ROCKY MOUNTAIN CHOCOLATE FACTORY INC
Form 10-Q
July 12, 2005

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**
**FORM 10-Q**

(Mark One)

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

For the quarterly period ended May 31, 2005

o **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 þ No o.

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

On June 30, 2005 the registrant had outstanding 6,223,920 shares of its common stock, $.03 par value.

The exhibit index is located on page 14.

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

FORM 10-Q

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## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

STATEMENTS OF OPERATIONS
(unaudited)

| | Three Months Ended May 31, 2005 | 2004 |
|---|---|---|
| **Revenues** | | |
| Sales | $ 4,031,530 | $ 3,583,836 |
| Franchise and royalty fees | 1,335,271 | 1,141,448 |
| Total revenues | 5,366,801 | 4,725,284 |
| **Costs and Expenses** | | |
| Cost of sales | 2,397,599 | 2,145,386 |
| Franchise costs | 338,349 | 294,956 |
| Sales and marketing | 305,749 | 274,920 |
| General and administrative | 528,944 | 508,775 |
| Retail operating | 388,928 | 346,895 |
| Depreciation and amortization | 209,608 | 201,619 |
| Total costs and expenses | 4,169,177 | 3,772,551 |
| **Income from Operations** | 1,197,624 | 952,733 |
| **Other Income (Expense)** | | |
| Interest expense | (19,652) | (27,509) |
| Interest income | 31,973 | 26,403 |
| Other, net | 12,321 | (1,106) |
| **Income Before Income Taxes** | 1,209,945 | 951,627 |
| **Income Tax Provision** | 457,360 | 359,715 |
| **Net Income** | $ 752,585 | $ 591,912 |
| **Basic Earnings per Common Share** | $ .12 | $ .10 |
| **Diluted Earnings per Common Share** | $ .11 | $ .09 |
| **Weighted Average Common Shares Outstanding** | 6,165,980 | 6,001,579 |
| **Dilutive Effect of Stock Options** | 511,104 | 429,005 |
| **Weighted Average Common Shares Outstanding, Assuming Dilution** | 6,677,084 | 6,430,584 |

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

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

BALANCE SHEETS

| | May 31, 2005 (unaudited) | February 28, 2005 |
|---|---|---|
| **Assets** | | |
| **Current Assets** | | |
| Cash and cash equivalents | $ 1,748,669 | $ 4,438,876 |
| Accounts receivable, less allowance for doubtful accounts of $80,296 and $80,641, respectively | 2,391,204 | 2,943,835 |
| Notes receivable | 432,900 | 451,845 |
| Refundable income taxes | | 364,630 |
| Inventories, less reserve for slow moving inventory of $119,170 and $127,345 | 3,394,357 | 2,518,212 |
| Deferred income taxes | 156,623 | 156,623 |
| Other | 397,085 | 250,886 |
| Total current assets | 8,520,838 | 11,124,907 |
| **Property and Equipment, Net** | 6,555,670 | 6,125,981 |
| **Other Assets** | | |
| Notes receivable, less valuation allowance of $52,005 | 247,494 | 400,084 |
| Goodwill, net | 1,133,751 | 1,133,751 |
| Intangible assets, net | 408,813 | 426,827 |
| Other | 46,709 | 36,424 |
| Total other assets | 1,836,767 | 1,997,086 |
| Total assets | $ 16,913,275 | $ 19,247,974 |
| **Liabilities and Stockholders Equity** | | |
| **Current Liabilities** | | |
| Current maturities of long-term debt | $ | $ 126,000 |
| Accounts payable | 788,782 | 1,088,476 |
| Accrued salaries and wages | 484,563 | 1,160,937 |
| Other accrued expenses | 418,126 | 324,215 |
| Dividend payable | 418,878 | 417,090 |
| Total current liabilities | 2,110,349 | 3,116,718 |
| **Long-Term Debt, Less Current Maturities** | | 1,539,084 |
| **Deferred Income Taxes** | 698,602 | 698,602 |
| **Commitments and Contingencies** | | |
| **Stockholders Equity** | | |
| Common stock, $.03 par value, 7,250,000 shares authorized, 6,186,005 and 6,136,180 issued and outstanding, respectively | 185,580 | 184,085 |
| Additional paid-in capital | 10,926,739 | 11,051,187 |

| | | |
|---|---|---|
| Retained earnings | 2,992,005 | 2,658,298 |
| Total stockholders equity | 14,104,324 | 13,893,570 |
| Total liabilities and stockholders equity | $ 16,913,275 | $ 19,247,974 |

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

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

STATEMENTS OF CASH FLOWS
(unaudited)

| | Three Months Ended May 31 | |
|---|---|---|
| | 2005 | 2004 |
| **Cash Flows From Operating activities** | | |
| Net income | $ 752,585 | $ 591,912 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 209,608 | 201,619 |
| Provision for obsolete inventory | 15,000 | |
| (Gain) loss on sale of property and equipment | (481) | 36,910 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 459,565 | 353,668 |
| Refundable income taxes | 364,630 | |
| Inventories | (887,330) | (288,580) |
| Other current assets | (147,592) | (120,427) |
| Accounts payable | (299,694) | (168,603) |
| Accrued liabilities | (581,462) | (525,748) |
| Net cash (used in) provided by operating activities | (115,171) | 80,751 |
| **Cash Flows From Investing Activities** | | |
| Proceeds received on notes receivable | 60,786 | 54,529 |
| Proceeds from sale of assets | 3,457 | 7,095 |
| Purchases of property and equipment | (424,302) | (332,239) |
| Increase in other assets | (9,850) | (2,557) |
| Net cash used in investing activities | (369,909) | (273,172) |
| **Cash Flows From Financing Activities** | | |
| Payments on long-term debt | (1,665,084) | (314,034) |
| Repurchase of stock | (245,995) | (320,331) |
| Proceeds from exercise of stock options | 131,944 | 135,279 |
| Costs of stock dividend or stock split | (8,902) | (7,942) |
| Dividends paid | (417,090) | (236,108) |
| Net cash used in financing activities | (2,205,127) | (743,136) |
| **Net Decrease in Cash and Cash Equivalents** | (2,690,207) | (935,557) |
| **Cash and Cash Equivalents, Beginning of Period** | 4,438,876 | 4,552,283 |
| **Cash and Cash Equivalents, End of Period** | $ 1,748,669 | $ 3,616,726 |

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

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 Rocky Mountain Chocolate Factory stores at May 31, 2005:

| | Sold, Not Yet Open | Open | Total |
|---|---|---|---|
| Company owned stores | | 9 | 9 |
| Company owned kiosks | | 1 | 1 |
| Franchise stores Domestic stores | 17 | 227 | 244 |
| Franchise Stores Domestic kiosks | 3 | 17 | 20 |
| Franchise units International | | 31 | 31 |
| | 20 | 285 | 305 |

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, 2005 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, 2005.

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 at date of grant. No compensation expense was recognized during the quarters ended May 31, 2005 or 2004. 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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NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION CONTINUED

Stock-Based Compensation Continued

| | Three Months ended May 31, 2005 | 2004 |
|---|---|---|
| Net Income as reported | $ 753 | $ 592 |
| 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 | 40 | 17 |
| Net Income pro forma | 713 | 575 |
| Basic Earnings per Share-as reported | .12 | .10 |
| Diluted Earnings per Share-as reported | .11 | .09 |
| Basic Earnings per Share-pro forma | .12 | .10 |
| Diluted Earnings per Share-pro forma | .11 | .09 |

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, 2005 and 2004, zero 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:

| | May 31, 2005 | February 28, 2005 |
|---|---|---|
| Ingredients and supplies | $ 1,642,301 | $ 1,365,421 |
| Finished candy | 1,752,056 | 1,152,791 |
| | $ 3,394,357 | $ 2,518,212 |

NOTE 4 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following:

| | May 31, 2005 | February 28, 2005 |
|---|---|---|
| Land | $ 513,618 | $ 513,618 |
| Building | 3,959,162 | 3,962,051 |
| Machinery and equipment | 7,631,571 | 7,553,261 |
| Furniture and fixtures | 640,852 | 611,930 |
| Leasehold improvements | 650,483 | 484,385 |
| Transportation equipment | 180,723 | 180,723 |

| | | | | |
|---|---|---|---|---|
| Construction in progress | | 823,253 | | 527,658 |
| | | 14,399,662 | | 13,833,626 |
| Less accumulated depreciation | | 7,843,992 | | 7,707,645 |
| Property and equipment, net | $ | 6,555,670 | $ | 6,125,981 |

NOTE 5 STOCKHOLDERS EQUITY

Stock Dividend

On February 15, 2005 the Board of Directors declared a 5 percent stock dividend payable on March 10, 2005 to shareholders of record as of February 28, 2005. Shareholders received one additional share of Common Stock for every twenty shares owned prior to the record date. Subsequent to the dividend there were 4,602,135 shares outstanding.

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NOTE 5 STOCKHOLDERS EQUITY CONTINUED

Stock Split

On May 18, 2005 the Board of Directors approved a four-for-three stock split payable June 13, 2005 to shareholders of record at the close of business on May 31, 2005. Shareholders received one additional share of common stock for every three shares owned prior to the record date. Immediately prior to the split there were 4,639,244 shares outstanding. Subsequent to the slit there were 6,186,005 shares outstanding.

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

Stock Repurchases

Between April 18, 2005 and April 20, 2005 the Company repurchased 17,647 Company shares at an average price of $13.94 per share.

Cash Dividend

The Company paid a quarterly cash dividend of $0.0675 per common share on March 16, 2005 to shareholders of record on March 11, 2005. On May 25, 2005 the Company declared a quarterly cash dividend of $0.0675 per common share payable on June 16, 2005 to shareholders of record on June 3, 2005.

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

| | Three Months Ended May 31, | |
|---|---|---|
| | 2005 | 2004 |
| Cash paid for: | | |
| Interest | $ 19,872 | $ 26,166 |
| Income taxes | 8,665 | 175,110 |
| Non-Cash Financing Activities | | |
| Dividend payable | $ 1,788 | $ 258,568 |
| Fair value of assets received upon settlement of note and accounts receivable | | |
| Store to be operated | $ 200,000 | |
| Inventory | 3,815 | |
| Note receivable | 153,780 | |

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. 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 28, 2005. 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:

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NOTE 7 OPERATING SEGMENTS CONTINUED

| | Franchising | Manufacturing | Other | Total |
|---|---|---|---|---|
| Three Months Ended May 31, 2005 | | | | |
| Total revenues | $ 1,977,030 | $ 3,730,675 | $ | $ 5,707,705 |
| Intersegment revenues | | (340,904) | | (340,904) |
| Revenue from external customers | 1,977,030 | 3,389,771 | | 5,366,801 |
| Segment profit (loss) | 707,979 | 1,072,019 | (570,053) | 1,209,945 |
| Total assets | 3,107,398 | 9,597,706 | 4,208,171 | 16,913,275 |
| Capital expenditures | 70,882 | 293,659 | 59,761 | 424,302 |
| Total depreciation & amortization | 59,674 | 96,941 | 52,993 | 209,608 |
| Three Months Ended May 31, 2004 | | | | |
| Total revenues | $ 1,693,008 | $ 3,297,135 | $ | $ 4,990,143 |
| Intersegment revenues | | (264,859) | | (264,859) |
| Revenue from external customers | 1,693,008 | 3,032,276 | | 4,725,284 |
| Segment profit (loss) | 531,821 | 942,167 | (522,361) | 951,627 |
| Total assets | 2,717,808 | 8,014,732 | 6,388,248 | 17,120,788 |
| Capital expenditures | 142,431 | 89,362 | 100,446 | 332,239 |
| Total depreciation & amortization | 57,338 | 96,434 | 47,847 | 201,619 |

NOTE 8 GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist of the following:

| | | May 31, 2005 | | February 28, 2005 | |
|---|---|---|---|---|---|
| | Amortization Period | Gross Carrying Value | Accumulated Amortization | Gross Carrying Value | Accumulated Amortization |
| Intangible assets subject to amortization | | | | | |
| Store design | 10 Years | $ 205,777 | $ 69,102 | $ 205,777 | $ 63,983 |
| Packaging licenses | 3-5 Years | 95,831 | 87,593 | 95,831 | 84,848 |
| Packaging design | 10 Years | 403,238 | 139,338 | 403,238 | 129,188 |
| Total | | 704,846 | 296,033 | 704,846 | 278,019 |
| 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 | $ 1,028,244 | $ 2,570,808 | $ 1,010,230 |

Amortization expense related to intangible assets totaled $18,014 and $18,015 during the three months ended May 31, 2005 and 2004, respectively. The aggregate estimated amortization expense for intangible assets remaining as of May 31, 2005 is as follows:

| | |
|---|---|
| 2006 | 54,679 |
| 2007 | 61,710 |
| 2008 | 61,710 |
| 2009 | 61,710 |
| 2010 | 61,710 |
| Thereafter | 107,294 |
| Total | 408,813 |

NOTE 9 STORE PURCHASE

Effective May 1, 2005 the Company financed a note in the amount of $153,780 and took possession of a previously financed franchise store and related inventory in satisfaction of $357,595 of notes and accounts receivable. The Company currently intends to retain and operate the store.

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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. I 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. Same store pounds purchased from the factory by franchised stores increased 0.7% in the first three months of Fiscal 2006.

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.

**Results of Operations**

**Three Months Ended May 31, 2005 Compared to the Three Months Ended May 31, 2004**

Basic earnings per share increased 20.0% from $.10 for the three months ended May 31, 2004 to $.12 for the three months ended May 31, 2005. Revenues increased 13.6% from fiscal 2005 to fiscal 2006. Operating income increased 25.7% from $953,000 in fiscal 2005 to $1.2 million in fiscal 2006. Net income increased 27.1% from $592,000 in fiscal 2005 to $753,000 in fiscal 2006. The increase in earnings per share, operating income, and net income for the first quarter of fiscal 2006 versus the same period in fiscal 2005 was due primarily to growth in the average number of franchise stores in operation and the corresponding increase in revenue.

Revenues

| | Three Months Ended May 31, | % |
|---|---|---|

| ($ s in thousands) | 2005 | 2004 | Change | Change |
|---|---|---|---|---|
| Factory sales | $ 3,389.7 | $ 3,032.3 | $ 357.4 | 11.8% |
| Retail sales | 641.8 | 551.6 | 90.2 | 16.4% |
| Franchise fees | 162.0 | 141.7 | 20.3 | 14.3% |
| Royalty and Marketing fees | 1,173.3 | 999.7 | 173.6 | 17.4% |
| Total | $ 5,366.8 | $ 4,725.3 | $ 641.5 | 13.6% |

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Factory Sales

The increase in factory sales was due to growth in the average number of franchised stores in operation to 276 in fiscal 2006 from 254 in fiscal 2005. Also contributing to this increase was growth in same store pounds purchased from the factory by franchised stores of 0.7%.

Retail Sales

Retail sales increased 16.4% in the first quarter of fiscal 2006 compared to the same period in the prior year. The improvement was due to an increase in the average number of stores in operation from 8 in fiscal 2005 to 9 in fiscal 2006 and an increase in same store sales of 7.9%.

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 9.4% from 224 in the first quarter of fiscal 2005 to 245 in 2006 and same store sales grew 4.1% in the first quarter of fiscal 2006 compared to the same period last year. Franchise fee revenues in the first quarter of fiscal 2006 increased 14.3% due to the increase of the franchise fee of approximately 25% partially offset by a slight decrease in the number of franchises sold versus the same period last year.

Costs and Expenses

| | Three Months Ended May 31, | | | % |
|---|---|---|---|---|
| ($ s in thousands) | 2005 | 2004 | Change | Change |
| Cost of sales factory | $ 2,147.4 | $ 1,937.7 | $ 209.7 | 10.8% |
| Cost of sales retail | 250.2 | 207.7 | 42.5 | 20.5% |
| Franchise costs | 338.4 | 294.9 | 43.5 | 14.7% |
| Sales and marketing | 305.8 | 274.9 | 30.9 | 11.2% |
| General and administrative | 528.9 | 508.8 | 20.1 | 4.0% |
| Retail operating | 388.9 | 346.9 | 42.0 | 12.1% |
| Total | $ 3,959.6 | $ 3,570.9 | $ 388.7 | 10.9% |

Gross margin

| | Three Months Ended May 31, | | | % |
|---|---|---|---|---|
| ($ s in thousands) | 2005 | 2004 | Change | Change |
| Factory | $ 1,242.3 | $ 1,094.6 | $ 147.7 | 13.5% |
| Retail | 391.6 | 343.9 | 47.7 | 13.9% |
| Total | $ 1,633.9 | $ 1,438.5 | $ 195.4 | 13.6% |
| | | | | |
| (Percent) | | | | |
| Factory | 36.6% | 36.1% | 0.5% | 1.4% |
| Retail | 61.0% | 62.3% | (1.3%) | (2.1%) |
| Total | 40.5% | 40.1% | 0.4% | 1.0% |

Cost of Sales

Factory margin, as a percentage of sales, is approximately the same as last year as expected. Increases in raw material costs mostly offset the efficiency associated with increased volume and a 3.5% price increase. The decline in Company-owned store margin is due to increased operating expenses and changes in mix of product sold.

Franchise Costs

The increase in franchise costs is due to a planned increase in personnel costs and related support expenditures. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 25.3% in the first quarter of fiscal 2006 from 25.8% in the first quarter of fiscal 2005. This decrease as a percentage of royalty, marketing and franchise fees is primarily a result of higher revenues relative to franchise costs.

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Sales and Marketing

The increase in sales and marketing is due primarily to a planned increase in personnel costs.

General and Administrative

The increase in general and administrative costs is due primarily to increased compensation and public company costs. As a percentage of total revenues, general and administrative expenses decreased to 9.9% in fiscal 2006 compared to 10.8% in fiscal 2005.

Retail Operating Expenses

This increase was due primarily to an increase in the average number of stores during the first quarter of fiscal 2006 versus the first quarter fiscal 2005. Retail operating expenses, as a percentage of retail sales, decreased from 62.9% in the first quarter of fiscal 2005 to 60.6% in the first quarter of fiscal 2006 due to a higher increase in revenue relative to the increase in costs.

Depreciation and Amortization

Depreciation and amortization of $210,000 in the first quarter of fiscal 2006 increase 4.0% from $202,000 incurred in the first quarter of fiscal 2005 due to increased purchases of equipment and related depreciation expense.

Other, Net

Other, net of $12,300 realized in the first quarter of fiscal 2006 represents an increase of $13,400 from the $1,100 incurred in the first quarter of fiscal 2005, 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. The Company paid its long-term debt in full during the first quarter of fiscal 2006.

Income Tax Expense

The Company s effective income tax rate in the first quarter of fiscal 2006 was 37.8%, which is the same rate as the first quarter of fiscal 2005.

**Liquidity and Capital Resources**

As of May 31, 2005, working capital was $6.4 million, compared with $8.0 million as of February 28, 2005, a decrease of $1.6 million. The decrease in working capital was primarily due to early retirement of the Company s long-term debt.

Cash and cash equivalent balances decreased from $4.4 million as of February 28, 2005 to $1.7 million as of May 31, 2005 as a result of cash flows used by operating, financing and investing activities. The Company s current ratio was 4.04 to 1 at May 31, 2005 in comparison with 3.57 to 1 at February 28, 2005. The Company monitors current and anticipated future levels of cash and cash equivalents in relation to anticipated operating, financing and investing requirements.

The Company has a $2.5 million ($2.5 million available as of May 31, 2005) 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 2006.

**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.

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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, 2005, all of the Company s long-term debt was paid in full. The Company also has a $2.5 million bank line of credit that bears interest at a variable rate. As of May 31, 2005, 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 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 the principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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## 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] |
|---|---|---|---|---|
| March 2005 | -0- | -0- | -0- | $ 246,000 |
| April 2005 | 17,647 | $ 13.94 | 17,647 | -0- |
| May 2005 | -0- | -0- | -0- | -0- |
| Total | 17,647 | $ 13.94 | 17,647 | $ -0- |

(1) During the first quarter of Fiscal 2006 ending May 31, 2005, the Company purchased 17,647 shares 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 February 23, 2004 plan was completed in April 2005.

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

| | |
|---|---|
| 3.1 | Articles of Incorporation of the Registrant, as amended, incorporated by reference to Exhibit 3.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988 |
| 3.2 | By-laws of the Registrant, as amended on November 25, 1997, incorporated by reference to Exhibit 3.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998 |
| 4.1 | Specimen Common Stock Certificate, incorporated by reference to Exhibit 4.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988 |
| 4.2 | Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant, incorporated by reference to Exhibit 4.1 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001 |
| 4.3 | Change in Terms Agreement dated August 31, 2001 in the amount of $2,800,000 between Wells Fargo Bank and the Registrant, incorporated by reference to Exhibit 4.2 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001 |
| 4.4 | Change in Terms Agreement dated August 31, 2001 in the amount of $2,092,500 between Wells Fargo Bank and the Registrant, incorporated by reference to Exhibit 4.3 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001 |

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4.5 Promissory Note dated August 31, 2001 in the amount of $2,000,000 between Wells Fargo Bank and the Registrant, incorporated by reference to Exhibit 4.4 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001

4.6 Fourth Amendment, dated October 31, 2003, to Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant, incorporated by reference to Exhibit 4.1 to the Quarterly Report on form 10.Q of the Registrant for the quarter ended November 30, 2003

10.1 Form of Stock Option Agreement for the Registrant, incorporated by reference to Exhibit 10.3 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1986

10.2 Incentive Stock Option Plan of the Registrant as amended July 27, 1990, incorporated by reference to Exhibit 10.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991

10.3 Form of Employment Agreement between the Registrant and its officers, incorporated by reference to Exhibit 99.2 to Schedule on Form 14D9 of the Registrant filed on May 21, 1999

10.4 Current form of franchise agreement used by the Registrant, filed herewith.

10.5 Form of Real Estate Lease between the Registrant as Lessee and franchisee as Sublessee, incorporated by reference to Exhibit 10.7 to Registration Statement on Form S-18 (Registration No. 33-2016-D)

10.6 Form of Nonqualified Stock Option Agreement for Nonemployee Directors for the Registrant, incorporated by reference to Exhibit 10.8 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991

10.7 Nonqualified Stock Option Plan for Nonemployee Directors dated March 20, 1990, incorporated by reference to Exhibit 10.9 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991

10.8 1995 Stock Option Plan of the Registrant, incorporated by reference to Exhibit 10.9 to Registration Statement on Form S-1 (Registration No. 33-62149) filed August 25, 1995

10.9 Forms of Incentive Stock Option Agreement for 1995 Stock Option Plan, incorporated by reference to Exhibit 10.10 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995

10.10 Forms of Nonqualified Stock Option Agreement for 1995 Stock Option Plan, incorporated by reference to Exhibit 10.11 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995

10.11 Form of Indemnification Agreement between the Registrant and its directors, incorporated by reference to Exhibit 10.12 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998

10.12 Form of Indemnification Agreement between the Registrant and its officers, incorporated by reference to Exhibit 10.13 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998

10.13 2000 Nonqualified Stock Option Plan for Nonemployee Directors of the Registrant, incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 (Registration No. 333-109936 filed on October 23, 2003.

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| 10.14 | Commodity Contract with Guittard Chocolate Company, incorporated by reference to Exhibit 10.16 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 2005 |
| 10.15 | Rocky Mountain Chocolate Factory, Inc. 2004 Stock Option Plan, incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 (Registration No. 333-119107) filed September 17, 2004 |
| 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 |

Signature

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 12, 2005

/s/ Bryan J. Merryman

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

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