

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

October 01, 2004

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended August 31, 2004

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-14749

Rocky Mountain Chocolate Factory, Inc.

(Exact name of registrant as specified in its charter)

Colorado

(State of incorporation)

84-0910696

(I.R.S. Employer Identification No.)

265 Turner Drive, Durango, CO 81303

(Address of principal executive offices)

(970) 259-0554

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange act). Yes No .

On September 15, 2004 the registrant had outstanding 4,287,402 shares of its common stock, \$.03 par value.

The exhibit index is located on page 17.

Table of Contents

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

FORM 10-Q

TABLE OF CONTENTS

| | Page No. |
|--|-----------------|
| <u>PART I. FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements</u> | 3 |
| <u>Statements of Income</u> | 3 |
| <u>Balance Sheets</u> | 4 |
| <u>Statements of Cash Flows</u> | 5 |
| <u>Notes to Interim Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 10 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 16 |
| <u>Item 4. Controls and Procedures</u> | 16 |
| <u>PART II. OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 17 |
| <u>Item 2. Changes in Securities and Use of Proceeds</u> | 17 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 17 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 17 |
| <u>Item 5. Other Information</u> | 17 |
| <u>Item 6. Exhibits and Reports on Form 8-K</u> | 17 |
| <u>SIGNATURES</u> | 18 |
| <u>Certification Filed Pursuant to Section 302 - CEO</u> | |
| <u>Certification Filed Pursuant to Section 302 - CFO</u> | |
| <u>Certification Filed Pursuant to Section 906 - CEO</u> | |
| <u>Certification Filed Pursuant to Section 906 - CFO</u> | |

Table of Contents**PART I. FINANCIAL INFORMATION**

Item 1. Financial Statements

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

STATEMENTS OF INCOME
(unaudited)

| | Three Months Ended August 31, | | Six Months Ended August 31, | |
|--|-------------------------------|-------------|-----------------------------|-------------|
| | 2004 | 2003 | 2004 | 2003 |
| Revenues | | | | |
| Sales | \$4,539,188 | \$4,310,622 | \$ 8,123,024 | \$7,278,005 |
| Franchise and royalty fees | 1,328,749 | 1,160,631 | 2,470,197 | 2,120,047 |
| Total revenues | 5,867,937 | 5,471,253 | 10,593,221 | 9,398,052 |
| Costs and Expenses | | | | |
| Cost of sales | 2,558,302 | 2,657,541 | 4,703,688 | 4,583,373 |
| Franchise costs | 317,352 | 251,629 | 612,308 | 498,545 |
| Sales and marketing | 272,351 | 252,085 | 547,271 | 505,969 |
| General and administrative | 525,018 | 510,966 | 1,033,793 | 941,439 |
| Retail operating | 379,308 | 463,495 | 726,203 | 699,470 |
| Depreciation and amortization | 201,264 | 227,069 | 402,883 | 428,041 |
| Total costs and expenses | 4,253,595 | 4,362,785 | 8,026,146 | 7,656,837 |
| Income from Operations | 1,614,342 | 1,108,468 | 2,567,075 | 1,741,215 |
| Other Income (Expense) | | | | |
| Interest expense | (24,068) | (38,503) | (51,577) | (81,832) |
| Interest income | 22,982 | 22,915 | 49,385 | 46,254 |
| Total other, net | (1,086) | (15,588) | (2,192) | (35,578) |
| Income Before Income Taxes | 1,613,256 | 1,092,880 | 2,564,883 | 1,705,637 |
| Provision for Income Taxes | 609,810 | 413,110 | 969,525 | 644,730 |
| Net Income | \$1,003,446 | \$ 679,770 | \$ 1,595,358 | \$1,060,907 |
| Basic Earnings per Common Share | \$.24 | \$.16 | \$.37 | \$.25 |
| Diluted Earnings per Common Share | \$.22 | \$.15 | \$.35 | \$.24 |
| Weighted Average Common Shares Outstanding | 4,264,180 | 4,174,225 | 4,275,511 | 4,160,762 |
| Dilutive Effect of Stock Options | 329,006 | 304,080 | 317,719 | 277,698 |
| Weighted Average Common Shares Outstanding, Assuming Dilution | 4,593,186 | 4,478,305 | 4,593,230 | 4,438,460 |

The accompanying notes are an integral part of these financial statements.

Table of Contents

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

BALANCE SHEETS

| | August 31, 2004 | February 29, 2004 |
|--|----------------------------|------------------------------|
| | <u>(unaudited)</u> | |
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 3,011,426 | \$ 4,552,283 |
| Accounts receivable, less allowance for doubtful accounts of \$66,337 and \$73,630 respectively | 2,676,603 | 2,388,848 |
| Notes receivable | 434,300 | 313,200 |
| Inventories | 3,203,566 | 2,471,810 |
| Deferred income taxes | 149,304 | 149,304 |
| Other | 463,952 | 353,733 |
| Total current assets | 9,939,151 | 10,229,178 |
| Property and Equipment, Net | 5,534,597 | 5,456,695 |
| Other Assets | | |
| Notes receivable, less valuation allowance of \$47,005 | 361,283 | 602,095 |
| Goodwill, net | 1,133,751 | 1,133,751 |
| Intangible assets, net | 462,856 | 498,885 |
| Other | 94,529 | 46,641 |
| Total other assets | 2,052,419 | 2,281,372 |
| Total assets | \$17,526,167 | \$17,967,245 |
| Liabilities and Stockholders Equity | | |
| Current Liabilities | | |
| Current maturities of long-term debt | \$ 854,100 | \$ 1,080,400 |
| Accounts payable | 1,176,156 | 952,542 |
| Accrued salaries and wages | 327,452 | 1,091,596 |
| Other accrued expenses | 630,295 | 474,906 |
| Dividend payable | 258,628 | 236,108 |
| Total current liabilities | 3,246,631 | 3,835,552 |
| Long-Term Debt, Less Current Maturities | 1,588,159 | 1,986,174 |
| Deferred Income Taxes | 555,567 | 555,567 |
| Commitments and Contingencies | | |
| Stockholders Equity | | |
| Common stock, \$.03 par value, 7,250,000 shares authorized, 4,287,402 and 4,272,820 issued and outstanding | 128,622 | 128,185 |
| Additional paid-in capital | 6,165,411 | 2,682,631 |
| Retained earnings | 5,841,777 | 8,779,136 |
| Total stockholders equity | 12,135,810 | 11,589,952 |
| Total liabilities and stockholders equity | \$17,526,167 | \$17,967,245 |

The accompanying notes are an integral part of these financial statements.

Table of Contents

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

STATEMENTS OF CASH FLOWS

(unaudited)

| | Six Months Ended August 31, | |
|---|--|-------------|
| | 2004 | 2003 |
| Cash Flows From Operating activities | | |
| Net income | \$ 1,595,358 | \$1,060,907 |
| Adjustments to reconcile net income to net cash Provided by operating activities: | | |
| Depreciation and amortization | 402,883 | 428,041 |
| Provision for doubtful accounts | | 50,000 |
| Provision for obsolete inventory | 30,000 | |
| Loss (gain) on sale of property and equipment | 36,207 | (1,252) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (287,755) | (507,330) |
| Refundable income taxes | | 502,419 |
| Inventories | (761,756) | 564,393 |
| Other current assets | (114,504) | (84,163) |
| Accounts payable | 223,614 | 14,429 |
| Accrued liabilities | (606,972) | (97,644) |
| Net cash provided by operating activities | 517,075 | 1,929,800 |
| Cash Flows From Investing Activities | | |
| Proceeds received on notes receivable | 119,712 | 105,042 |
| Addition to notes receivable | | (52,362) |
| Proceeds from sale of assets | 20,900 | 75,327 |
| Purchases of property and equipment | (480,309) | (90,238) |
| Increase in other assets | (61,983) | (9,305) |
| Net cash (used in) provided by investing activities | (401,680) | 28,464 |
| Cash Flows From Financing Activities | | |
| Payments on long-term debt | (624,315) | (605,105) |
| Repurchase and redemption of common stock | (844,205) | |
| Dividends paid | (494,676) | |
| Costs of stock dividend | (7,942) | |
| Proceeds from exercise of stock options | 314,886 | 138,280 |
| Net cash used in financing activities | (1,656,252) | (466,825) |
| Net (Decrease) Increase in Cash and Cash Equivalents | (1,540,857) | 1,491,439 |
| Cash and Cash Equivalents, Beginning of Period | 4,552,283 | 1,282,972 |
| Cash and Cash Equivalents, End of Period | \$ 3,011,426 | \$2,774,411 |

The accompanying notes are an integral part of these financial statements.

Table of Contents

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

NOTES TO INTERIM FINANCIAL STATEMENTS

NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Rocky Mountain Chocolate Factory, Inc. is an international franchiser, confectionery manufacturer and retail operator in the United States, Guam, Canada and the United Arab Emirates. The Company manufactures an extensive line of premium chocolate candies and other confectionery products. The Company's revenues are currently derived from three principal sources: sales to franchisees and others of chocolates and other confectionery products manufactured by the Company; the collection of initial franchise fees and royalties from franchisees' sales; and sales at Company-owned stores of chocolates and other confectionery products. The following table summarizes the number of RMCF stores at August 31, 2004:

| | Sold, Not Yet Open | Open | Total |
|----------------------------------|-------------------------------|-------------|--------------|
| Company owned stores | | 8 | 8 |
| Franchise stores Domestic stores | 20 | 216 | 236 |
| Franchise Stores Domestic kiosks | 3 | 13 | 16 |
| Franchise units International | | 31 | 31 |
| | 23 | 268 | 291 |

Basis of Presentation

The accompanying financial statements have been prepared by the Company, without audit, and reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and Securities and Exchange Commission regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the six months ended August 31, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year.

These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended February 29, 2004.

Stock-Based Compensation

Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees* and provides the required pro forma disclosures prescribed by SFAS 123 and SFAS 148.

The Company has adopted the disclosure-only provisions of SFAS 123. In accordance with those provisions, the Company applies APB 25 and related interpretations in accounting for its stock option plans and, accordingly, does not recognize compensation cost if the exercise price is not less than market. No compensation expense was recognized during the quarters ended August 31, 2004 or 2003. If the Company had elected to recognize compensation cost based on the fair value of the options granted at grant dates as prescribed by SFAS 123, net income and earnings per share would have been reduced to the pro-forma amounts indicated in the table below for the three and six months ending August 31, (in 000 s except per share amounts):

Table of Contents

NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION CONTINUED

Stock-Based Compensation Continued

| | Three Months ended August 31, | | Six Months Ended August 31, | |
|---|----------------------------------|--------|--------------------------------|----------|
| | 2004 | 2003 | 2004 | 2003 |
| Net Income - as reported | \$ 1,003 | \$ 680 | \$ 1,595 | \$ 1,061 |
| Add: Stock-based compensation expense included in reported net income, net of tax | | | | |
| Deduct: Stock-based compensation expense determined under fair value based method, net of tax | 43 | 18 | 60 | 37 |
| Net Income - pro forma | 960 | 662 | 1,535 | 1,024 |
| Basic Earnings per Share-as reported | .24 | .16 | .37 | .25 |
| Diluted Earnings per Share-as reported | .22 | .15 | .35 | .24 |
| Basic Earnings per Share-pro forma | .23 | .16 | .36 | .25 |
| Diluted Earnings per Share-pro forma | .21 | .15 | .34 | .23 |

NOTE 2 EARNINGS PER SHARE

Basic earnings per share is calculated using the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through stock options. For the three months ended August 31, 2004 and 2003, zero and 143,550 stock options were excluded from the computation of earnings per share because their effect would have been anti-dilutive. For the six months ended August 31, 2004 and 2003, zero and 188,922 stock options were excluded from the computation of earnings per share because their effect would have been anti-dilutive.

NOTE 3 INVENTORIES

Inventories consist of the following:

| | August 31, 2004 | February 29, 2004 |
|--------------------------|-----------------|----------------------|
| Ingredients and supplies | \$1,550,455 | \$1,363,524 |
| Finished candy | 1,653,111 | 1,108,286 |
| | \$3,203,566 | \$2,471,810 |

NOTE 4 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following:

| August 31, 2004 | February 29, 2004 |
|-----------------|-------------------|
|-----------------|-------------------|

| | | |
|-------------------------------|--------------|--------------|
| Land | \$ 513,618 | \$ 513,618 |
| Building | 3,921,823 | 3,864,582 |
| Machinery and equipment | 7,287,728 | 7,106,039 |
| Furniture and fixtures | 631,579 | 637,523 |
| Leasehold improvements | 484,011 | 494,515 |
| Transportation equipment | 180,723 | 180,723 |
| | 13,019,482 | 12,797,000 |
| Less accumulated depreciation | 7,484,885 | 7,340,305 |
| Property and equipment, net | \$ 5,534,597 | \$ 5,456,695 |

NOTE 5 STOCKHOLDERS EQUITY

Stock Dividend

On May 4, 2004 the Board of Directors declared a 10 percent stock dividend payable on May 27, 2004 to shareholders of record as of May 13, 2004. Shareholders received one additional share of Common Stock for every ten shares owned prior to the record date. Subsequent to the dividend there were 4,286,722 shares outstanding.

All share and per share data have been restated in all periods presented to give effect to the stock dividend.

Table of Contents**NOTE 5 STOCKHOLDERS EQUITY CONTINUED****Stock Repurchases**

Between March 11, 2004 and June 14, 2004 the Company repurchased 89,440 Company shares at an average price of \$9.44 per share.

Cash Dividend

The Company paid a quarterly cash dividend of \$0.0545 per common share on March 16, 2004 to shareholders of record on March 3, 2004. The Company paid a quarterly cash dividend of \$0.06 per common share on June 16, 2004 to shareholders of record on June 3, 2004. On August 23, 2004, the Company declared a quarterly cash dividend of \$0.06 per common share payable on September 16, 2004 to shareholders of record on September 2, 2004.

Future declaration of dividends will depend on, among other things, the Company's results of operations, capital requirements, financial condition and on such other factors as the Company's Board of Directors may in its discretion consider relevant and in the best long term interest of the shareholders.

NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION

| | Six Months Ended August 31, | |
|-------------------------------|--|-------------|
| | 2004 | 2003 |
| Cash paid (received) for: | | |
| Interest | \$ 51,333 | \$ 81,563 |
| Income taxes | 835,210 | (208,635) |
| Non-Cash Financing Activities | | |
| Dividend Payable | \$258,628 | \$ 189,969 |

NOTE 7 OPERATING SEGMENTS

The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. The Company's retail stores provide an environment for testing consumer behavior, various pricing strategies, new products and promotions, operating and training methods and merchandising techniques. Three operational stores previously classified as held for sale were reclassified as assets held and used when management's intentions changed. All Company-owned retail stores are evaluated by management in relation to their contribution to franchising efforts and are included in the Franchising segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 to the Company's financial statements included in the Company's annual report on Form 10-K for the year ended February 29, 2004. The Company evaluates performance and allocates resources based on operating contribution, which excludes unallocated corporate general and administrative costs and income tax expense or benefit. The Company's reportable segments are strategic businesses that utilize common merchandising, distribution, and marketing functions, as well as common information systems and corporate administration. All inter-segment sales prices are market based. Each segment is managed separately because of the differences in required infrastructure and the difference in products and services:

| | <u>Franchising</u> | <u>Manufacturing</u> | <u>Other</u> | <u>Total</u> |
|---------------------------------------|--------------------|----------------------|--------------|--------------|
| Three Months Ended August 31, 2004 | | | | |
| Total revenues | \$2,137,006 | \$4,117,397 | \$ | \$ 6,254,403 |
| Intersegment revenues | | (386,466) | | (386,466) |
| Revenue from external customers | 2,137,006 | 3,730,931 | | 5,867,937 |
| Segment profit (loss) | 868,808 | 1,319,101 | (574,653) | 1,613,256 |
| Total assets | 2,752,993 | 8,915,001 | 5,858,173 | 17,526,167 |
| Capital expenditures | 22,606 | 41,710 | 83,754 | 148,070 |
| Total depreciation & amortization | 56,983 | 96,434 | 47,847 | 201,264 |

Table of Contents

NOTE 7 OPERATING SEGMENTS CONTINUED

| | <u>Franchising</u> | <u>Manufacturing</u> | <u>Other</u> | <u>Total</u> |
|-----------------------------------|--------------------|----------------------|--------------|--------------|
| Three Months Ended | | | | |
| August 31, 2003 | | | | |
| Total revenues | \$2,066,048 | \$3,693,068 | \$ | \$ 5,759,116 |
| Intersegment revenues | | (287,863) | | (287,863) |
| Revenue from external customers | 2,066,048 | 3,405,205 | | 5,471,253 |
| Segment profit (loss) | 763,317 | 905,443 | (575,880) | 1,092,880 |
| Total assets | 2,501,641 | 8,302,240 | 5,789,641 | 16,593,522 |
| Capital expenditures | 2,003 | 2,537 | 19,014 | 23,554 |
| Total depreciation & amortization | 79,846 | 99,487 | 47,736 | 227,069 |
| | <u>Franchising</u> | <u>Manufacturing</u> | <u>Other</u> | <u>Total</u> |
| Six Months Ended | | | | |
| August 31, 2004 | | | | |
| Total revenues | \$3,830,014 | \$7,414,532 | \$ | \$11,244,546 |
| Intersegment revenues | | (651,325) | | (651,325) |
| Revenue from external customers | 3,830,014 | 6,763,207 | | 10,593,221 |
| Segment profit (loss) | 1,400,629 | 2,261,268 | (1,097,014) | 2,564,883 |
| Total assets | 2,752,993 | 8,915,001 | 5,858,173 | 17,526,167 |
| Capital expenditures | 165,037 | 131,072 | 184,200 | 480,309 |
| Total depreciation & amortization | 114,320 | 192,869 | 95,694 | 402,883 |
| Six Months Ended | | | | |
| August 31, 2003 | | | | |
| Total revenues | \$3,422,087 | \$6,449,584 | \$ | \$ 9,871,671 |
| Intersegment revenues | | (473,619) | | (473,619) |
| Revenue from external customers | 3,422,087 | 5,975,965 | | 9,398,052 |
| Segment profit (loss) | 1,233,133 | 1,549,544 | (1,077,040) | 1,705,637 |
| Total assets | 2,501,641 | 8,302,240 | 5,789,641 | 16,593,522 |
| Capital expenditures | 22,247 | 54,039 | 13,952 | 90,238 |
| Total depreciation & amortization | 134,305 | 198,264 | 95,472 | 428,041 |

NOTE 8 GOODWILL AND INTANGIBLE ASSETS

Effective March 1, 2002 the Company adopted Statement of Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Intangible Assets. SFAS 142 revised the accounting for purchased goodwill and intangible assets. Under SFAS 142, goodwill and intangible assets with indefinite lives will no longer be amortized, will be tested for impairment annually and also in the event of an impairment indicator, and must be assigned to reporting units for purposes of impairment testing and segment reporting. The Company has historically amortized goodwill on the

straight-line method over ten to twenty-five years. Beginning March 1, 2002, quarterly and annual goodwill amortization is no longer recognized.

Intangible assets consist of the following:

| | Amortization Period | August 31, 2004 | | February 29, 2004 | |
|--|------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| | | Gross Carrying Value | Accumulated Amortization | Gross Carrying Value | Accumulated Amortization |
| Intangible assets subject to amortization | | | | | |
| Store design | 10 Years | \$ 205,777 | \$ 53,746 | \$ 205,777 | \$ 43,508 |
| Packaging licenses | 3-5 Years | 95,831 | 79,356 | 95,831 | 73,865 |
| Packaging design | 10 Years | 403,238 | 108,888 | 403,238 | 88,588 |
| Total | | 704,846 | 241,990 | 704,846 | 205,961 |
| Intangible assets not subject to amortization | | | | | |
| Franchising segment- | | | | | |
| Company stores goodwill | | 1,275,962 | 336,847 | 1,275,962 | 336,847 |
| Franchising goodwill | | 295,000 | 197,682 | 295,000 | 197,682 |
| Manufacturing segment-Goodwill | | 295,000 | 197,682 | 295,000 | 197,682 |
| Total Goodwill | | 1,865,962 | 732,211 | 1,865,962 | 732,211 |
| Total intangible assets | | \$2,570,808 | \$974,201 | \$2,570,808 | \$938,172 |

Table of Contents**NOTE 8 GOODWILL AND INTANGIBLE ASSETS CONTINUED**

Amortization expense related to intangible assets totaled \$36,029 and \$37,815 during the six months ended August 31, 2004 and 2003, respectively. The aggregate estimated amortization expense for intangible assets remaining as of August 31, 2004 is as follows:

| | |
|--------------------------|-----------|
| Remainder of fiscal 2005 | \$ 36,000 |
| 2006 | 77,800 |
| 2007 | 61,100 |
| 2008 | 61,100 |
| 2009 | 61,100 |
| Thereafter | 165,756 |
| Total | 462,856 |

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the unaudited financial statements and related Notes of the Company included elsewhere in this report. This Management's Discussion and Analysis of Financial Condition and Results of Operations and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements that involve risks and uncertainties.

The Company is a product-based international franchiser. The Company's revenues and profitability are derived principally from its franchised system of retail stores that feature chocolate and other confectionery products. The Company also sells its candy in selected locations outside its system of retail stores to build brand awareness. The Company operates eight retail units as a laboratory to test marketing, design and operational initiatives.

The Company is subject to seasonal fluctuations in sales because of the location of its franchisees, which have traditionally been located in resort or tourist locations. As the Company expands its geographical diversity to include regional malls, it has seen some moderation to its seasonal sales mix. Seasonal fluctuation in sales cause fluctuations in quarterly results of operations. Historically, the strongest sales of the Company's products have occurred during the Christmas holiday and summer vacation seasons. Additionally, quarterly results have been, and in the future are likely to be, affected by the timing of new store openings and sales of franchises. Because of the seasonality of the Company's business and the impact of new store openings and sales of franchises, results for any quarter are not necessarily indicative of results that may be achieved in other quarters or for a full fiscal year.

The most important factors in continued growth in the Company's earnings are ongoing unit growth, increased same store sales and increased same store pounds purchased from the factory. Historically, unit growth has more than offset decreases in same store sales and same store pounds purchased.

The Company's ability to successfully achieve expansion of its Rocky Mountain Chocolate Factory franchise system depends on many factors not within the Company's control including the availability of suitable sites for new store establishment and the availability of qualified franchisees to support such expansion.

Efforts to reverse the decline in same store pounds purchased from the factory by franchised stores and to increase total factory sales depends on many factors not within the Company's control including the receptivity of its franchise system of its product introductions and promotional programs. Same store pounds purchased from the factory by franchised stores increased 6.6% in the first quarter, 15.5% the second quarter and 11.9% in the first six months of Fiscal 2005.

As a result, the actual results realized by the Company could differ materially from the results discussed in or contemplated by the forward-looking statements made herein. Words or phrases such as will, anticipate, expect, believe, intend, estimate, project, plan or similar expressions are intended to identify forward-looking statements. Readers are cautioned not to place undue reliance on the forward-looking statements in this Quarterly Report on Form 10-Q.

Table of Contents**Results of Operations****Three Months Ended August 31, 2004 Compared to the Three Months Ended August 31, 2003**

Basic earnings per share increased 50.0% from \$.16 for the three months ended August 31, 2003 to \$.24 for the three months ended August 31, 2004. Revenues increased 7.3% from fiscal 2004 to fiscal 2005. Operating income increased 45.6% from \$1.1 million in fiscal 2004 to \$1.6 million in fiscal 2005. Net income increased 47.6% from \$680,000 in fiscal 2004 to \$1.0 million in fiscal 2005. The increase in earnings per share, operating income, and net income for the second quarter of fiscal 2005 versus the same period in fiscal 2004 was due primarily to growth in the average number of franchise stores in operation and the corresponding increase in revenue.

| (\$ s in thousands) | Three Months Ended August 31, | | Change | % Change |
|----------------------------|----------------------------------|-----------|---------|-------------|
| | 2004 | 2003 | | |
| Factory sales | \$3,730.9 | \$3,405.2 | \$325.7 | 9.6% |
| Retail sales | 808.2 | 905.4 | (97.2) | (10.7%) |
| Franchise fees | 153.2 | 162.9 | (9.7) | (6.0%) |
| Royalty and Marketing fees | 1,175.6 | 997.8 | 177.8 | 17.8% |
| Total | \$5,867.9 | \$5,471.3 | \$396.6 | 7.2% |

Factory Sales

Factory sales increased for the three months ended August 31, 2004 due to a 15.5% increase in same store pounds purchased from the factory by franchised stores and a 54.3% increase in pounds purchased by new franchised stores when compared to the three months ended August 31, 2003. The average number of franchised stores in operation increased to 260 in the second quarter of fiscal 2005 from 226 in fiscal 2004. These increases in factory sales were partially offset by timing differences in product shipments to the Company's single largest customer outside its system of franchised retail stores. Although sales to this customer decreased 78.9% in the second quarter of fiscal 2005 when compared to the same period in the prior fiscal year, total sales to this customer in fiscal 2005 will exceed fiscal 2004 levels.

Retail Sales

Same store retail sales increased 9.0% in the second quarter of fiscal 2005 compared to the same period in the prior year. This increase was offset by an accounting adjustment of \$164,200 related to management's decision in the second quarter of fiscal 2004 to own and operate three company-owned stores that were previously classified as held for sale.

Royalties, Marketing Fees and Franchise Fees

The increase in royalties and marketing fees resulted from growth in both the average number of domestic units in operation and same store sales. The average number of domestic units in operation grew 14.5% from 200 in the second quarter of fiscal 2004 to 229 in 2005 and same store sales grew 5.6% in the second quarter of fiscal 2005 compared to the same period last year. Franchise fee revenues in the second quarter of fiscal 2005 was approximately the same as the second quarter of fiscal 2004.

Costs and Expenses**Table of Contents**

| (\$ s in thousands) | Three months ended | | Change | % Change |
|----------------------------|--------------------|-----------|----------|-------------|
| | 2004 | 2003 | | |
| Cost of sales factory | \$2,259.1 | \$2,349.8 | \$(90.7) | (3.9%) |
| Cost of sales retail | 299.2 | 307.8 | (8.6) | (2.8%) |
| Franchise costs | 317.4 | 251.6 | 65.8 | 26.2% |
| Sales and marketing | 272.4 | 252.1 | 20.3 | 8.1% |
| General and administrative | 525.0 | 510.9 | 14.1 | 2.8% |
| Retail operating | 379.3 | 463.5 | (84.2) | (18.2%) |
| Total | \$4,052.4 | \$4,135.7 | \$(83.3) | (2.0%) |

Table of Contents

Gross margin

| (\$ s in thousands) | Three months ended | | Change | % Change |
|---------------------|--------------------|-----------|---------|-------------|
| | 2004 | 2003 | | |
| Factory | \$1,471.8 | \$1,055.4 | \$416.4 | 39.5% |
| Retail | 509.0 | 597.6 | (88.6) | (14.8%) |
| Total | \$1,980.8 | \$1,653.0 | \$327.8 | 19.8% |
| (Percent) | | | | |
| Factory | 39.4% | 31.0% | 8.4% | 27.1% |
| Retail | 63.0% | 66.0% | (3.0%) | (4.5%) |
| Total | 43.6% | 38.3% | 5.3% | 13.8% |

Costs and Expenses

Cost of Sales

Factory margins improved 840 basis points from fiscal 2004 to fiscal 2005 due primarily to a reduction in excess inventory and the resultant increase in utilization and efficiency of our manufacturing facilities. Reduction in Company-owned store margin is due to changes in mix of product sold, increase costs and static pricing.

Franchise Costs

The increase in franchise costs is due to a planned increase in personnel costs and related support expenditures as well as costs incurred related to the Company's bi-annual franchisee convention. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs increased to 23.9% in the second quarter of fiscal 2005 from 21.7% in the second quarter of fiscal 2004. This increase as a percentage of royalty, marketing and franchise fees is primarily a result of higher franchise costs relative to revenues.

Sales and Marketing

The increase in sales and marketing is due primarily to a planned increase in personnel costs as well a higher planned advertising and marketing expense.

General and Administrative

The increase in general and administrative costs is due primarily to increased compensation costs and professional fees. As a percentage of total revenues, general and administrative expenses decreased to 8.9% in fiscal 2005 compared to 9.3% in fiscal 2004.

Retail Operating Expenses

The decrease in retail operating expenses was due to an accounting adjustment of \$100,900 related to management's decision in the second quarter of fiscal 2004 to own and operate three company-owned stores that were previously classified as held for sale. Retail operating expenses, as a percentage of retail sales, decreased from 51.2% in the second quarter of fiscal 2004 to 46.9% in the second quarter of fiscal 2005 due to more efficient operations.

Depreciation and Amortization

Depreciation and amortization of \$201,000 in the second quarter of fiscal 2005 decreased 11.4% from \$227,000 incurred in the second quarter of fiscal 2004 due primarily to an accounting adjustment of \$12,100 related to management's decision in the second quarter of fiscal 2004 to own and operate three Company-owned stores that were previously classified as held for sale and the increase in the estimated expected asset life of certain Company-owned retail stores in operation.

Table of Contents

Other Expense, Net

Other expense, net of \$1,100 incurred in the second quarter of fiscal 2005 represents a 93.0% decrease from the \$16,000 incurred in the second quarter of fiscal 2003, due primarily to lower interest expense on lower average outstanding balances of long-term debt plus increased interest income on notes receivable and invested cash.

Income Tax Expense

The Company's effective income tax rate in the second quarter of fiscal 2005 was 37.8%, which is the same rate as the second quarter of fiscal 2004.

Six Months Ended August 31, 2004 Compared to the Six Months Ended August 31, 2003

Basic earnings per share increased 48.0% from \$.25 for the six months ended August 31, 2003 to \$.37 for the six months ended August 31, 2004. Revenues increased 12.7% from fiscal 2004 to fiscal 2005. Operating income increased 47.4% from \$1.7 million in fiscal 2004 to \$2.6 million in fiscal 2005. Net income increased 50.4% from \$1.1 million in fiscal 2004 to \$1.6 million in fiscal 2005. The increase in earnings per share, operating income, and net income for the first six months of fiscal 2005 versus the same period in fiscal 2004 was due primarily to growth in the average number of franchise stores in operation and the corresponding increase in revenue.

Revenues

| (\$ s in thousands) | Six Months Ended August 31, | | Change | % Change |
|----------------------------|--------------------------------|-----------|-----------|-------------|
| | 2004 | 2003 | | |
| Factory sales | \$ 6,763.2 | \$5,976.0 | \$ 787.2 | 13.2% |
| Retail sales | 1,359.8 | 1,302.0 | 57.8 | 4.4% |
| Franchise fees | 294.9 | 309.8 | (14.9) | (4.8%) |
| Royalty and marketing fees | 2,175.3 | 1,810.3 | 365.0 | 20.2% |
| Total | \$10,593.2 | \$9,398.1 | \$1,195.1 | 12.7% |

Factory Sales

Factory sales increased for the six months ended August 31, 2004 due to a 11.9% increase in same store pounds purchased from the factory by franchised stores and a 62.9% increase in pounds purchased by new franchised stores when compared to the six months ended August 31, 2003. The average number of stores in operation increased to 258 in the first six months of fiscal 2005 from 224 in fiscal 2004. These increases in factory sales were partially offset by timing differences in product shipments to the Company's single largest customer outside its system of franchised retail stores. Although sales to this customer decreased 78.9% in the first six months of fiscal 2005 when compared to the same period in the prior fiscal year, total sales to this customer in fiscal 2005 will exceed fiscal 2004 levels.

Retail Sales

Same store retail sales increased 6.1% in the first six months of fiscal 2005 compared to the same period in the prior year.

Royalties, Marketing Fees and Franchise Fees

The increase in royalties and marketing fees resulted from growth in both the average number of domestic units in operation and same store sales. The average number of domestic units in operation grew 15.2% from 197 in the first six months of fiscal 2004 to 227 in 2005 and same store sales grew 5.6% in the first six months of fiscal 2005 compared to the same period last year. Franchise fee revenues in the first six months of fiscal 2005 were approximately the same as the first six months of fiscal 2004.

Table of Contents

Costs and Expenses

| (\$ s in thousands) | Six months ended | | | % |
|----------------------------|------------------|-----------|---------|--------|
| | 2004 | 2003 | Change | Change |
| Cost of sales - factory | \$4,196.8 | \$4,126.0 | \$ 70.8 | 1.7% |
| Cost of sales - retail | 506.9 | 457.4 | 49.5 | 10.8% |
| Franchise costs | 612.3 | 498.5 | 113.8 | 22.8% |
| Sales and marketing | 547.3 | 506.0 | 41.3 | 8.2% |
| General and administrative | 1,033.8 | 941.4 | 92.4 | 9.8% |
| Retail operating | 726.2 | 699.5 | 26.7 | 3.8% |
| Total | \$7,623.3 | \$7,228.8 | \$394.5 | 5.5% |

Gross margin

| (\$ s in thousands) | Six months ended | | | % |
|---------------------|------------------|-----------|---------|--------|
| | 2004 | 2003 | Change | Change |
| Factory | \$2,566.4 | \$1,850.0 | \$716.4 | 38.7% |
| Retail | 852.9 | 844.6 | 8.3 | 1.0% |
| Total | \$3,419.3 | \$2,694.6 | \$724.7 | 26.9% |
| (Percent) | | | | |
| Factory | 37.9% | 31.0% | 6.9% | 22.3% |
| Retail | 62.7% | 64.9% | (2.2%) | (3.4%) |
| Total | 42.1% | 37.0% | 5.1% | 13.8% |

Costs and Expenses

Cost of Sales

Factory margins improved 690 basis points from fiscal 2004 to fiscal 2005 due primarily to a reduction in excess inventory and the resultant increases in utilization and efficiency of our manufacturing facilities. The Company manufactured 45.7% more product in the first six months of fiscal 2005 compared to the first six months of fiscal 2004. Reduction in Company-owned store margin is due to changes in mix of product sold, increased costs and static pricing.

Franchise Costs

The increase in franchise costs is due to a planned increase in personnel costs and related support expenditures as well as costs incurred related to the Company's bi-annual franchisee convention. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs increased to 24.8% in the first six months of fiscal 2005 from 23.5% in the first six months of fiscal 2004. This increase as a percentage of royalty, marketing and franchise fees is primarily a result of higher franchise costs relative to revenues.

Sales and Marketing

Table of Contents

The increase in sales and marketing is due primarily to a planned increase in personnel costs as well as higher planned advertising and marketing expense.

General and Administrative

The increase in general and administrative costs is due primarily to increased compensation costs, professional fees, and the disposal of assets associated with the remodel of the Company's Durango, Colorado store. A decrease in provision for bad debts partially offset these increases. As a percentage of total revenues, general and administrative expenses decreased to 9.8% in fiscal 2005 compared to 10.0% in fiscal 2004. This decrease resulted from a higher increase in total revenues relative to the increase in general and administrative costs.

Table of Contents

Retail Operating Expenses

This increase was due primarily to increased compensation expense during the first six months of fiscal 2005 versus the first six months of fiscal 2004. Retail operating expenses, as a percentage of retail sales, decreased from 53.7% in the first six months of fiscal 2004 to 53.4% in the first six months of fiscal 2005 due to a higher increase in revenue relative to the increase in costs.

Depreciation and Amortization

Depreciation and amortization of \$403,000 in the first six months of fiscal 2005 decreased 5.9% from \$428,000 incurred in the first six months of fiscal 2004 due primarily to the increase in the estimated expected asset life of certain Company-owned retail stores in operation.

Other Expense, Net

Other expense, net of \$2,200 incurred in the first six months of fiscal 2005 represents a 93.8% decrease from the \$36,000 incurred in the first six months of fiscal 2004, due primarily to lower interest expense on lower average outstanding balances of long-term debt plus increased interest income on notes receivable and invested cash.

Income Tax Expense

The Company's effective income tax rate in the first six months of fiscal 2005 was 37.8% which is the same rate as the first six months of fiscal 2004.

Liquidity and Capital Resources

As of August 31, 2004, working capital was \$6.7 million, compared with \$6.4 million as of February 29, 2004, an increase of \$300,000. The increase in working capital was primarily due to operating results.

Cash and cash equivalent balances decreased from \$4.6 million as of February 29, 2004 to \$3.0 million as of August 31, 2004 as a result of cash flows provided by operating activities less than cash flows used by financing and investing activities. The Company's current ratio was 3.06 to 1 at August 31, 2004 in comparison with 2.67 to 1 at February 29, 2004. The Company monitors current and anticipated future levels of cash and cash equivalents in relation to anticipated operating, financing and investing requirements.

The Company's long-term debt is comprised primarily of a real estate mortgage facility used to finance the Company's factory expansion (unpaid balance as of August 31, 2004 of \$1.7 million), and chattel mortgage notes (unpaid balance as of August 31, 2004 of \$0.7 million) used to improve and automate the Company's factory infrastructure.

The Company has a \$2.5 million (\$2.5 million available as of August 31, 2004) working capital line of credit collateralized by substantially all of the Company's assets with the exception of the Company's retail store assets. The line is subject to renewal in July, 2005.

The Company believes cash flows generated by operating activities and available financing will be sufficient to fund the Company's operations at least through the end of fiscal 2005.

Impact of Inflation

Inflationary factors such as increases in the costs of ingredients and labor directly affect the Company's operations. Most of the Company's leases provide for cost-of-living adjustments and require the Company to pay taxes, insurance and maintenance expenses, all of which are subject to inflation. Additionally the Company's future lease costs for new facilities may include potentially escalating costs of real estate and construction. There is no assurance that the Company will be able to pass on increased costs to its customers.

Depreciation expense is based on the historical cost to the Company of its fixed assets, and is therefore potentially less than it would be if it were based on current replacement cost. While property and equipment acquired in prior years will ultimately have to be replaced at higher prices, it is expected that replacement will be a gradual process over many years.

Table of Contents

Seasonality

The Company is subject to seasonal fluctuations in sales, which cause fluctuations in quarterly results of operations. Historically, the strongest sales of the Company's products have occurred during the Christmas holiday and summer vacation seasons. In addition, quarterly results have been, and in the future are likely to be, affected by the timing of new store openings and sales of franchises. Because of the seasonality of the Company's business and the impact of new store openings and sales of franchises, results for any quarter are not necessarily indicative of results that may be achieved in other quarters or for a full fiscal year.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company does not engage in commodity futures trading or hedging activities and does not enter into derivative financial instrument transactions for trading or other speculative purposes. The Company also does not engage in transactions in foreign currencies or in interest rate swap transactions that could expose the Company to market risk. However, the Company is exposed to some commodity price and interest rate risks.

The Company frequently enters into purchase contracts of between six to eighteen months for chocolate and certain nuts. These contracts permit the Company to purchase the specified commodity at a fixed price on an as-needed basis during the term of the contract. Because prices for these products may fluctuate, the Company may benefit if prices rise during the terms of these contracts, but it may be required to pay above-market prices if prices fall and it is unable to renegotiate the terms of the contract.

As of August 31, 2004, all of the Company's long-term debt was subject to a variable interest rate. The Company also has a \$2.5 million bank line of credit that bears interest at a variable rate. As of August 31, 2004, no amount was outstanding under the line of credit. The Company does not believe that it is exposed to any material interest rate risk related to its long-term debt or the line of credit.

The Chief Financial Officer and Chief Operating Officer of the Company has primary responsibility over the Company's long-term and short-term debt and for determining the timing and duration of commodity purchase contracts and negotiating the terms and conditions of those contracts.

Item 4. Controls and Procedures

Under the supervision and with the participation of management, including the principal executive officer and principal financial officer, the Company has evaluated the effectiveness of the design and operation of the disclosure controls and procedures within 90 days of the filing date of this quarterly report, and, based on their evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. Disclosure controls and procedures are the Company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files under the Exchange Act is accumulated and communicated to management, including the principal executive officer and the principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Table of Contents**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings

The Company is not currently involved in any legal proceedings that are material to the Company's business or financial condition.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽¹⁾ | (d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs ⁽²⁾ |
|-------------|---|---|--|--|
| June 2004 | 53,000 | \$ 9.88 | 53,000 | \$246,200 |
| July 2004 | -0- | -0- | -0- | 246,200 |
| August 2004 | -0- | -0- | -0- | 246,200 |
| Total | 53,000 | \$ 9.88 | 53,000 | \$246,200 |

(1) During the second quarter of Fiscal 2005 ending August 31, 2004, the Company purchased 53,000 shares for \$523,874 in the open market.

(2) On both September 26, 2003 and February 23, 2004, the Company announced plans to repurchase up to \$1,000,000 of the Company's common stock in the open market or in private transactions, whenever deemed appropriate by management. The plans were only to expire once the designated amounts were reached. The September 26, 2003 plan was completed in March 2004. The Company intends to continue the February 23, 2004 plan until it has been fulfilled.

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

The 2004 Annual Meeting of the Shareholders of the Company was held in Durango, Colorado on August 13, 2004.

The first matter voted on by the stockholders was the election of Franklin E. Crail, Bryan J. Merryman, Gerald A. Kien, Lee N. Mortenson, Fred M. Trainor and Clyde Wm. Engle as directors of the Company. No nominee received less than 79.45% of the shares voted.

The second matter voted on by the stockholders was a resolution to consider and vote upon a proposal to approve the Company's 2004 Stock Option Plan. The resolution was adopted with the approval of 86.94% of the shares voted.

Item 5. Other Information

None

Item 6. Exhibits

A. Exhibits

31.1 Certification Filed Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer

31.2 Certification Filed Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer

32.1 Certification Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer

32.2 Certification Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer

Table of Contents

Signatures

Pursuant to the requirements 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.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
(Registrant)

Date: October 1, 2004

/s/ Bryan J. Merryman

Bryan J. Merryman, Chief Operating Officer,
Chief Financial Officer, Treasurer and Director

Table of Contents

Index to Exhibits

- 31.1 Certification Filed Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer
- 31.2 Certification Filed Pursuant To Section 302 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer
- 32.1 Certification Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer
- 32.2 Certification Furnished Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer