loss before income taxes	(748)	(9,370)	(8,612)	(36,308)	(55,038)
Other non-operating:					
Income (loss) before income taxes	$ (4,065)	$ 9,924	$ (58,502)	$ (14,141)	$ (66,784)
Consolidated results:					
Revenues	$ 583,892	$ 678,580	$ 1,091,094	$ 1,730,823	$ 4,084,389
Loss before income taxes	(512,246)	(186,929)	(358,719)	(917,225)	(1,975,119)
Income taxes (benefit)	2,572	2,536	2,668	(800,328)	(792,552)
Net loss	$ (514,818)	$ (189,465)	$ (361,387)	$ (116,897)	$ (1,182,567)
Per share data:					
Basic:					
Net loss	$ (2.02)	$ (0.74)	$ (1.15)	$ (0.31)	$ (3.94)
Weighted-average common shares outstanding	254,578	254,764	312,996	376,894	300,179
Assuming dilution:					
Net loss	$ (2.02)	$ (0.74)	$ (1.15)	$ (0.31)	$ (3.94)
Adjusted weighted-average common shares and effect of dilutive securities	254,578	254,764	312,996	376,894	300,179

(a) Cost of revenues includes land and community valuation adjustments of $358.6 million, $109.2 million, $132.6 million, and $150.8 million and net realizable value adjustments of $0.6 million, $7.3 million, $8.3 million, and $97.6 million for the 1st Quarter, 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively.

(b) Loss before income taxes includes the write-off (recovery) of deposits and pre-acquisition costs of $0.6 million, $0.3 million, $17.2 million, and $36.1 million for the 1st Quarter, 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively. Loss before income taxes also includes impairments of investments of unconsolidated joint ventures of $50.4 million, $2.4 million, $5.8 million, and ($4.5) million for the 1st Quarter, 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively. Additionally, a goodwill impairment of $563.0 million was recorded during the 4th Quarter.

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PULTE HOMES, INC.

UNAUDITED QUARTERLY INFORMATION

(000 s omitted, except per share data)

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
2008					
Homebuilding:					
Revenues	$ 1,398,109	$ 1,580,468	$ 1,521,789	$ 1,611,672	$ 6,112,038
Cost of revenues *(a)*	1,910,002	1,605,390	1,626,974	1,836,809	6,979,175
Loss before income taxes *(b)*	(705,130)	(221,321)	(301,966)	(466,294)	(1,694,711)
Financial Services:					
Revenues	$ 43,488	$ 38,945	$ 36,438	$ 32,145	$ 151,016
Income (loss) before income taxes	15,044	10,802	10,092	(7,893)	28,045
Other non-operating:					
Loss before income taxes	$ (2,970)	$ (4,708)	$ (2,717)	$ (5,538)	$ (15,933)
Consolidated results:					
Revenues	$ 1,441,597	$ 1,619,413	$ 1,558,227	$ 1,643,817	$ 6,263,054
Loss before income taxes	(693,056)	(215,227)	(294,591)	(479,725)	(1,682,599)
Income taxes (benefit)	3,088	(56,810)	(14,204)	(141,560)	(209,486)
Net loss	$ (696,144)	$ (158,417)	$ (280,387)	$ (338,165)	$ (1,473,113)
Per share data:					
Basic:					
Net loss	$ (2.75)	$ (0.63)	$ (1.11)	$ (1.33)	$ (5.81)
Weighted-average common shares outstanding	253,166	253,454	253,582	253,841	253,512
Assuming dilution:					
Net loss	$ (2.75)	$ (0.63)	$ (1.11)	$ (1.33)	$ (5.81)
Adjusted weighted-average common shares and effect of dilutive securities	253,166	253,454	253,582	253,841	253,512

(a) Cost of revenues includes land and community valuation adjustments of $598.8 million, $153.5 million, $249.9 million, and $204.6 million and net realizable value adjustments of $64.5 million, $44.7 million, $15.9 million, and $146.0 million for the 1st Quarter, 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively.

(b) Loss before income taxes includes the write-off (recovery) of deposits and pre-acquisition costs of $0.3 million, $20.1 million, ($0.9 million), and $13.8 million for the 1st Quarter, 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively. Loss before income taxes also includes impairments of investments of unconsolidated joint ventures of $1.7 million, $1.4 million, and $15.4 million for the 2nd Quarter, 3rd Quarter, and 4th Quarter, respectively. Additionally, a goodwill impairment of $5.0 million was recorded in the 4th Quarter

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE
This Item is not applicable.

ITEM 9A. CONTROLS AND PROCEDURES
Disclosure Controls and Procedures

Management, including our Chairman, President and Chief Executive Officer and Executive Vice President and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2009. Based upon, and as of the date of that evaluation, our Chairman, President and Chief Executive Officer and Executive Vice President and Chief Financial Officer concluded that the disclosure controls and procedures were effective as of December 31, 2009.

Internal Control Over Financial Reporting

(a) Management s Annual Report on Internal Control Over Financial Reporting
Management is responsible for the preparation and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements have been prepared in conformity with United States generally accepted accounting principles and reflect management s judgments and estimates concerning events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining effective internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Management recognizes that there are inherent limitations in the effectiveness of any internal control and effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Additionally, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the Company s internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2009. Management s assessment was based on criteria for effective internal control over financial reporting described in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. On August 18, 2009, the Company completed the acquisition of Centex Corporation (Centex). As permitted by the Securities and Exchange Commission, management excluded the Centex operations from its assessment of internal control over financial reporting as of December 31, 2009. Centex operations constituted approximately $2.1 billion of consolidated total assets (excluding goodwill and other intangible assets) as of December 31, 2009, and $1.1 billion of consolidated total revenues for the year then ended. Based on this assessment, management asserts that the Company has maintained effective internal control over financial reporting as of December 31, 2009.

Ernst & Young LLP, the independent registered public accounting firm that audited the Company s consolidated financial statements included in this annual report, has issued its report on the effectiveness of the Company s internal control over financial reporting as of December 31, 2009.

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Internal Control Over Financial Reporting (continued)

(b) Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Pulte Homes, Inc.

We have audited Pulte Homes, Inc. s internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Pulte Homes, Inc. s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management s Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

As indicated in the accompanying Management s Annual Report on Internal Control Over Financial Reporting, management s assessment of and conclusion on the effectiveness of internal control over financial reporting did not include the internal controls of Centex Corporation, which is included in the 2009 consolidated financial statements of Pulte Homes, Inc. and constituted $2.1 billion of total assets (excluding goodwill and other intangible assets) as of December 31, 2009 and $1.1 billion of revenues for the year then ended. Our audit of internal control over financial reporting of Pulte Homes, Inc. also did not include an evaluation of the internal control over financial reporting of Centex Corporation.

In our opinion, Pulte Homes, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Pulte Homes, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of operations, shareholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2009 and our report dated February 19, 2010 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Detroit, Michigan

February 19, 2010

Internal Control Over Financial Reporting (continued)

(c) Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter ended December 31, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

This Item is not applicable.

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information required by this Item with respect to our executive officers is set forth in Item 4A. Information required by this Item with respect to members of our Board of Directors and with respect to our audit committee will be contained in the Proxy Statement for the 2010 Annual Meeting of Shareholders (2010 Proxy Statement) under the captions Election of Directors and Committees of the Board of Directors Audit Committee and in the chart disclosing Audit Committee membership and is incorporated herein by this reference. Information required by this Item with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934 will be contained in the 2010 Proxy Statement under the caption Beneficial Security Ownership Section 16(a) Beneficial Ownership Reporting Compliance, and is incorporated herein by this reference. Information required by this Item with respect to our code of ethics will be contained in the 2010 Proxy Statement under the caption Corporate Governance Governance Guidelines; Business Practices Policy; Code of Ethics and is incorporated herein by this reference.

Our code of ethics for principal officers, our business practices policy, our corporate governance guidelines and the charters of the Audit, Compensation and Management Development, and Nominating and Governance committees of our Board of Directors are also posted on our website and are available in print, free of charge, upon request.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this Item will be contained in the 2010 Proxy Statement under the captions 2009 Executive Compensation and 2009 Director Compensation and is incorporated herein by this reference, provided that the Compensation and Management Development Committee Report shall not be deemed to be filed with this Annual Report on Form 10-K.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required by this Item will be contained in the 2010 Proxy Statement under the captions Beneficial Security Ownership and Equity Compensation Plan Information and is incorporated herein by this reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information required by this Item will be contained in the 2010 Proxy Statement under the captions Certain Relationships and Related Transactions and Election of Directors Independence and is incorporated herein by this reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information required by this Item will be contained in the 2010 Proxy Statement under the captions Audit and Non-Audit Fees and Audit Committee Preapproval Policies and is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) The following documents are filed as part of this Annual Report on Form 10-K:

(1) Financial Statements

(2) Financial Statement Schedule

All schedules are omitted because the required information is not present, is not present in amounts sufficient to require submission of the schedule, or because the required information is included in the financial statements or notes thereto.

(3) Exhibits

The following exhibits are filed with this Annual Report on Form 10-K or are incorporated herein by reference:

Exhibit Number and Description

(2)	(a)	Agreement and Plan of Merger, dated as of April 7, 2009, by and among Pulte Homes, Inc., Pi Nevada Building Company, and Centex Corporation (Incorporated by reference to Exhibit 2.1 of our Current Report on Form 8-K filed with the Securities and Exchange Commission (SEC) on April 10, 2009)
(3)	(a)	Restated Articles of Incorporation, of Pulte Homes, Inc. (Incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K, filed with the SEC on August 18, 2009)
	(b)	By-laws, as amended, of Pulte Homes, Inc. (Incorporated by reference to Exhibit 3.1 of our Current Report on Form 8-K, filed with the SEC on April 8, 2009)
	(c)	Certificate of Designation of Series A Junior Participating Preferred Shares, dated August 6, 2009 (Incorporated by reference to Exhibit 3(b) of our Registration Statement on Form 8-A, filed with the SEC on August 18, 2009)
(4)	(a)	Any instrument with respect to long-term debt, where the securities authorized thereunder do not exceed 10% of the total assets of Pulte Homes, Inc. and its subsidiaries, has not been filed. The Company agrees to furnish a copy of such instruments to the SEC upon request.
	(b)	Section 382 Rights Agreement, dated as of March 5, 2009, between Pulte Homes, Inc. and Computershare Trust Company, N.A., as rights agent (which includes the Form of Rights Certificate as Exhibit B) (Incorporated by reference to Exhibit 4 of our Registration Statement on Form 8-A, filed with the SEC on March 6, 2009)
	(c)	First Amendment to Section 382 Rights Agreement, dated as of April 7, 2009, between Pulte Homes, Inc. and Computershare Trust Company, N.A., as rights agent (Incorporated by reference to Exhibit 4.1 of our Current Report on

Form 8-K, filed with the SEC on April 10, 2009)

(d) Second Amendment to Section 382 Rights Agreement, dated as of September 24, 2009 between Pulte Home, Inc. and Computershare Trust Company, N.A., as rights agent (Incorporated by reference to Exhibit 4.1 of our Current Report on Form 8-K, filed with the SEC on September 24, 2009)

(10)	(a)	1994 Stock Incentive Plan for Key Employees (Incorporated by reference to our Proxy Statement dated March 31, 1994, and as Exhibit 4.1 of our Registration Statement on Form S-8, Registration No. 33-98944)
	(b)	1995 Stock Incentive Plan for Key Employees (Incorporated by reference to our Proxy Statement dated March 31, 1995, and as Exhibit 4.1 of our Registration Statement on Form S-8, Registration No. 33-99218)
	(c)	1997 Stock Plan for Nonemployee Directors (Incorporated by reference to our Proxy Statement dated March 27, 1998, and as Exhibit 4.3 of our Registration Statement on Form S-8, Registration No. 333-52047)
	(d)	Pulte Homes, Inc. 401(k) Plan (Incorporated by reference to Exhibit 4.3 of our Registration Statement on Form S-8, No. 333-115570)
	(e)	Intercreditor and Subordination Agreement, dated October 1, 2003, among Asset Seven Corp., Pulte Realty Corporation, certain subsidiaries of Pulte Homes, Inc., Bank One, NA, as Administrative Agent, and Bank One Trust Company, National Association, as Trustee (Incorporated by reference to Exhibit 10(f) to our Annual Report on Form 10-K for the year ended December 31, 2003)
	(f)	Third Amended and Restated Credit Agreement, dated as of June 20, 2007, among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(a) of our Current Report on Form 8-K, filed with the SEC on July 3, 2007)
	(g)	First Amendment to Third Amended and Restated Credit Agreement, dated as of November 21, 2007, among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(a) of our Current Report on Form 8-K, filed with the SEC on November 27, 2007)
	(h)	Second Amendment to Third Amended and Restated Credit Agreement, dated as of February 15, 2008, among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(a) of our Current Report on Form 8-K, filed with the SEC on February 20, 2008)
	(i)	Third Amendment to the Third Amended and Restated Credit Agreement, dated as of November 21, 2008, among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(a) of our Current Report on Form 8-K, filed with the SEC on November 21, 2008)
	(j)	Schedule 1.1 (b) to Third Amended and Restated Credit Agreement, dated as of June 20, 2007, among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(d) of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2009)
	(k)	Facility Agreement dated as of June 23, 2009 among Pulte Homes, Inc., Various Financial Institutions, and Deutsche Bank AG, New York Branch (Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed with the SEC on June 26, 2009)
	(l)	Waiver to Third Amended and Restated Credit Agreement dated November 3, 2009 among Pulte Homes, Inc., JPMorgan Chase Bank, N.A., as Administrative Agent, and the lenders named therein (Incorporated by reference to Exhibit 10(h) of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009)
	(m)	Fourth Amendment and Wavier to Third Amended and Restated Credit Agreement, dated December 11, 2009 (Incorporated by reference to Exhibit 10(a) of our Current Report on Form 8-K, filed with the SEC on December 14, 2009)
	(n)	Long-Term Incentive Plan (Incorporated by reference to our Proxy Statement dated March 31, 2000)
	(o)	Pulte Corporation 2000 Incentive Plan for Key Employees (Incorporated by reference to Exhibit 4.3 of our Registration Statement on Form S-8, Registration No. 333-66284)

(10)	(p)	Pulte Corporation 2000 Stock Plan for Nonemployee Directors (Incorporated by reference to Exhibit 4.3 of our Registration Statement on Form S-8, Registration No. 333-66284)
	(q)	Form of Restricted Stock Award agreement under Pulte Corporation 2000 Stock Incentive Plan for Key Employees (Incorporated by reference to Exhibit 10(l) of our Annual Report on Form 10-K for the year ended December 31, 2006)
	(r)	Form of Restricted Stock Award agreement (as amended) under Pulte Corporation 2000 Stock Incentive Plan for Key Employees (Incorporated by Reference to Exhibit 10(o) of our Annual Report on Form 10-K for the year ended December 31, 2008)
	(s)	Pulte Homes, Inc. 2002 Stock Incentive Plan (Incorporated by reference to our Proxy Statement dated April 3, 2002 and as Exhibit 4.3 of our Registration Statement on Form S-8, No. 333-123223)
	(t)	Pulte Homes, Inc. Senior Management Annual Incentive Plan (Incorporated by reference to our Proxy Statement dated March 27, 2003)
	(u)	Pulte Homes, Inc. 2008 Senior Management Incentive Plan (Incorporated by reference to our Proxy Statement dated April 7, 2008).
	(v)	Pulte Homes, Inc. Long-Term Incentive Program (Incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K, filed with the SEC on May 20, 2008)
	(w)	Form of Pulte Homes, Inc. Long Term Incentive Award Agreement (Incorporated by reference to Exhibit 10.3 of our Current Report on Form 8-K, filed with the SEC on May 20, 2008)
	(x)	Form of Pulte Homes, Inc. 2008-2010 Grant Acceptance Agreement Company Performance Measures (Incorporated by reference to Exhibit 10.4 of our Current Report on Form 8-K, filed with the SEC on May 20, 2008)
	(y)	Form of Pulte Homes, Inc 2008-2010 Grant Acceptance Agreement Individual Performance Measures (Incorporated by reference to Exhibit 10.5 of our Current Report on Form 8-K, filed with the SEC on May 20, 2008)
	(z)	Pulte Homes, Inc. 2004 Stock Incentive Plan (Incorporated by reference to our Proxy Statement dated March 29, 2004 and as Exhibit 4.4 of our Registration Statement on Form S-8, No. 333-123223)
	(aa)	Pulte Homes, Inc. 2004 Stock Incentive Plan (as Amended and Restated as of July 9, 2009) (Incorporated by reference to Exhibit 10(a) of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2009)
	(ab)	Form of Restricted Stock Award agreement under Pulte Homes, Inc. 2004 Stock Incentive Plan (Incorporated by reference to Exhibit 10(p) of our Annual Report on Form 10-K for the year ended December 31, 2006)
	(ac)	Form of Restricted Stock Award agreement (as amended) under Pulte Homes, Inc. 2004 Stock Incentive Plan (Incorporated by reference to Exhibit 10(r) of our Annual Report on Form 10-K for the year ended December 31, 2007)
	(ad)	Form of Stock Option Agreement under Pulte Homes, Inc. 2002 and 2004 Stock Incentive Plans (Incorporated by reference to Exhibit 10(s) of our Annual Report on Form 10-K for the year ended December 31, 2007)
	(ae)	Form of Stock Option Agreement (as amended) under Pulte Homes, Inc. 2002 and 2004 Stock Incentive Plans (Incorporated by reference to Exhibit 10(t) of our Annual Report on Form 10-K for the year ended December 31, 2007)
	(af)	Centex Corporation Amended and Restated 1987 Stock Option Plan (Amended and Restated Effective February 11, 2009) (Incorporated by reference to Exhibit 10.4 of Centex s Current Report on Form 8-K, filed with the SEC on February 13, 2009)
	(ag)	Amended and Restated Centex Corporation 2001 Stock Plan (Amended and Restated Effective February 11, 2009) (Incorporated by reference to Exhibit 10.2 of Centex s Current Report on Form 8-K, filed with the SEC on February 13, 2009)

(10)	(ah)	Form of stock option agreement for the Amended and Restated Centex Corporation 2001 Stock Plan (Incorporated by reference to Exhibit 10.5 of Centex s Current Report on Form 8-K, filed with the SEC on May 13, 2008)
	(ai)	Centex Corporation 2003 Equity Incentive Plan (Amended and Restated Effective February 11, 2009) (Incorporated by reference to Exhibit 10.1 of Centex s Current Report on Form 8-K, filed with the SEC on February 13, 2009)
	(aj)	Form of stock option agreement for the Centex Corporation 2003 Equity Incentive Plan (Incorporated by reference to Exhibit 10.6 of Centex s Current Report on Form 8-K, filed with the SEC on May 13, 2008)
	(ak)	Pulte Homes, Inc. Long Term Compensation Deferral Plan (As Amended and Restated Effective January 1, 2004) (Incorporated by reference to Exhibit 10(a) of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2006)
	(al)	Pulte Homes, Inc. Deferred Compensation Plan for Non-Employee Directors (as amended and restated effective as of December 8, 2009) (Filed herewith)
	(am)	Fifth Amended and Restated Security and Collateral Agreement by and among Pulte Mortgage LLC, JP Morgan Chase Bank, N.A., as administrative agent, and LaSalle Bank National Association, as collateral agent, dated as of May 16, 2006 (Incorporated by reference to Exhibit 10(a) of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006)
	(an)	Sixth Amended and Restated Revolving Credit Agreement by and among Pulte Mortgage LLC, JPMorgan Chase Bank, N.A., as administrative agent, J.P. Morgan Securities, Inc., as lead arranger and sole bookrunner, and LaSalle Bank National Association, as collateral agent, dated as of May 16, 2006 (Incorporated by reference to Exhibit 10(b) of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2006)
	(ao)	Master Repurchase Agreement dated as of May 15, 2009 among Comerica Bank, as Agent and a Buyer, the other Buyers party hereto and Pulte Mortgage LLC, as Seller (Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed with the SEC on May 20, 2009)
	(ap)	First Amendment to Master Repurchase Agreement dated September 28, 2009 among Comerica Bank, as Agent and a Buyer, the other Buyers party hereto and Pulte Mortgage LLC, as Seller (Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed with the SEC on October 2, 2009)
	(aq)	Master Repurchase Agreement dated as of July 31, 2009 between Bank of America, N.A., as Buyer, and Pulte Mortgage LLC, as Seller (Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed with the SEC on August 6, 2009)
	(ar)	Master Repurchase Agreement dated September 30, 2009 between JPMorgan Chase Bank, N.A. as Buyer and Pulte Mortgage LLC, as Seller (Incorporated by reference to exhibit 10.2 of our Current Report on Form 8-K, filed with the SEC on October 2, 2009)
	(as)	Consulting Agreement, dated as of April 7, 2009, between Pulte Homes, Inc. and Timothy R. Eller (Incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K, filed with the SEC on April 10, 2009)
	(at)	Assignment and Assumption Agreement dated as of August 18, 2009 between Pulte Homes, Inc. and Centex Corporation (Incorporated by reference to Exhibit 10.2 of our Current Report on Form 8-K, filed with the SEC on August 20, 2009)
(12)		Ratio of Earnings to Fixed Charges at December 31, 2009 (Filed herewith)
(21)		Subsidiaries of the Registrant (Filed herewith)
(23)		Consent of Independent Registered Public Accounting Firm (Filed herewith)
(31)	(a)	Rule 13a-14(a) Certification by Richard J. Dugas, Jr., Chairman, President, and Chief Executive Officer (Filed herewith)
	(b)	Rule 13a-14(a) Certification by Roger A. Cregg, Executive Vice President and Chief Financial Officer (Filed herewith)
(32)		Certification Pursuant to 18 United States Code § 1350 and Rule 13a-14(b) of the Securities Exchange Act of 1934 (Filed herewith)

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PULTE HOMES, INC.

(Registrant)

February 19, 2010

By: /s/ Roger A. Cregg
Roger A. Cregg
Executive Vice President

and Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capabilities and on the dates indicated:

Signature	Title	Date
/s/ Richard J. Dugas, Jr.	Chairman of the Board of Directors,	
Richard J. Dugas, Jr.	President, and Chief Executive Officer (Principal Executive Officer)	February 19, 2010
/s/ Roger A. Cregg	Executive Vice Prescient and Chief Financial Officer	
Roger A. Cregg	(Principal Financial Officer)	February 19, 2010
/s/ Michael J. Schweninger Michael J. Schweninger	Vice President and Controller (Principal Accounting Officer)	February 19, 2010
/s/ William J. Pulte William J. Pulte	Member of Board of Directors	February 19, 2010
/s/ Brian P. Anderson Brian P. Anderson	Member of Board of Directors	February 19, 2010
/s/ Timothy R. Eller Timothy R. Eller	Member of Board of Directors	February 19, 2010
/s/ Cheryl W. Grisé Cheryl W. Grisé	Member of Board of Directors	February 19, 2010
/s/ Debra J. Kelly-Ennis Debra J. Kelly-Ennis	Member of Board of Directors	February 19, 2010
/s/ David N. McCammon David N. McCammon	Member of Board of Directors	February 19, 2010

/s/ Clint W. Murchison III Clint W. Murchison III	Member of Board of Directors	February 19, 2010
/s/ Patrick J. O Leary Patrick J. O Leary	Member of Board of Directors	February 19, 2010
/s/ James J. Postl James J. Postl	Member of Board of Directors	February 19, 2010
/s/ Bernard W. Reznicek Bernard W. Reznicek	Member of Board of Directors	February 19, 2010
/s/ Thomas M. Schoewe Thomas M. Schoewe	Member of Board of Directors	February 19, 2010