

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

July 11, 2003

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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 May 31, 2003

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 81301

(Address of principal executive offices)

(970) 259-0554

(Registrant's telephone number, including area code)

Indicate by checkmark 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 .

On June 30, 2003 the registrant had outstanding 2,529,456 shares of its common stock, \$.03 par value.

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

Item 1. Financial Statements

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF INCOME

| | Three Months Ended May 31, | |
|---|-----------------------------------|-------------------|
| | 2003 | 2002 |
| Revenues | | |
| Sales | \$2,967,383 | \$2,950,802 |
| Franchise and royalty fees | 959,416 | 1,021,537 |
| Total revenues | 3,926,799 | 3,972,339 |
| Costs and Expenses | | |
| Cost of sales | 1,925,832 | 1,736,942 |
| Franchise costs | 246,916 | 292,031 |
| Sales and marketing | 253,884 | 313,813 |
| General and administrative | 430,473 | 467,972 |
| Retail operating | 235,975 | 198,600 |
| Depreciation and amortization | 200,972 | 206,046 |
| Total costs and expenses | 3,294,052 | 3,215,404 |
| Income from Operations | 632,747 | 756,935 |
| Other Income (Expense) | | |
| Interest expense | (43,329) | (85,548) |
| Interest income | 23,339 | 67,245 |
| Other, net | (19,990) | (18,303) |
| Income Before Income Taxes | 612,757 | 738,632 |
| Provision for Income Taxes | 231,620 | 279,205 |
| Net Income | \$ 381,137 | \$ 459,427 |
| Basic Earnings per Common Share | \$.15 | \$.18 |
| Diluted Earnings per Common Share | \$.14 | \$.17 |
| Weighted Average Common Shares Outstanding Basic | 2,513,514 | 2,484,194 |
| Dilutive Effect of Employee Stock Options | 152,314 | 283,209 |
| Weighted Average Common Shares Outstanding Diluted | 2,665,828 | 2,767,403 |

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

Table of ContentsROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
BALANCE SHEETS

| | May 31, 2003 | February 28, 2003 |
|--|------------------|----------------------|
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 2,125,365 | \$ 1,282,972 |
| Accounts receivable, less allowance for doubtful accounts of \$72,945 and \$65,117 | 1,892,262 | 2,021,391 |
| Refundable income taxes | 109,506 | 548,490 |
| Notes receivable | 292,600 | 288,100 |
| Inventories | 2,811,570 | 3,062,135 |
| Deferred income taxes | 174,616 | 174,616 |
| Other | 407,736 | 276,002 |
| Total current assets | 7,813,655 | 7,653,706 |
| Property and Equipment, Net | 5,504,589 | 5,618,239 |
| Other Assets | | |
| Notes receivable, less valuation allowance of \$49,446 | 772,633 | 801,309 |
| Goodwill, net | 1,039,872 | 1,039,872 |
| Intangible assets, net | 549,456 | 557,167 |
| Assets held for sale | 309,985 | 373,525 |
| Other | 34,624 | 40,428 |
| Total other assets | 2,706,570 | 2,812,301 |
| Total assets | \$ 16,024,814 | \$ 16,084,246 |
| Liabilities and Stockholders Equity | | |
| Current Liabilities | | |
| Current maturities of long-term debt | \$ 1,214,900 | \$ 1,218,400 |
| Accounts payable | 626,559 | 612,770 |
| Accrued salaries and wages | 337,435 | 678,223 |
| Other accrued expenses | 435,259 | 363,192 |
| Total current liabilities | 2,614,153 | 2,872,585 |
| Long-Term Debt, Less Current Maturities | 2,775,775 | 3,072,798 |
| Deferred Gain on Sale of Assets | 15,657 | 15,657 |
| Deferred Income Taxes | 232,215 | 232,215 |
| Commitments and Contingencies | | |
| Stockholders Equity | | |
| Common stock, \$.03 par value; 7,250,000 shares authorized; 2,529,456 and 2,500,123 issued and outstanding | 75,884 | 75,004 |
| Additional paid-in capital | 2,835,439 | 2,721,433 |
| Retained earnings | 7,475,691 | 7,094,554 |
| Total stockholders equity | 10,387,014 | 9,890,991 |
| Total liabilities and stockholders equity | \$ 16,024,814 | \$ 16,084,246 |

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

Table of ContentsROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF CASH FLOWS

| | Three Months Ended May 31, | |
|--|-------------------------------|-------------------|
| | 2003 | 2002 |
| Cash Flows From Operating activities | | |
| Net income | \$ 381,137 | \$ 459,427 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 200,972 | 206,046 |
| Provision for inventory loss | | 10,000 |
| Gain on sale of property and equipment | 339 | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 129,129 | 544,122 |
| Refundable income taxes | 438,984 | |
| Inventories | 250,565 | (731,002) |
| Other assets | (131,734) | (119,270) |
| Accounts payable | 13,789 | 204,198 |
| Accrued liabilities | (268,721) | (417,797) |
| Net cash provided by operating activities | 1,014,460 | 155,724 |
| Cash Flows From Investing Activities | | |
| Proceeds received on notes receivable | 24,176 | 53,892 |
| Proceeds from sale of assets | 65,240 | |
| Purchases of property and equipment | (66,684) | (56,446) |
| Increase in other assets | (9,162) | (14,166) |
| Net cash provided by (used in) investing activities | 13,570 | (16,720) |
| Cash Flows From Financing Activities | | |
| Payments on long-term debt | (300,523) | (314,160) |
| Proceeds from line of credit | | 100,000 |
| Payments on line of credit | | (100,000) |
| Costs of stock split | | (9,091) |
| Reduction of loan to officer | | 39,999 |
| Proceeds from exercise of stock options | 114,886 | 102,014 |
| Net cash used in financing activities | (185,637) | (181,238) |
| Net Increase (Decrease) in Cash and Cash Equivalents | 842,393 | (42,234) |
| Cash and Cash Equivalents, Beginning of Period | 1,282,972 | 165,472 |
| Cash and Cash Equivalents, End of Period | \$ 2,125,365 | \$ 123,238 |

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

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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.

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 three months ended May 31, 2003 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 28, 2003.

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 May 31, 2003 or 2002. 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 months ending May 31 (in 000's except per share amounts):

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| | <u>2003</u> | <u>2002</u> |
|--|-------------|-------------|
| Net Income as reported | \$381 | \$459 |
| Total stock-based compensation expense determined under fair value based method, net of tax | 18 | 23 |
| Net Income pro forma | 363 | 436 |
| Basic Earnings per Share-as reported | .15 | .18 |
| Diluted Earnings per Share-as reported | .14 | .17 |
| Basic Earnings per Share-pro forma | .14 | .18 |
| Diluted Earnings per Share-pro forma | .14 | .16 |

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 May 31, 2003 and 2002, 141,997 and 13,333 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:

| | <u>May 31, 2003</u> | <u>February 28, 2003</u> |
|--------------------------|---------------------|--------------------------|
| Ingredients and supplies | \$1,573,271 | \$1,583,631 |
| Finished candy | 1,238,299 | 1,478,504 |
| | \$2,811,570 | \$3,062,135 |

NOTE 4 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following:

| | <u>May 31, 2003</u> | <u>February 28, 2003</u> |
|-------------------------------|---------------------|--------------------------|
| Land | \$ 513,618 | \$ 513,618 |
| Building | 3,846,376 | 3,838,936 |
| Machinery and equipment | 6,795,636 | 6,746,190 |
| Furniture and fixtures | 658,145 | 658,145 |
| Leasehold improvements | 494,959 | 489,405 |
| Transportation equipment | 180,723 | 180,723 |
| | 12,489,457 | 12,427,017 |
| Less accumulated depreciation | 6,984,868 | 6,808,778 |
| Property and equipment, net | \$ 5,504,589 | \$ 5,618,239 |

NOTE 5 STOCKHOLDERS EQUITY

Stock Split

On January 28, 2002 the Board of Directors approved a four-for-three stock split payable March 4, 2002 to shareholders of record at the close of business on February 11, 2002. Shareholders received one additional share of Common Stock for every three shares owned prior to the record date and \$18,560 was reclassified from additional paid-in capital to common stock for the par value of the additional shares. Immediately prior to the split there were 1,855,918 shares outstanding. Subsequent to the split there were 2,474,640 shares outstanding. All share and per share data have been restated in all periods presented to give effect to the stock split.

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NOTE 5 STOCKHOLDERS EQUITY (continued)

Stock Repurchases

On May 15, 1998, the Company purchased 448,000 shares and certain of its directors and executive officers purchased 138,667 shares of the Company's issued and outstanding common stock at \$3.8625 per share from La Salle National Bank of Chicago, Illinois, which obtained these shares through foreclosure from certain shareholders unrelated to any transactions of the Company. The Company loaned certain officers and directors the funds to acquire 53,333 of the 138,667 shares purchased by them. The loans were secured by the related shares, with interest payable annually at 7.5% and were due May 15, 2003. The last of these loans was paid in full in May, 2002.

NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION

| | Three Months Ended May 31, | |
|---------------------------|-------------------------------|----------|
| | 2003 | 2002 |
| Cash paid (received) for: | | |
| Interest | \$ 42,945 | \$ 4,803 |
| Income taxes | (289,685) | 146,351 |

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 new products and promotions, operating and training methods and merchandising techniques. These 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 28, 2003. 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:

| Three Months Ended May 31, 2003 | Franchising | Manufacturing | Other | Total |
|---|-------------|---------------|-----------|------------|
| Total revenues | 1,356,039 | 2,756,516 | | 4,112,555 |
| Intersegment revenues | | (185,756) | | (185,756) |
| Revenue from external customers | 1,356,039 | 2,570,760 | | 3,926,799 |
| Segment profit (loss) before income taxes | 469,815 | 644,102 | (501,160) | 612,757 |
| Total assets | 2,260,508 | 8,125,758 | 5,638,548 | 16,024,814 |
| Capital expenditures | 20,244 | 51,502 | (5,062) | 66,684 |
| Total depreciation & amortization | 54,459 | 98,777 | 47,736 | 200,972 |
| Three Months Ended May 31, 2002 | | | | |
| Total revenues | 1,343,287 | 2,810,220 | | 4,153,507 |
| Intersegment revenues | | (181,168) | | (181,168) |
| Revenue from external customers | 1,343,287 | 2,629,052 | | 3,972,339 |
| Segment profit (loss) before income taxes | 437,635 | 836,472 | (535,475) | 738,632 |
| Total assets | 1,932,580 | 9,619,966 | 5,307,435 | 16,859,981 |

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| | | | | |
|-----------------------------------|--------|---------|--------|---------|
| Capital expenditures | 32,739 | 11,000 | 12,707 | 56,446 |
| Total depreciation & amortization | 50,631 | 106,215 | 49,200 | 206,046 |

Table of Contents**NOTE 8 ASSET SALES AND FORECLOSURES**

At May 31, 2003, the Company had approximately \$1,115,000 of notes receivable outstanding. The notes require monthly payments and bear interest at rates ranging from 7.5% to 12.5%. The notes mature through October 2006 and are secured by the assets financed.

During fiscal 2002 the Company adjusted the repayment schedule of the notes from a single franchisee to correspond to the franchisee's store operating cycles. The Company also financed an additional \$300,000 of inventory and wrote-off \$243,750 of the notes receivable. During fiscal 2003 the Company financed \$230,000 for an additional store for the franchisee. During the third quarter of fiscal 2003 the Company recorded an additional \$1,667,000 provision for potential loss on accounts and notes receivable and foreclosure costs related to the insolvency of this franchisee. In December 2002, the Company foreclosed on four of the stores previously operated by the franchisee and plans to operate one such retail outlet as a Company-owned store and sell three stores to other franchisees. At May 31, 2003 the Company has no balance recorded for notes receivable from this franchisee.

NOTE 9 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 | May 31, 2003 | | February 28, 2003 | |
|--|------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| | | Gross Carrying Value | Accumulated Amortization | Gross Carrying Value | Accumulated Amortization |
| Intangible assets subject to amortization | | | | | |
| Store design | 10 Years | \$ 200,054 | \$ 27,892 | \$ 189,640 | \$ 23,034 |
| Packaging licenses | 3-5 Years | 95,831 | 64,500 | 95,831 | 61,670 |
| Packaging design | 10 Years | 403,238 | 57,275 | 403,238 | 46,838 |
| Total | | 699,123 | 149,667 | 688,709 | 131,542 |
| Intangible assets not subject to amortization | | | | | |
| Franchising segment- | | | | | |
| Company stores goodwill | | 1,182,083 | 336,847 | 1,182,083 | 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 | | 1,772,083 | 732,211 | 1,772,083 | 732,211 |
| Total intangible assets | | \$2,471,206 | \$881,878 | \$2,460,792 | \$863,753 |

Amortization expense related to intangible assets totaled \$18,126 and \$21,131 during the three months ended May 31, 2003 and 2002. The aggregate estimated amortization expense for intangible assets remaining as of May 31, 2003 is as follows:

| | |
|--------------------------|-----------|
| Remainder of fiscal 2004 | \$ 54,400 |
| 2005 | 71,400 |
| 2006 | 71,400 |
| 2007 | 60,200 |
| 2008 | 60,000 |
| Thereafter | 232,056 |

| | |
|-------|-----------|
| Total | \$549,456 |
|-------|-----------|

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NOTE 10 ASSETS HELD FOR SALE

Assets held for sale consist of three fully operational stores and individual items of equipment, furniture and fixtures that were acquired in partial satisfaction of certain notes receivable from a franchisee. The notes were originally extended as part of store sales and construction financing of additional stores for the franchisee (Note 8). Management expects to dispose of the operating stores and other acquired assets to either existing franchisees who plan to upgrade or expand their operations or to prospective franchisees. These assets are included in Other for segment reporting.

Revenues for these stores totaled \$164,221 and net income, before taxes, totaled \$19,684 for the quarter ended May 31, 2003.

NOTE 11 RECENT ACCOUNTING PRONOUNCEMENTS

In July 2002, the Financial Accounting Standards Board (FASB) issued SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 nullifies FASB Emerging Issues Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. It requires that a liability be recognized for those costs only when the liability is incurred, that is, when it meets the definition of a liability in the Financial Accounting Standards Board's conceptual framework. SFAS No. 146 also establishes fair value as the objective for initial measurement of liabilities related to exit or disposal activities. SFAS 146 is effective for exit or disposal activities that are initiated after December 31, 2002, with earlier adoption encouraged. The Company does not expect SFAS 146 to have a material effect on the Company's financial position or results of operations.

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. The nature of the Company's operations and the environment in which it operates subject it to changing economic, competitive, regulatory and technological conditions, risks and uncertainties. The Company notes the following factors that, among others, could cause future results to differ materially from the forward-looking statements, expectations and assumptions expressed or implied in this Quarterly Report on Form 10-Q. Many of the forward-looking statements contained in this document may be identified by the use of forward-looking words such as will, intend, believe, expect, anticipate, should, plan, estimate and potential, or similar expressions. Factors which could cause results to differ include, but are not limited to: changes in the confectionery business environment, seasonality, consumer interest in the Company's products, general economic conditions, consumer trends, costs and availability of raw materials, competition and the effect of government regulation. Government regulation which the Company and its franchisees either are or may be subject to and which could cause results to differ from forward-looking statements include, but are not limited to: local, state and federal laws regarding health, sanitation, safety, building and fire codes, franchising, employment, manufacturing, packaging and distribution of food products and motor carriers.

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 depend on many factors, including new store openings and the receptivity of the Company's franchise system to its product introductions and promotional programs.

Table of Contents**Results of Operations****Three Months Ended May 31, 2003 Compared to the Three Months Ended May 31, 2002**

Net income was approximately \$381,100 for the three months ended May 31, 2003, or \$.15 per basic share, versus \$459,400, or \$.18 per basic share, for the three months ended May 31, 2002.

Revenues

| (\$'s in thousands) | Three Months Ended May 31, | | Change | % Change |
|----------------------------|-------------------------------|-----------|--------|-------------|
| | 2003 | 2002 | | |
| Factory sales | \$2,570.8 | \$2,629.1 | (58.3) | (2.2%) |
| Retail sales | 396.6 | 321.7 | 74.9 | 23.3% |
| Franchise fees | 146.9 | 156.0 | (9.1) | (5.8%) |
| Royalty and Marketing fees | 812.5 | 865.5 | (53.0) | (6.1%) |
| Total | \$3,926.8 | \$3,972.3 | (45.5) | (1.1%) |

Factory Sales

Factory sales decreased \$58,000, or 2.2%, to \$2.57 million in the first quarter of fiscal 2004, compared to \$2.63 million in the first quarter of fiscal 2003. This decrease was due primarily to a decrease in same store pounds purchased from the factory by franchised stores of 4.4% in the first quarter of fiscal 2004 compared to the first quarter of fiscal 2003. The decline in same store pounds purchased from the factory appears to be caused by a shift in sales mix by franchisees toward store-made products and away from factory-made products. It is difficult to know the cause or causes of this decline and many factors may be involved. The Company believes that retail over-pricing of factory product and large price increases at retail of factory-made product in a weak retail environment also contribute to this shift in sales mix. The Company is continuing to evaluate this issue and ways to reverse the trend.

Retail Sales

Retail sales increased \$75,000, or 23.3%, to \$397,000 in the first quarter of fiscal 2004, compared to \$322,000 in the first quarter of fiscal 2003. This increase resulted primarily from an increase in the average number of stores in operation in the first quarter of fiscal 2004 (5) versus the same period last year (4). Three additional stores are classified as Assets Held For Sale.

Royalties, Marketing Fees and Franchise Fees

Royalties and marketing fees decreased \$53,000, or 6.1%, to \$812,000 in the first quarter of fiscal 2004, compared to \$865,000 in the first quarter of fiscal 2003. This decrease resulted from a decrease in same store sales at franchised stores of approximately 4.6%. The Company believes that the decline is due to continued softness in retail sales caused by an uncertain economic environment. Franchise fee revenues decreased in the first quarter of fiscal 2004 due to a decrease in the number of franchises sold in the first quarter of fiscal 2004 versus the first quarter of fiscal 2003.

Costs and Expenses

Cost of Sales

Cost of sales as a percentage of sales increased to 64.9% in the first quarter of fiscal 2004 from 58.9% in the first quarter of fiscal 2003. The increase resulted from a decrease in factory margins. The decrease in factory margin, from 38.7% in fiscal 2003 to 30.9% in fiscal 2004, is due primarily to production inefficiencies in the first quarter of fiscal 2004 as the Company continued to aggressively reduce inventory levels. The Company manufactured approximately 48% as much product in the first quarter of fiscal 2004 as was manufactured in the first quarter of fiscal 2003. The Company expects full year factory margins to be comparable to fiscal 2003 full year margins. Improvement of Company-owned store margin from 61.4% in fiscal 2003 to 62.3% in fiscal 2004 is due to changes in mix of product sold.

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Franchise Costs

Franchise costs decreased 15.4% from \$292,000 in the first quarter of fiscal 2003 to \$247,000 in the first quarter of fiscal 2004. The decrease is due to a planned reduction in personnel costs and related support expenditures. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 25.7% in the first quarter of fiscal 2004 from 28.6% in the first quarter of fiscal 2003. This decrease as a percentage of royalty, marketing and franchise fees is primarily a result of decreased franchise costs.

Sales and Marketing

Sales and marketing decreased 19.1% to \$254,000 in the first quarter of fiscal 2004 from \$314,000 in the first quarter of fiscal 2003. The decrease is due primarily to decreased personnel costs as well as more focused and efficient marketing programs.

General and Administrative

General and administrative expenses decreased 8.0% to \$430,000 in the first quarter of fiscal 2004 from \$468,000 in the first quarter of fiscal 2003. The decrease is primarily due to decreased personnel costs. As a percentage of total revenues, general and administrative expenses decreased to 11.0% in fiscal 2004 compared to 11.8% in fiscal 2003. This decrease, as a percentage of total revenues, resulted from the decrease in general and administrative costs relative to the 1.1% decline in total revenues.

Retail Operating Expenses

Retail operating expenses increased from \$199,000 in the first quarter of fiscal 2003 to \$236,000 in the first quarter of fiscal 2004, an increase of 18.8%. This increase was due primarily to an increase in the average number of stores in operation during the first quarter of fiscal 2004 (5) versus the first quarter of fiscal 2003 (4). Retail operating expenses, as a percentage of retail sales, decreased from 61.7% in the first quarter of fiscal 2003 to 59.5% in the first quarter of fiscal 2004 due to a change in mix of stores in operation.

Depreciation and Amortization

Depreciation and amortization of \$201,000 in the first quarter of fiscal 2004 approximated the \$206,000 incurred in the first quarter of fiscal 2003.

Other Expense, Net

Other expense, net of \$20,000 incurred in the first quarter of fiscal 2004 represents a 9.2% increase from the \$18,000 incurred in the first quarter of fiscal 2003, due primarily to lower interest income on lower average outstanding amounts of notes receivable. The Company also incurred lower interest expense on lower average outstanding balances of long-term debt.

Income Tax Expense

The Company's effective income tax rate in the first quarter of fiscal 2004 was 37.8% which is the same rate as the first quarter of fiscal 2003.

Liquidity and Capital Resources

As of May 31, 2003 working capital was \$5.2 million, compared with \$4.8 million as of February 28, 2003, an increase of \$400,000. The increase in working capital was primarily due to operating results.

Cash and cash equivalent balances increased from \$1.3 million of February 28, 2003 to \$2.1 million as of May 31, 2003 as a result of cash flows provided by operating and investing activities in excess of cash flows used in financing activities. The Company's current ratio was 2.99 to 1 at May 31, 2003 in comparison with 2.66 to 1 at February 28, 2003. The Company monitors current and anticipated future levels of cash and cash equivalents in relation to anticipated operating, financing and investing requirements.

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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 May 31, 2003 of \$1.9 million), and chattel mortgage notes (unpaid balance as of May 31, 2003 of \$2.1 million) used to improve and automate the Company's factory infrastructure.

The Company has a \$2.5 million (\$2.5 million available as of May 31, 2003) 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 2003.

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 2004.

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.

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 May 31, 2003, 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 May 31, 2003, 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.

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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 Company's principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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. Changes in Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

None

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

A. Exhibits

10.1 Current form of Franchise Agreement used by the Registrant.

99.1 Certification Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, Chief Executive Officer

99.2 Certification Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, Chief Financial Officer

B. Reports on Form 8-K

A Current Report on Form 8-K was furnished to the SEC on May 8, 2003 disclosing Item 12 information.

SIGNATURES

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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: July 11, 2003

/s/ Bryan J. Merryman

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

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Certifications:

I, Franklin E. Crail, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rocky Mountain Chocolate Factory, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and have presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

Date: July 11, 2003

/s/ Franklin E. Crail

Franklin E. Crail, President, Chief Executive
Officer and Chairman of the Board of Directors

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Certifications:

I, Bryan J. Merryman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rocky Mountain Chocolate Factory, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) for the registrant and we have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures and have presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

Date: July 11, 2003

/s/ Bryan J. Merryman

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

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EXHIBIT INDEX

| EXHIBIT NUMBER | DESCRIPTION |
|---------------------------|--|
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| 99.1 | Certification Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, Chief Executive Officer |
| 99.2 | Certification Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, Chief Financial Officer |