

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

July 10, 2006

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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, 2006

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 a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and larger accelerated filer in Rule 12b of the Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

On June 30, 2006 the registrant had outstanding 6,087,708 shares of its common stock, \$.03 par value.

The exhibit index is located on page 15

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

Item 1. Financial Statements

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF OPERATIONS
(unaudited)

	Three Months Ended May 31,	
	2006	2005
Revenues		
Sales	\$5,349,157	\$4,031,530
Franchise and royalty fees	1,419,255	1,335,271
Total revenues	6,768,412	5,366,801
Costs and Expenses		
Cost of sales	3,336,395	2,397,599
Franchise costs	332,533	338,349
Sales and marketing	351,214	305,749
General and administrative	632,885	528,944
Retail operating	408,811	388,928
Depreciation and amortization	235,681	209,608
Total costs and expenses	5,297,519	4,169,177
Income from Operations	1,470,893	1,197,624
Other Income (Expense)		
Interest expense		(19,652)
Interest income	25,153	31,973
Other, net	25,153	12,321
Income Before Income Taxes	1,496,046	1,209,945
Income Tax Provision	565,505	457,360
Net Income	\$ 930,541	\$ 752,585
Basic Earnings per Common Share	\$.15	\$.12
Diluted Earnings per Common Share	\$.14	\$.11
Weighted Average Common Shares Outstanding	6,228,146	6,165,980
Dilutive Effect of Stock Options	254,359	511,104
Weighted Average Common Shares Outstanding, Assuming Dilution	6,482,505	6,677,084

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

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
BALANCE SHEETS

	May 31, 2006 (unaudited)	February 28, 2006
Assets		
Current Assets		
Cash and cash equivalents	\$ 834,212	\$ 3,489,750
Accounts receivable, less allowance for doubtful accounts of \$44,497 and \$46,920, respectively	2,817,497	3,296,690
Notes receivable	105,000	116,997
Inventories, less reserve for slow moving inventory of \$68,705 and \$61,032	3,569,191	2,938,234
Deferred income taxes	117,715	117,715
Other	541,939	481,091
Total current assets	7,985,554	10,440,477
Property and Equipment, Net	6,541,503	6,698,604
Other Assets		
Notes receivable, less valuation allowance of \$52,005	257,580	278,741
Goodwill, net	1,133,751	1,133,751
Intangible assets, net	384,191	402,469
Other	98,825	103,438
Total other assets	1,874,347	1,918,399
Total assets	\$ 16,401,404	\$ 19,057,480
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	\$ 942,292	\$ 1,145,410
Accrued salaries and wages	604,881	507,480
Other accrued expenses	899,603	750,733
Dividend payable	488,067	504,150
Total current liabilities	2,934,843	2,907,773
Deferred Income Taxes	663,889	663,889
Commitments and Contingencies		
Stockholders' Equity		
Common stock, \$.03 par value, 100,000,000 shares authorized, 6,074,637 and 6,281,920 issued and outstanding, respectively	182,239	188,458
Additional paid-in capital	7,253,129	10,372,530
Retained earnings	5,367,304	4,924,830
Total stockholders' equity	12,802,672	15,485,818
Total liabilities and stockholders' equity	\$ 16,401,404	\$ 19,057,480

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	
	2006	2005
Cash Flows From Operating activities		
Net income	\$ 930,541	\$ 752,585
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	235,681	209,608
Provision for obsolete inventory	15,000	15,000
(Gain) loss on sale of property and equipment	37,283	(481)
Changes in operating assets and liabilities:		
Accounts receivable	479,193	459,565
Refundable income taxes		364,630
Inventories	(645,957)	(887,330)
Other current assets	(55,330)	(147,592)
Accounts payable	(203,118)	(299,694)
Accrued liabilities	211,115	(581,462)
Net cash provided by (used in) operating activities	1,004,408	(115,171)
Cash Flows From Investing Activities		
Proceeds received on notes receivable	33,158	60,786
Proceeds from sale of assets		3,457
Purchases of property and equipment	(54,998)	(424,302)
(Decrease) in other assets	4,164	(9,850)
Net cash used in investing activities	(17,676)	(369,909)
Cash Flows From Financing Activities		
Payments on long-term debt		(1,665,084)
Repurchase of stock	(3,182,934)	(245,995)
Proceeds from exercise of stock options	44,814	131,944
Costs of stock dividend or stock split		(8,902)
Dividends paid	(504,150)	(417,090)
Net cash used in financing activities	(3,642,270)	(2,205,127)
Net Decrease in Cash and Cash Equivalents	(2,655,538)	(2,690,207)
Cash and Cash Equivalents, Beginning of Period	3,489,750	4,438,876
Cash and Cash Equivalents, End of Period	\$ 834,212	\$ 1,748,669

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. The following table summarizes the number of Rocky Mountain Chocolate Factory stores at May 31, 2006:

	Sold, Not Yet		Total
	Open	Open	
Company owned stores		8	8
Company owned kiosks		1	1
Franchise stores Domestic stores	23	239	262
Franchise Stores Domestic kiosks	3	20	23
Franchise units International		34	34
	26	302	328

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, 2006 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, 2006.

Stock-Based Compensation

At May 31, 2006, the Company had stock-based compensation plans for employees and nonemployee directors which authorized the granting of stock options.

Prior to March 1, 2006, the Company accounted for the plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations, permitted under Statement of Financial Accounting Standard No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). As a result, employee stock option-based compensation was included as a pro forma disclosure in the Notes to the Company's Financial Statements for prior year periods.

Table of Contents**NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION CONTINUED****Stock-Based Compensation Continued**

Effective March 1, 2006, the Company adopted the recognition provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment (SFAS No. 123R), using the modified-prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested, as of March 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) all share-based payments granted subsequent to March 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Results for the prior periods have not been restated.

The Company recognized total equity-based compensation expense of \$0 for the quarter ended May 31, 2006.

Compensation costs related to share-based compensation are generally amortized over the vesting period in selling, general and administrative expenses in the statement of operations.

Prior to adopting SFAS No. 123R, the Company presented all benefits from tax deductions arising from equity-based compensation as a non-cash transaction in the Statement of Cash Flows. SFAS No. 123R requires that the tax benefits in excess of the compensation cost recognized for those exercised options be classified as cash provided by financing activities. No excess tax benefit was included in net cash provided by financing activities for the first quarter ended May 31, 2006.

The weighted-average fair value of stock options granted during the three-month periods ended May 31, 2006 and May 31, 2005 was \$0 and \$4.16 per share, respectively. As of May 31, 2006, there was \$0 (before any related tax benefit) of unrecognized compensation cost related to non-vested share-based compensation that is expected to be recognized over the remainder of fiscal 2007.

	Three Months ended May 31, 2006	Three Months ended May 31, 2005
Net Income as reported	\$ 931	\$ 753
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
Net Income pro forma	931	713
Basic Earnings per Share-as reported	.15	.12
Diluted Earnings per Share-as reported	.14	.11
Basic Earnings per Share-pro forma	.15	.12
Diluted Earnings per Share-pro forma	.14	.11

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, 2006 and 2005 137,320 and zero stock options were excluded, respectively, 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, 2006	February 28, 2006
Ingredients and supplies	\$ 1,746,235	\$ 1,507,193
Finished candy	1,822,956	1,431,041
	\$ 3,569,191	\$ 2,938,234

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Property and equipment consists of the following:

	May 31, 2006	February 28, 2006
Land	\$ 513,618	\$ 513,618
Building	4,711,242	4,705,242
Machinery and equipment	6,291,443	6,252,011
Furniture and fixtures	817,520	817,137
Leasehold improvements	641,637	641,637
Transportation equipment	331,641	331,640
	13,307,101	13,261,285
Less accumulated depreciation	6,765,598	6,562,681
Property and equipment, net	\$ 6,541,503	\$ 6,698,604

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 4,602,137 shares outstanding.

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 split there were 6,186,007 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

On June 30, 2006 the Company repurchased 1,700 shares at an average price of \$12.80 per share. Between March 24, 2006 and May 18, 2006 the Company repurchased 224,213 shares at an average price of \$14.20 per share. Between October 7, 2005 and February 3, 2006 the Company repurchased 176,599 shares at an average price of \$15.36 per share. Between April 18 and April 20, 2005 the Company repurchased 17,647 shares at an average price of \$13.94 per share. Between March 11, 2004 and June 14, 2004 the Company repurchased 125,216 Company shares at an average price of \$6.74 per share.

Cash Dividend

The Company paid a quarterly cash dividend of \$0.08 per common share on March 16, 2006 to shareholders of record on March 8, 2006. On May 20, 2006 the Company declared a quarterly cash dividend of \$0.08 per common share payable on June 16, 2006 to shareholders of record on June 2, 2006.

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.

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NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION

	Three Months Ended May 31,	
	2006	2005
Cash paid for:		
Interest	\$	\$ 19,872
Income taxes	400,560	8,665
Non-Cash Financing Activities Dividend payable	\$ (16,083)	\$ 1,788
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-owned 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, 2006. 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:

	Franchising	Manufacturing	Other	Total
Three Months Ended May 31, 2006				
Total revenues	\$2,062,850	\$ 5,153,879	\$	\$ 7,216,729
Intersegment revenues		(448,317)		(448,317)
Revenue from external customers	2,062,850	4,705,562		6,768,412
Segment profit (loss)	676,359	1,448,818	(629,131)	1,496,046
Total assets	2,820,100	10,272,520	3,308,784	16,401,404
Capital expenditures	13,064	23,713	18,221	54,998
Total depreciation & amortization	62,502	114,497	58,682	235,681
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

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Intangible assets consist of the following:

	Amortization Period	May 31, 2006		February 28, 2006	
		Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Intangible assets subject to amortization					
Store design	10 Years 3-5 Years	\$ 205,777	\$ 90,371	\$ 205,777	\$ 85,093
Packaging licenses		120,830	100,414	120,830	99,164
Packaging design	10 Years	430,973	182,604	430,973	170,854
Total		757,580	373,389	757,580	355,111
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 \$ 2,623,542 \$ 1,105,600 \$ 2,623,542 \$ 1,087,322
Amortization expense related to intangible assets totaled \$18,278 and \$18,014 during the three months ended May 31, 2006 and 2005, respectively. The aggregate estimated amortization expense for intangible assets remaining as of May 31, 2006 is as follows:

2007	54,800
2008	73,100
2009	73,100
2000	73,100
2011	73,100
Thereafter	36,991
Total	384,191

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.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**A Note About Forward-Looking Statements**

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 statements, other than statements of historical fact, included in this report are forward-looking statements. 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 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. For a detailed discussion of the risks and uncertainties that may cause the Company's actual results to differ from the forward-looking statements contained herein, please see the Risk Factors contained in the Company's 10-K for

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the fiscal year ended February 28, 2006 which can be viewed at the SEC's website at www.sec.gov or through our website at www.rmcf.com. These forward-looking statements apply only as of the date of this report. As such they should not be unduly relied upon for more current circumstances. Except as required by law, the Company is not obligated to release publicly any revisions to these forward-looking statements that might reflect events or circumstances occurring after the date of this report or those that might reflect the occurrence of unanticipated events. 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 nine 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 are located in street fronts, tourist locations, factory outlets and regional malls. 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 depend on many factors, including new store openings and the receptivity of the Company's franchise system to the Company's product introductions and promotional programs. Same store pounds purchased in the first quarter of fiscal 2007 were approximately the same as the prior year. 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. 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, 2006 Compared to the Three Months Ended May 31, 2005

Basic earnings per share increased 25.0% from \$.12 for the three months ended May 31, 2005 to \$.15 for the three months ended May 31, 2006. Revenues increased 26.1% from fiscal 2006 to fiscal 2007. Operating income increased 22.8% from \$1.2 million in fiscal 2006 to \$1.5 million in fiscal 2007. Net income increased 23.7% from \$753,000 in fiscal 2006 to \$931,000 in fiscal 2007. The increase in earnings per share, operating income, and net income for the first quarter of fiscal 2007 versus the same period in fiscal 2006 was due primarily to growth in sales to customers outside the system of franchise stores and growth in the average number of franchise stores in operation and the corresponding increase in revenue.

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Revenues	Three Months Ended		Change	% Change
	2006	May 31, 2005		
(\$ s in thousands)				
Factory sales	\$4,705.5	\$3,389.7	\$1,315.8	38.8%
Retail sales	643.6	641.8	1.8	0.2%
Franchise fees	127.1	162.0	(34.9)	(21.5%)
Royalty and Marketing fees	1,292.2	1,173.3	118.9	10.1%
Total	\$6,768.4	\$5,366.8	\$1,401.6	26.1%

Factory Sales

The increase in factory sales was due to a 529% increase in product shipments to customers outside its system of franchised retail stores, primarily due to sales of certain specialty packaging items related to Mother's Day to an internet-based gifting service, and growth in the average number of franchised stores in operation to 297 in fiscal 2007 from 276 in fiscal 2006. Same store pounds purchased in the first quarter of fiscal 2007 were approximately the same as the prior year.

Retail Sales

Retail sales were flat in the first quarter of fiscal 2007 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 6.9% from 245 in the first quarter of fiscal 2006 to 262 in 2007 and same store sales grew 0.4% in the first quarter of fiscal 2007 compared to the same period last year. Franchise fee revenues in the first quarter of fiscal 2007 decreased 21.5% due to a decrease in the number of franchises sold versus the same period last year.

Costs and Expenses	Three Months Ended		Change	% Change
	2006	May 31, 2005		
(\$ s in thousands)				
Cost of sales - factory	\$3,082.6	\$2,147.4	\$935.2	43.6%
Cost of sales - retail	253.8	250.2	3.6	1.4%
Franchise costs	332.5	338.4	(5.9)	(1.7%)
Sales and marketing	351.2	305.8	45.4	14.8%
General and administrative	632.9	528.9	104.0	19.7%
Retail operating				