

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

October 14, 2010

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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 August 31, 2010**

**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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 229.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

On September 30, 2010 the registrant had outstanding 6,063,508 shares of its common stock, \$.03 par value.

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## Item 1. Financial Statements

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

|  | Three Months Ended August 31,<br>2010 | 2009        | Six Months Ended August 31,<br>2010 | 2009         |
|--|---------------------------------------|-------------|-------------------------------------|--------------|
| <b>Revenues</b>  |                                       |             |                                     |              |
| Sales  | \$5,126,923                           | \$4,597,519 | \$11,354,217                        | \$ 9,984,402 |
| Franchise and royalty fees   | 1,499,341                             | 1,489,386   | 2,887,385                           | 2,771,690    |
| Total revenues   | 6,626,264                             | 6,086,905   | 14,241,602                          | 12,756,092   |
| <b>Costs and Expenses</b>  |                                       |             |                                     |              |
| Cost of sales, exclusive of depreciation and amortization expense of \$82,302, \$84,040, \$165,722 and \$168,924, respectively | 3,077,445                             | 2,858,301   | 7,126,343                           | 6,466,226    |
| Franchise costs  | 353,227                               | 401,627     | 713,297                             | 771,762      |
| Sales and marketing  | 358,794                               | 339,448     | 748,238                             | 677,761      |
| General and administrative   | 644,584                               | 535,989     | 1,312,355                           | 1,202,936    |
| Retail operating   | 579,670                               | 384,277     | 1,122,149                           | 708,313      |
| Depreciation and amortization  | 172,885                               | 175,657     | 341,342                             | 354,688      |
| Total costs and expenses   | 5,186,605                             | 4,695,299   | 11,363,724                          | 10,181,686   |
| <b>Income from Operations</b>  | 1,439,659                             | 1,391,606   | 2,877,878                           | 2,574,406    |
| <b>Interest income</b>   | 16,138                                | 7,275       | 25,065                              | 12,380       |
| <b>Income Before Income Taxes</b>  | 1,455,797                             | 1,398,881   | 2,902,943                           | 2,586,786    |
| <b>Provision for Income Taxes</b>  | 512,155                               | 516,554     | 1,027,700                           | 956,710      |
| <b>Net Income</b>  | \$ 943,642                            | \$ 882,327  | \$ 1,875,243                        | \$ 1,630,076 |
| <b>Basic Earnings per Common Share</b>   | \$ .16                                | \$ .15      | \$ .31                              | \$ .27       |
| <b>Diluted Earnings per Common Share</b>   | \$ .15                                | \$ .14      | \$ .30                              | \$ .26       |
| <b>Weighted Average Common Shares Outstanding</b>  | 6,044,048                             | 6,005,891   | 6,037,015                           | 5,999,277    |
| <b>Dilutive Effect of Stock Options</b>  | 243,457                               | 204,839     | 232,772                             | 201,182      |
| <b>Weighted Average Common Shares Outstanding, Assuming Dilution</b>   | 6,287,505                             | 6,210,730   | 6,269,787                           | 6,200,459    |

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



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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.  
BALANCE SHEETS

|   | August 31,<br>2010<br>(unaudited) | February 28,<br>2010 |
|---|-----------------------------------|----------------------|
| <b>Assets</b>   |                                   |                      |
| <b>Current Assets</b>   |                                   |                      |
| Cash and cash equivalents   | \$ 3,770,508                      | \$ 3,743,092         |
| Accounts receivable, less allowance for doubtful accounts of \$476,991 and \$395,291 respectively | 3,507,894                         | 4,427,526            |
| Notes receivable, current portion   | 185,580                           | 91,059               |
| Inventories, less reserve for slow moving inventory of \$267,127 and \$263,872 respectively       | 4,165,958                         | 3,281,447            |
| Deferred income taxes   | 383,387                           | 461,249              |
| Other   | 403,063                           | 220,163              |
| Total current assets  | 12,416,390                        | 12,224,536           |
| <b>Property and Equipment, Net</b>  | 5,261,064                         | 5,186,709            |
| <b>Other Assets</b>   |                                   |                      |
| Notes receivable, less current portion and valuation allowance of \$3,000 and \$0, respectively   | 552,972                           | 263,650              |
| Goodwill, net   | 1,046,944                         | 1,046,944            |
| Intangible assets, net  | 78,938                            | 110,025              |
| Other   | 70,149                            | 88,050               |
| Total other assets  | 1,749,003                         | 1,508,669            |
| Total assets  | \$ 19,426,457                     | \$ 18,919,914        |
| <b>Liabilities and Stockholders Equity</b>  |                                   |                      |
| <b>Current Liabilities</b>  |                                   |                      |
| Accounts payable  | \$ 914,732                        | \$ 877,832           |
| Accrued salaries and wages  | 494,702                           | 646,156              |
| Other accrued expenses  | 682,585                           | 946,528              |
| Dividend payable  | 606,351                           | 602,694              |
| Deferred income   | 280,438                           | 220,938              |
| Total current liabilities   | 2,978,808                         | 3,294,148            |
| <b>Deferred Income Taxes</b>  | 832,228                           | 894,429              |
| <b>Commitments and Contingencies</b>  |                                   |                      |
| <b>Stockholders Equity</b>  |                                   |                      |
| Preferred stock, \$.10 par value; 250,000 authorized; -0- shares issued and outstanding           |                                   |                      |
| Series A Junior Participating Preferred Stock, authorized 50,000 shares                           |                                   |                      |
| Undesignated series, authorized 200,000 shares  |                                   |                      |

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|   |               |               |
|---|---------------|---------------|
| Common stock, \$.03 par value, 100,000,000 shares authorized, 6,063,508 and<br>6,026,938 issued and outstanding | 181,905       | 180,808       |
| Additional paid-in capital  | 7,843,791     | 7,626,602     |
| Retained earnings   | 7,589,725     | 6,923,927     |
| Total stockholders' equity  | 15,615,421    | 14,731,337    |
| Total liabilities and stockholders' equity  | \$ 19,426,457 | \$ 18,919,914 |

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)

|   | Six Months Ended<br>August 31, |              |
|---|--------------------------------|--------------|
|   | 2010                           | 2009         |
| <b>Cash Flows From Operating activities</b>                                       |                                |              |
| Net income  | \$ 1,875,243                   | \$ 1,630,076 |
| Adjustments to reconcile net income to net cash Provided by operating activities: |                                |              |
| Depreciation and amortization   | 341,342                        | 354,688      |
| Provision for obsolete inventory  | 30,000                         | 30,000       |
| Provision for loss on accounts and notes receivable                               | 85,000                         | 150,000      |
| Gain on sale of property and equipment  | (8,592)                        | (38,416)     |
| Expense recorded for stock compensation   | 218,286                        | 162,598      |
| Deferred income taxes   | 15,661                         | 14,787       |
| Changes in operating assets and liabilities:                                      |                                |              |
| Accounts receivable   | 770,628                        | 512,516      |
| Inventories   | (914,511)                      | (98,711)     |
| Other current assets  | (187,931)                      | (114,752)    |
| Accounts payable  | 36,900                         | (200,681)    |
| Accrued liabilities   | (415,398)                      | 40,349       |
| Deferred income   | 59,500                         | (34,500)     |
| Net cash provided by operating activities   | 1,906,128                      | 2,407,954    |
| <b>Cash Flows From Investing Activities</b>                                       |                                |              |
| Addition to notes receivable  | (441,811)                      | (170,425)    |
| Proceeds received on notes receivable   | 54,968                         |              |
| Proceeds from sale or distribution of assets                                      | 25,500                         | 5,000        |
| Purchases of property and equipment   | (314,946)                      | (197,883)    |
| (Increase) decrease in other assets   | 3,364                          | 394          |
| Net cash used in investing activities   | (672,925)                      | (362,914)    |
| <b>Cash Flows From Financing Activities</b>                                       |                                |              |
| Dividends paid  | (1,205,787)                    | (1,198,270)  |
| Net cash used in financing activities   | (1,205,787)                    | (1,198,270)  |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>                       | 27,416                         | 846,770      |
| <b>Cash and Cash Equivalents, Beginning of Period</b>                             | 3,743,092                      | 1,253,947    |
| <b>Cash and Cash Equivalents, End of Period</b>                                   | \$ 3,770,508                   | \$ 2,100,717 |

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



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## ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

## NOTES TO INTERIM (UNAUDITED) FINANCIAL STATEMENTS

## NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION

## Nature of Operations

Rocky Mountain Chocolate Factory, Inc. (the Company) is an international franchisor, confectionery manufacturer and retail operator in the United States, 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 August 31, 2010:

|                                  | Sold, Not Yet |      |       |
|----------------------------------|---------------|------|-------|
|                                  | Open          | Open | Total |
| Company-owned stores             |               | 12   | 12    |
| Franchise stores Domestic stores | 9             | 246  | 255   |
| Franchise stores Domestic kiosks |               | 8    | 8     |
| Franchise units International    |               | 53   | 53    |
| Cold Stone Creamery co branded   | 9             | 30   | 39    |
| Total                            | 18            | 349  | 367   |

## 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 presented. The financial 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 presented. The results of operations for the six months ended August 31, 2010 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 audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2010.

## Subsequent Events

On September 30, 2010 the Company, through its wholly-owned subsidiary, Aspen Leaf Yogurt, signed new, five-year leases with Ashley Plaza Center, LLC and DDR DB STONE OAK, LP, for purposes of securing locations to develop the Aspen Leaf Yogurt brand through the opening of Company-owned locations. The new leases commence on the earlier of opening date, or 90 days following delivery of the location by the landlord. Base rent is initially set at approximately \$5,700 per month, combined, and subject to periodic cost of living adjustment. In addition to base rent, the Company will pay monthly its proportionate share of estimated property taxes, assessments and maintenance costs, which currently sum to approximately \$1,800 per month, combined.

On September 30, 2010 the Company filed Articles of Incorporation with the State of Colorado for the purpose of incorporating Aspen Leaf Yogurt, Inc. as a Corporation under the Colorado Business Corporation Act, as amended. Aspen Leaf Yogurt, Inc. is a wholly owned subsidiary of the Company.

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## NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION CONTINUED

## Stock-Based Compensation

At August 31, 2010, the Company had stock-based compensation plans for employees and non-employee directors that authorized the granting of stock awards.

## Stock-Based Compensation Continued

The Company recognized \$100,107 and \$218,286 of equity-based compensation expense during the three and six month periods ended August 31, 2010, respectively, compared to \$74,759 and \$162,598, during the three and six month periods ended August 31, 2009, respectively. Compensation costs related to share-based compensation are generally amortized over the vesting period.

The following table summarizes stock option transactions for common stock during the six months ended August 31, 2010 and August 31, 2009:

|  | Six Months Ended<br>August 31, |          |
|--|--------------------------------|----------|
|  | 2010                           | 2009     |
| Outstanding stock options as of February 28:           | 367,762                        | 371,437  |
| Granted  |                                |          |
| Exercised  |                                |          |
| Cancelled/forfeited                                    | (9,702)                        |          |
| Outstanding stock options as of August 31:             | 358,060                        | 371,437  |
| Weighted average exercise price                        | \$ 9.81                        | \$ 10.00 |
| Weighted average remaining contractual term (in years) | 3.70                           | 4.61     |

The following table summarizes non-vested restricted stock unit transactions for common stock during the six months ended August 31, 2010 and August 31, 2009:

|  | Six Months Ended<br>August 31, |          |
|--|--------------------------------|----------|
|  | 2010                           | 2009     |
| Outstanding non-vested restricted stock units as of February 28: | 129,280                        | 165,400  |
| Granted  | 44,300                         |          |
| Vested   | (32,320)                       | (33,080) |
| Cancelled/forfeited  |                                |          |
| Outstanding non-vested restricted stock units as of August 31:   | 141,260                        | 132,320  |
| Weighted average grant date fair value                           | \$ 9.17                        | \$ 9.04  |
| Weighted average remaining vesting period (in years)             | 3.46                           | 3.90     |

During the six month period ended August 31, 2010, the Company issued 4,000 fully vested, unrestricted shares of stock to non-employee directors compared with 3,000 fully vested, unrestricted shares issued to non-employee directors in same period of the prior fiscal year. There were no unrestricted shares issued during the three month period ended August 31, 2010 and August 31, 2009. In connection with these non-employee director stock issuances, the Company recognized \$38,000 and \$13,080 of equity-based compensation expense during the six-month period ended August 31, 2010 and August 31, 2009, respectively.

During the three and six month periods ended August 31, 2010, the Company recognized \$97,687 and \$177,866, respectively, of equity-based compensation expense related to non-vested, non-forfeited restricted stock unit grants. The restricted stock unit grants generally vest 20% annually over a period of five years. During the three months ended August 31, 2010, 32,320 restricted stock units vested and were issued as common stock. Total unrecognized compensation expense of non-vested, non-forfeited shares granted, as of August 31, 2010, was \$1,234,363, which is expected to be recognized over the weighted average period of 3.5 years



**Table of Contents****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 and restricted stock units. For the three months ended August 31, 2010 and 2009, 116,004 and 129,381 stock options, respectively, were excluded from the computation of earnings per share because their effect would have been anti-dilutive. For the six months ended August 31, 2010 and 2009, 120,855 and 216,699 stock options, respectively, were excluded from the computation of earnings per share because their effect would have been anti-dilutive. Restricted stock units become dilutive within the period granted and remain dilutive until the units vest and are issued as common stock.

**NOTE 3 INVENTORIES**

Inventories consist of the following:

|                          | August 31,<br>2010 | February 28,<br>2010 |
|--------------------------|--------------------|----------------------|
| Ingredients and supplies | \$2,189,180        | \$ 1,945,626         |
| Finished candy           | 1,976,778          | 1,335,821            |
| Total inventories        | \$4,165,958        | \$ 3,281,447         |

**NOTE 4 PROPERTY AND EQUIPMENT, NET**

Property and equipment consists of the following:

|                               | August 31, 2010 | February 28,<br>2010 |
|-------------------------------|-----------------|----------------------|
| Land                          | \$ 513,618      | \$ 513,618           |
| Building                      | 4,699,167       | 4,699,167            |
| Machinery and equipment       | 7,351,190       | 7,006,146            |
| Furniture and fixtures        | 845,407         | 794,387              |
| Leasehold improvements        | 386,271         | 404,191              |
| Transportation equipment      | 379,238         | 379,238              |
|                               | 14,174,891      | 13,796,747           |
| Less accumulated depreciation | 8,913,827       | 8,610,038            |
| Property and equipment, net   | \$ 5,261,064    | \$ 5,186,709         |

**NOTE 5 STOCKHOLDERS EQUITY****Shareholder Rights Plan**

On May 19, 2009, the Company and Computershare Trust Company, N.A. entered into an Amended and Restated Shareholder Rights Agreement ( Rights Agreement ) which amended and restated the existing Shareholder Rights Agreement dated May 28, 1999, ( Existing Rights Plan ). In connection with the Existing Rights Plan the Company's Board of Directors declared a dividend of one right to purchase one one-hundredth of a share of the Company's Series A Junior Participating Preferred Stock, par value \$0.10 per share, for each outstanding share of the Company's common stock, par value \$0.03 per share, of the Company that was outstanding on May 28, 1999. Each share of Series A Junior Participating Preferred Stock originally entitled the holder to one hundred votes and dividends equal to one hundred times the aggregate per share amount of dividends declared per common share. There are no shares of Series A Junior Participating Preferred Stock outstanding. The Existing Rights Plan was set to expire on May 28, 2009 and, through board declaration, was replaced in its entirety by the Rights Agreement on May 18, 2009 when the Board of Directors of the Company authorized and declared a dividend of one Right (a Right ) for each outstanding share of Common Stock of the Company (the Common Shares ). The dividend was paid on May 19, 2009 (the Record Date ) to the holders of record of the Common Shares at the close of business on that date. The Rights will become exercisable

and detachable only following the earlier of 10 days following a public announcement that a person or group has acquired beneficial ownership of 15 percent or more of the outstanding Common Shares or 10 business days following the announcement of a tender offer or exchange offer for 15 percent or more of the outstanding Common Shares. In addition, the Company has authorized the issuance of one Right with respect to each share of Common Stock that shall become outstanding between the Record Date and the earliest of the Distribution Date, the Redemption Date and the Final Expiration Date. When exercisable, each Right entitles the registered holder to purchase

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

from the Company one one-thousandth of a share of Series A Junior Participating Preferred Stock, par value \$0.10 per share, of the Company (the Preferred Shares ), at a price of \$30 per one one-thousandth of a Preferred Share (the Purchase Price ), subject to adjustment. Each share of Series A Junior Participating Preferred Stock entitles the holder to one thousand votes and dividends equal to one thousand times the aggregate per share amount of dividends declared per common share.

**Cash Dividend**

The Company paid a quarterly cash dividend of \$0.10 per common share on March 12, 2010 to shareholders of record on February 26, 2010. The Company paid a quarterly cash dividend of \$0.10 per common share on June 11, 2010 to shareholders of record on May 27, 2010. On August 26, 2010 the Company declared a quarterly cash dividend of \$0.10 per common share payable on September 17, 2010 to shareholders of record on September 7, 2010.

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

**NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION**

|                               | Six Months Ended<br>August 31, |             |
|-------------------------------|--------------------------------|-------------|
|                               | 2010                           | 2009        |
| Cash paid (received) for:     |                                |             |
| Interest                      | \$ (25,065)                    | \$ (24,521) |
| Income taxes                  | \$1,302,678                    | \$911,555   |
| Non-Cash Financing Activities |                                |             |
| Dividend Payable              | \$ 3,657                       | \$ 3,608    |

**NOTE 7 OPERATING SEGMENTS**

The Company classifies its business interests into three reportable segments: Franchising, Manufacturing and Retail Stores. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 to these financial statements and Note 1 to the Company's financial statements included in the Company's annual report on Form 10-K for the fiscal year ended February 28, 2010. 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 | Retail     | Other     | Total        |
|---------------------------------------|-------------|---------------|------------|-----------|--------------|
| Three Months Ended<br>August 31, 2010 |             |               |            |           |              |
| Total revenues                        | \$1,499,341 | \$ 4,669,056  | \$ 922,659 | \$        | \$ 7,091,056 |
| Intersegment revenues                 |             | (464,792)     |            |           | (464,792)    |
| Revenue from external<br>customers    | 1,499,341   | 4,204,264     | 922,659    |           | 6,626,264    |
| Segment profit (loss)                 | 851,892     | 1,307,853     | (37,303)   | (666,645) | 1,455,797    |
| Total assets                          | 1,535,636   | 10,130,134    | 1,789,257  | 5,971,430 | 19,426,457   |
| Capital expenditures                  | 2,767       | 57,304        | 23,113     | 132,045   | 215,229      |
| Total depreciation &<br>amortization  | 19,555      | 87,139        | 27,992     | 38,199    | 172,885      |



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## NOTE 7 OPERATING SEGMENTS CONTINUED

|                                       | Franchising  | Manufacturing | Retail     | Other     | Total        |
|---------------------------------------|--------------|---------------|------------|-----------|--------------|
| Three Months Ended<br>August 31, 2009 |              |               |            |           |              |
| Total revenues                        | \$ 1,489,386 | \$ 4,349,208  | \$ 670,910 | \$        | \$ 6,509,504 |
| Intersegment revenues                 |              | (422,599)     |            |           | (422,599)    |
| Revenue from external customers       | 1,489,386    | 3,926,609     | 670,910    |           | 6,086,905    |
| Segment profit (loss)                 | 791,863      | 1,153,571     | 67,821     | (614,374) | 1,398,881    |
| Total assets                          | 1,480,623    | 10,348,688    | 1,496,713  | 3,924,241 | 17,250,265   |
| Capital expenditures                  | 2,293        | 71,978        | 73,656     | 29,349    | 177,277      |
| Total depreciation & amortization     | 22,898       | 89,754        | 17,552     | 45,453    | 175,657      |

|                                     | Franchising | Manufacturing | Retail      | Other       | Total        |
|-------------------------------------|-------------|---------------|-------------|-------------|--------------|
| Six Months Ended<br>August 31, 2010 |             |               |             |             |              |
| Total revenues                      | \$2,887,385 | \$10,612,796  | \$1,736,158 | \$          | \$15,236,339 |
| Intersegment revenues               |             | (994,737)     |             |             | (994,737)    |
| Revenue from external customers     | 2,887,385   | 9,618,059     | 1,736,158   |             | 14,241,602   |
| Segment profit (loss)               | 1,510,660   | 2,875,615     | (111,242)   | (1,372,091) | 2,902,943    |
| Total assets                        | 1,535,636   | 10,130,134    | 1,789,257   | 5,971,430   | 19,426,457   |
| Capital expenditures                | 3,523       | 110,761       | 29,260      | 171,402     | 314,946      |
| Total depreciation & amortization   | 39,667      | 175,728       | 49,738      | 76,209      | 341,342      |

|                                     |             |              |             |             |              |
|-------------------------------------|-------------|--------------|-------------|-------------|--------------|
| Six Months Ended<br>August 31, 2009 |             |              |             |             |              |
| Total revenues                      | \$2,771,690 | \$ 9,667,092 | \$1,176,484 | \$          | \$13,615,266 |
| Intersegment revenues               |             | (859,174)    |             |             | (859,174)    |
| Revenue from external customers     | 2,771,690   | 8,807,918    | 1,176,484   |             | 12,756,092   |
| Segment profit (loss)               | 1,377,054   | 2,502,723    | 30,595      | (1,323,586) | 2,586,786    |
| Total assets                        | 1,480,623   | 10,348,688   | 1,496,713   | 3,924,241   | 17,250,265   |
| Capital expenditures                | 2,293       | 89,572       | 76,669      | 29,349      | 197,883      |
| Total depreciation & amortization   | 45,547      | 179,896      | 35,240      | 94,006      | 354,688      |

Revenue from one customer of the Company's Manufacturing segment represented approximately \$1.4 million of the Company's revenues from external customers during the six months ended August 31, 2010 compared to \$1.3 million during the six months ended August 31, 2009.

## NOTE 8 GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist of the following:



|  | Amortization<br>Period | August 31, 2010            |                             | February 28, 2010          |                             |
|--|------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
|  |                        | Gross<br>Carrying<br>Value | Accumulated<br>Amortization | Gross<br>Carrying<br>Value | Accumulated<br>Amortization |
| Intangible assets subject to<br>amortization     |                        |                            |                             |                            |                             |
| Store design                                     | 10<br>Years            | \$ 207,745                 | \$ 180,091                  | \$ 205,777                 | \$ 169,535                  |
| Packaging licenses                               | 3-5<br>Years           | 120,830                    | 120,830                     | 120,830                    | 119,164                     |
| Packaging design                                 | 10<br>Years            | 430,973                    | 379,689                     | 430,973                    | 358,856                     |
| Total  |                        | 759,548                    | 680,610                     | 757,580                    | 647,555                     |
| Intangible assets not subject to<br>amortization |                        |                            |                             |                            |                             |
| Franchising segment-                             |                        |                            |                             |                            |                             |
| Company stores goodwill                          |                        | 1,099,328                  | 267,020                     | 1,099,328                  | 267,020                     |
| Franchising goodwill                             |                        | 295,000                    | 197,682                     | 295,000                    | 197,682                     |
| Manufacturing                                    |                        |                            |                             |                            |                             |
| segment-Goodwill                                 |                        | 295,000                    | 197,682                     | 295,000                    | 197,682                     |
| Trademark  |                        | 20,000                     |                             | 20,000                     |                             |
| Total Goodwill                                   |                        | 1,709,328                  | 662,384                     | 1,709,328                  | 662,384                     |
| Total intangible assets                          |                        | \$2,468,576                | \$1,342,994                 | \$2,466,908                | \$1,309,939                 |

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

Amortization expense related to intangible assets totaled \$33,055 and \$36,555 during the six months ended August 31, 2010 and 2009, respectively. The aggregate estimated amortization expense for intangible assets remaining as of August 31, 2009 is as follows:

|                          |          |
|--------------------------|----------|
| Remainder of fiscal 2011 | 31,400   |
| 2012                     | 40,200   |
| 2013                     | 4,700    |
| 2014                     | 680      |
| Thereafter               | 1,958    |
| Total                    | \$78,938 |

**NOTE 9 STORE PURCHASE**

On May 16, 2010, the Company purchased a previously franchise operated Rocky Mountain Chocolate Factory store and related assets in satisfaction of \$54,607 of accounts receivable. The Company currently intends to retain and operate the store and believes that the store has the potential to contribute to future operating results. The Company Adopted ASC Topic 805, Business Combinations, as of March 1, 2009. ASC Topic 805 establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. In accordance with ASC 805, the Company recorded the business acquisition using the acquisition method. The Company recorded the value of the business acquisition at fair value and recorded a gain of \$8,592 associated with the business acquisition. The following table summarizes the allocation of fair value on the date of acquisition:

|  |          |
|--|----------|
| Fair value of assets acquired in business combination          |          |
| Store assets consisting of equipment, furniture, and fixtures: | \$63,198 |

Effective March 1, 2009, the Company adopted the fair value measurement and disclosure provisions of ASC Topic 805, Business Combinations, which establishes specific criteria for the fair value measurements of financial and nonfinancial assets and liabilities that are already subject to fair value measurements under current accounting rules. The Company determined the fair value of the business combination using transaction information for historical asset costs, adjusted for the age of the asset. These inputs to the valuation methodology are unobservable and significant to the fair value measurement (Level 3 of the ASC Topic 805 value hierarchy).

**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 within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. 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, the success of the Company's agreement with Cold Stone Creamery Brands to open co-branded stores, including but not limited to new store openings and the effect of government regulation. Government regulation which the Company and*

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*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 the fiscal year ended February 28, 2009 which can be viewed at the SEC's website at [www.sec.gov](http://www.sec.gov) or through our website at [www.rmcf.com](http://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.*

We are a product-based international franchisor. Our revenues and profitability are derived principally from our franchised system of retail stores that feature chocolate and other confectionery products. We also sell our candy in selected locations outside our system of retail stores to build brand awareness. We operate twelve retail units as a laboratory to test marketing, design and operational initiatives.

We are subject to seasonal fluctuations in sales because of the location of our franchisees, which are located in street fronts, tourist locations, factory outlets and regional centers. Seasonal fluctuation in sales cause fluctuations in quarterly results of operations. Historically, the strongest sales of our 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 our 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 our 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.

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

Efforts to reverse the decline in same store pounds purchased from the factory by franchised stores and to increase total factory sales depends on many factors not within our control including the receptivity by our franchise system of our product introductions and promotional programs. Same store pounds purchased from the factory by franchised stores increased approximately 0.5% in the first quarter, declined approximately 1.0% in the second quarter and declined approximately 0.2% in the first six months of fiscal 2011 as compared to the same periods in fiscal 2010.

As a result, the actual results realized by us 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 August 31, 2010 Compared to the Three Months Ended August 31, 2009**

Basic earnings per share increased 6.7% from \$.15 in the second quarter of fiscal 2010 to \$.16 in the same period of fiscal 2011. Revenues increased 8.9% from \$6.1 million in the second quarter of fiscal 2010 to \$6.6 million in the same period of fiscal 2011. Operating income increased 3.5% from \$1.39 million in the second quarter of fiscal 2010 to \$1.44 million in the second quarter of fiscal 2011. Net income increased 6.9% from \$882,000 in the second quarter of fiscal 2010 to \$944,000 in the second quarter of fiscal 2011. The increase in operating income and net income for the second quarter of fiscal 2011 compared to the same period in

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fiscal 2010 was due primarily to an increase in shipments of product to our network of franchised and licensed stores and an increase in shipments to customers outside our network of franchised and licensed stores.

| (\$ s in thousands)        | Three Months Ended<br>August 31, |           | Change  | %     |
|----------------------------|----------------------------------|-----------|---------|-------|
|                            | 2010                             | 2009      |         |       |
| Factory sales              | \$4,204.2                        | \$3,926.6 | \$277.6 | 7.1%  |
| Retail sales               | 922.7                            | 670.9     | 251.8   | 37.5% |
| Franchise fees             | 52.5                             | 44.0      | 8.5     | 19.3% |
| Royalty and Marketing fees | 1,446.9                          | 1,445.4   | 1.5     | 0.1%  |
| Total                      | \$6,626.3                        | \$6,086.9 | \$539.4 | 8.9%  |

**Factory Sales**

The increase in factory sales for the second quarter of fiscal 2011 compared to the same period in fiscal 2010 was due to an increase in sales to our franchise system, an increase in sales of factory product to licensed locations and customers outside our system of franchised stores. These increases were partially offset by a 1% decrease in same store pounds purchased by franchised stores.

**Retail Sales**

The increase in retail sales resulted primarily from an increase in the average number of Company-owned stores in operation from 7 during the second quarter of fiscal 2010 to 12 in the same period of fiscal 2011. Same store retail sales decreased 7.2% in the second quarter of fiscal 2011 compared to the same period in fiscal 2010.

**Royalties, Marketing Fees and Franchise Fees**

Royalties and marketing fees were approximately the same in the second quarter of fiscal 2011 and in the same period of fiscal 2010. Same store sales at franchise locations decreased 0.7% during the second quarter of fiscal 2011 compared to the same period in the prior year. Average licensed locations in operation increased from 7 units in the second quarter of fiscal 2010 to 26 units in the same period of fiscal 2011. This increase was offset by a decrease in the average number of domestic units in operation from 265 in the second quarter of fiscal 2010 to 257 in the same period of fiscal 2011.

**Costs and Expenses**

| (\$ s in thousands)            | Three months ended<br>August 31, |           | Change  | %       |
|--------------------------------|----------------------------------|-----------|---------|---------|
|                                | 2010                             | 2009      |         |         |
| Cost of sales factory adjusted | \$2,737.9                        | \$2,620.7 | \$117.2 | 4.5%    |
| Cost of sales retail           | 339.5                            | 237.6     | 101.9   | 42.9%   |
| Franchise costs                | 353.2                            | 401.6     | (48.4)  | (12.1%) |
| Sales and marketing            | 358.8                            | 339.5     | 19.3    | 5.7%    |
| General and administrative     | 644.6                            | 536.0     | 108.6   | 20.3%   |
| Retail operating               | 579.7                            | 384.3     | 195.4   | 50.8%   |
| Total                          | \$5,013.7                        | \$4,519.7 | \$494.0 | 10.9%   |

**Adjusted gross margin**

| (\$ s in thousands)           | Three months ended<br>August 31, |           | Change  | %     |
|-------------------------------|----------------------------------|-----------|---------|-------|
|                               | 2010                             | 2009      |         |       |
| Factory adjusted gross margin | \$1,466.3                        | \$1,305.9 | \$160.4 | 12.3% |
| Retail                        | 583.2                            | 433.3     | 149.9   | 34.6% |
| Total                         | \$2,049.5                        | \$1,739.2 | \$310.3 | 17.8% |

(Percent)

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|                               |       |       |        |        |
|-------------------------------|-------|-------|--------|--------|
| Factory adjusted gross margin | 34.9% | 33.3% | 1.6%   | 4.8%   |
| Retail                        | 63.2% | 64.6% | (1.4%) | (2.2%) |
| Total                         | 40.0% | 37.8% | 2.2%   | 5.8%   |

Adjusted gross margin is equal to gross margin minus depreciation and amortization expense. We believe adjusted gross margin is helpful in understanding our past performance as a supplement to

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gross margin and other performance measures calculated in conformity with accounting principles generally accepted in the United States ( GAAP ). We believe that adjusted gross margin is useful to investors because it provides a measure of operating performance and our ability to generate cash that is unaffected by non-cash accounting measures. Additionally, we use adjusted gross margin rather than gross margin to make incremental pricing decisions. Adjusted gross margin has limitations as an analytical tool because it excludes the impact of depreciation and amortization expense and you should not consider it in isolation or as a substitute for any measure reported under GAAP. Our use of capital assets makes depreciation and amortization expense a necessary element of our costs and our ability to generate income. Due to these limitations, we use adjusted gross margin as a measure of performance only in conjunction with GAAP measures of performance such as gross margin. The following table provides a reconciliation of adjusted gross margin to gross margin, the most comparable performance measure under GAAP:

| (\$ s in thousands)                 | Three Months Ended<br>August 31, |            |
|-------------------------------------|----------------------------------|------------|
|                                     | 2010                             | 2009       |
| Factory adjusted gross margin       | \$ 1,466.3                       | \$ 1,305.9 |
| Less: Depreciation and Amortization | 82.3                             | 84.0       |
| Factory GAAP gross margin           | \$ 1,384.0                       | \$ 1,221.9 |
| Costs and Expenses                  |                                  |            |
| Cost of Sales                       |                                  |            |

Factory margins increased 160 basis points from the second quarter of fiscal 2010 compared to the second quarter of fiscal 2011 due primarily to manufacturing efficiencies associated with 6.4% higher production. The decrease in Company-owned store margin is due primarily to a change in product mix associated with a change in the number of Company-owned stores in operation from 12 in the second quarter of fiscal 2011 compared to 7 in the second quarter of fiscal 2010.

**Franchise Costs**

The decrease in franchise costs for the second quarter of fiscal 2011 compared to the same period in fiscal 2010 is primarily due to a decrease in professional fees. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 23.6% in the second quarter of fiscal 2011 from 27.0% in the same period of fiscal 2010. This decrease as a percentage of royalty, marketing and franchise fees is primarily a result of lower franchise costs relative to revenues.

**Sales and Marketing**

The increase in sales and marketing for the second quarter of fiscal 2011 compared to the same period in fiscal 2010 is due primarily to an increase in marketing related compensation costs.

**General and Administrative**

The increase in general and administrative costs for the second quarter of fiscal 2011 compared to the same period in fiscal 2010 is due primarily to an increase in compensation expense and an increase in professional fees. As a percentage of total revenues, general and administrative expense increased to 9.7% in the second quarter of fiscal 2011 compared to 8.8% in the same period of fiscal 2010.

**Retail Operating Expenses**

The increase in retail operating expenses during the second quarter of fiscal 2011 compared to the same period of fiscal 2010 was due primarily to an increase in the average number of Company-owned stores from 7 during the second quarter of fiscal 2010 to 12 during the same period of fiscal 2011. Retail operating expenses, as a percentage of retail sales, increased from 57.3% in the second quarter of fiscal 2010 to 62.8% in the same period of fiscal 2011.

**Depreciation and Amortization**

Depreciation and amortization of \$173,000 in the second quarter of fiscal 2011 decreased 1.7% from \$176,000 incurred in the same period of fiscal 2010 due to certain assets becoming fully depreciated.

**Table of Contents****Interest Income**

Interest income of \$16,100 realized in the second quarter of fiscal 2011 represents an increase of \$8,800 from the \$7,300 realized in the same period of fiscal 2010 due to higher average outstanding cash balances and an increase in interest income related to notes receivable.

**Income Tax Expense**

Our effective income tax rate in the second quarter of fiscal 2011 was 35.2% which is a decrease of 1.7% compared to the same period of fiscal 2010. The decrease in the effective tax rate is primarily due to an increase in allowable deductions related to federal incentives for domestic production activities and a decrease in the tax rate in states where we derive a significant portion of our income.

**Six Months Ended August 31, 2010 Compared to the Six Months Ended August 31, 2009**

Basic earnings per share increased 14.8% from \$.27 for the six months ended August 31, 2009 to \$.31 for the same period of fiscal 2011. Revenues increased 11.6% to \$14.2 million for the six months ended August 31, 2010 compared to \$12.8 million in the same period of fiscal 2010. Operating income increased 11.8% from \$2.6 million in the six months ended August 31, 2009 to \$2.9 million in the same period of fiscal 2011. Net income increased 15.0% from \$1.6 million in the six months ended August 31, 2009 to \$1.9 million in the same period of fiscal 2011. The increase in revenues and net income for the six months ended August 31, 2010 compared to the same period of fiscal 2010 was due primarily to an increase in revenues from domestic franchise retail locations and increased shipments of product to customers outside our network of franchised retail stores.

**Revenues**

| (\$ s in thousands)        | Six Months Ended<br>August 31, |             | Change     | %      |
|----------------------------|--------------------------------|-------------|------------|--------|
|                            | 2010                           | 2009        |            |        |
| Factory sales              | \$ 9,618.0                     | \$ 8,807.9  | \$ 810.0   | 9.2%   |
| Retail sales               | 1,736.2                        | 1,176.5     | 559.7      | 47.6%  |
| Franchise fees             | 129.5                          | 54.0        | 75.5       | 139.8% |
| Royalty and marketing fees | 2,757.9                        | 2,717.7     | 40.2       | 1.5%   |
| Total                      | \$ 14,241.6                    | \$ 12,756.1 | \$ 1,485.5 | 11.6%  |

**Factory Sales**

The increase in factory sales for the first six months of fiscal 2011 compared to the same period in fiscal 2010 was primarily due to a 7.6% increase in purchases by our network of franchised and licensed retail stores and a 16.7% increase in shipments of product to customers outside our network of franchised retail stores. Same store pounds purchased for the first six months of fiscal 2011 were approximately unchanged from the same period in fiscal 2010.

**Retail Sales**

The increase in retail sales resulted primarily from an increase in the average number of Company-owned stores in operation from 7 in the first six months of fiscal 2010 to 12 in the same period of fiscal 2011. Same store retail sales at Company-owned locations decreased 6.0% in the first six months of fiscal 2011 compared to the same period in fiscal 2010. This decrease was primarily the result of decreases in foot traffic in tourist street front locations.

**Royalties, Marketing Fees and Franchise Fees**

The increase in royalties and marketing fees from the first six months of fiscal 2011 compared to the same period of fiscal 2010 resulted from an increase of 0.1% in same store sales and an increase in the number of Cold Stone Creamery Co-branded locations in operation. These increases were partially offset by a decrease in the average number of domestic franchise units in operation. The average number of domestic franchise units in operation decreased 3.7% from 269 in the first six months of fiscal 2010 to 259 during the same period in fiscal 2011. Franchise fee revenues in the first six months of fiscal 2011 increased as a result of an increase in the number of domestic franchise store openings from 2 in the same period of fiscal 2010 to 4 openings in the first six months of fiscal 2011 and an increase in Cold Stone Creamery co-branded location openings from 8 during the first quarter of fiscal 2010 to 11 in the same period of fiscal 2011.





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## Costs and Expenses

| (\$ s in thousands)            | Six months ended<br>August 31, |           | Change    | %<br>Change |
|--------------------------------|--------------------------------|-----------|-----------|-------------|
|                                | 2010                           | 2009      |           |             |
| Cost of sales factory adjusted | \$ 6,470.1                     | \$6,037.2 | \$ 432.9  | 7.2%        |
| Cost of sales retail           | 656.2                          | 429.0     | 227.7     | 53.0%       |
| Franchise costs                | 713.3                          | 771.8     | (58.5)    | (7.6%)      |
| Sales and marketing            | 748.2                          | 677.8     | 70.4      | 10.4%       |
| General and administrative     | 1,312.4                        | 1,202.9   | 109.5     | 9.1%        |
| Retail operating               | 1,122.1                        | 708.3     | 413.8     | 58.4%       |
| Total                          | \$11,022.3                     | \$9,827.0 | \$1,195.3 | 12.2%       |
| Adjusted gross margin          |                                |           |           |             |

| (\$ s in thousands) | Six months ended<br>August 31, |           | Change  | %<br>Change |
|---------------------|--------------------------------|-----------|---------|-------------|
|                     | 2010                           | 2009      |         |             |
| Factory             | \$3,147.9                      | \$2,770.7 | \$377.2 | 13.6%       |
| Retail              | 1,080.0                        | 747.5     | 332.5   | 44.5%       |
| Total               | \$4,227.9                      | \$3,518.2 | \$709.7 | 20.2%       |

| (Percent) | 2010  | 2009  | Change | %<br>Change |
|-----------|-------|-------|--------|-------------|
| Factory   | 32.7% | 31.5% | 1.2%   | 3.8%        |
| Retail    | 62.2% | 63.5% | (1.3%) | (2.0%)      |
| Total     | 37.2% | 35.2% | 2.0%   | 5.7%        |

Adjusted gross margin is equal to gross margin minus depreciation and amortization expense. We believe adjusted gross margin is helpful in understanding our past performance as a supplement to gross margin and other performance measures calculated in conformity with accounting principles generally accepted in the United States ( GAAP ). We believe that adjusted gross margin is useful to investors because it provides a measure of operating performance and our ability to generate cash that is unaffected by non-cash accounting measures. Additionally, we use adjusted gross margin rather than gross margin to make incremental pricing decisions. Adjusted gross margin has limitations as an analytical tool because it excludes the impact of depreciation and amortization expense and you should not consider it in isolation or as a substitute for any measure reported under GAAP. Our use of capital assets makes depreciation and amortization expense a necessary element of our costs and our ability to generate income. Due to these limitations, we use adjusted gross margin as a measure of performance only in conjunction with GAAP measures of performance such as gross margin. The following table provides a reconciliation of adjusted gross margin to gross margin, the most comparable performance measure under GAAP:

| (\$ s in thousands)                 | Six Months Ended<br>August 31, |           |
|-------------------------------------|--------------------------------|-----------|
|                                     | 2010                           | 2009      |
| Factory adjusted gross margin       | \$3,147.9                      | \$2,770.7 |
| Less: Depreciation and Amortization | 165.7                          | 168.9     |
| Factory GAAP gross margin           | \$2,982.2                      | \$2,601.8 |
| Costs and Expenses                  |                                |           |
| Cost of Sales                       |                                |           |

Factory margins increased 120 basis points for the first six months of fiscal 2011 compared to the same period in fiscal 2010 due primarily to manufacturing efficiencies associated with 8.8% higher production. The decrease in Company-owned store margin is due primarily to a change in product mix associated with a change in the number of Company-owned stores in operation from 12 in the second quarter of fiscal 2011 compared to 7 in the same period of fiscal 2010.

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**Franchise Costs**

The decrease in franchise costs during the first six months of fiscal 2011 compared to the same period in fiscal 2010 is due primarily to decreased professional fees related to franchise operations. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 24.7% in the first six months of fiscal 2011 from 27.8% in the same period of fiscal 2010. This decrease as a percentage of royalty, marketing and franchise fees is primarily a result of lower franchise costs relative to revenues.

**Sales and Marketing**

The increase in sales and marketing for the second quarter of fiscal 2011 compared to the same period in fiscal 2010 is due primarily to an increase in costs associated with marketing related compensation expense and marketing materials.

**General and Administrative**

The increase in general and administrative costs for the first six months of fiscal 2011 compared to the same period in fiscal 2010 is due primarily to increased compensation costs. As a percentage of total revenues, general and administrative expenses decreased to 9.2% in the first six months of fiscal 2011 compared to 9.4% in the same period of fiscal 2010.

**Retail Operating Expenses**

The increase in retail operating expenses was due primarily to an increase in the average number of Company-owned stores in operation from 7 in the first six months of fiscal 2010 to 12 in the same period of fiscal 2011. Retail operating expenses, as a percentage of retail sales, increased from 60.2% in the first six months of fiscal 2010 to 64.6% in the same period of fiscal 2011.

**Depreciation and Amortization**

Depreciation and amortization of \$341,000 in the first six months of fiscal 2011 decreased 3.8% from \$355,000 incurred in the same period of fiscal 2010 due to certain assets becoming fully depreciated.

**Interest Income**

Interest income of \$25,065 realized in the first six months of fiscal 2011 represents an increase of \$12,685 from the \$12,380 realized in the same period of fiscal 2010 due to higher average outstanding cash balances and an increase in interest income realized related to notes receivable.

**Income Tax Expense**

Our effective income tax rate in the first six months of fiscal 2011 was 35.4% which is a decrease of 1.6% compared to 37.0% effective income tax rate in the same period in of fiscal 2010. The decrease in the effective tax rate is primarily due to an increase in allowable deductions related to federal incentives for domestic production activities and a decrease in the tax rate in states where we derive a significant portion of our income.

**Liquidity and Capital Resources**

As of August 31, 2010, working capital was \$9.4 million, compared with \$8.9 million as of February 28, 2010, an increase of \$500,000. The change in working capital was due primarily to operating results.

Cash and cash equivalent balances increased from \$3.7 million as of February 28, 2010 to \$3.8 million as of August 31, 2010 as a result of cash flows provided by operating activities greater than cash flows used by financing and investing activities. Our current ratio was 4.17 to 1 at August 31, 2010 in comparison with 3.71 to 1 at February 28, 2010. We monitor current and anticipated future levels of cash and cash equivalents in relation to anticipated operating, financing and investing requirements.

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We have a \$5 million (\$5 million available as of August 31, 2010) working capital line of credit collateralized by substantially all of our assets with the exception of our retail store assets. The line is subject to renewal in July, 2011. We believe cash flows generated by operating activities and available financing will be sufficient to fund our operations at least through the end of fiscal 2011.

### **Impact of Inflation**

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

Depreciation expense is based on the historical cost to us of our 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**

We are subject to seasonal fluctuations in sales, which cause fluctuations in quarterly results of operations. Historically, the strongest sales of our 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 our 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 contracts.

As of August 31, 2010, the Company had no long-term debt. The Company has a \$5.0 million bank line of credit that bears interest at a variable rate. As of August 31, 2010, 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 the line of credit.

The Chief Financial Officer and Chief Operating Officer of the Company have 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**

#### **Evaluation of Disclosure Controls and Procedures**

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) that are designed to ensure that material information relating to the Company is made known to the officers who certify the Company's financial reports and to other members of senior management and the Board of Directors. These disclosure controls and procedures are designed to ensure that information required to be disclosed in the Company's reports that are filed or submitted

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under the Exchange Act, are recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Management, with the participation of the CEO and CFO, has evaluated the effectiveness, as of August 31, 2010, of the Company's disclosure controls and procedures. Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures were effective as of August 31, 2010.

**Changes in Internal Control over Financial Reporting**

There has been no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the six months ended August 31, 2010, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION**

Item 1. Legal Proceedings

The Company is not currently involved in any legal proceedings other than routine litigation incidental to its business.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the factors discussed in Part 1, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended February 28, 2010. There have been no material changes in our risk factors from those disclosed in our Annual Report on Form 10-K.

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

None

Item 3. Defaults Upon Senior Securities

None

Item 4. Reserved

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 Annual Report on Form 10-K of the Registrant for the year ended February 28, 2009
- 3.2 By-laws of the Registrant, as amended on December 11, 2007, incorporated by reference to Exhibit 3.2 to Current Report on Form 8-K of the Registrant filed on December 14, 2007
- 10.1 \*Promissory Note dated July 31, 2010 in the amount of \$5,000,000 between Wells Fargo Bank and the Registrant.
- 10.2 \*Commercial Security Agreement dated July 31, 2010 between Wells Fargo Bank and the Registrant.
- 10.3 \*Business Loan Agreement dated July 31, 2010 between Wells Fargo Bank and the Registrant.

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Item 6. Exhibits Continued

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

\* Filed herewith.

\*\* Furnished  
herewith.

**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ROCKY MOUNTAIN CHOCOLATE FACTORY,  
INC.  
(Registrant)

Date: October 14, 2010

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