

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-K

May 05, 2006

**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K**

(Mark One)

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

For the fiscal year ended February 28, 2006

OR

**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)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT

None

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT

Common Stock, \$.03 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act. Yes No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 Act). Yes No

On April 28, 2006, there were 6,218,520 shares of Common Stock outstanding. The aggregate market value of the Common Stock (based on the average of the closing bid and ask prices as quoted on the Nasdaq National Market System on April 28, 2006) held by non-affiliates was \$77,218,384.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement furnished to stockholders in connection with the 2006 Annual Meeting of Stockholders (the "Proxy Statement") are incorporated by reference in Part III of this Report. The Proxy Statement will

be filed with the Securities and Exchange Commission within 120 days of the close of the registrant's fiscal year.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
FORM 10-K
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PART I.
ITEM 1. BUSINESS

General

Founded in 1981 and incorporated in Colorado in 1982, Rocky Mountain Chocolate Factory, Inc. (the Company, and sometimes referred to herein with the pronouns we, us, or our) is an international franchiser and confectionery manufacturer. The Company is headquartered in Durango, Colorado and manufactures an extensive line of premium chocolate candies and other confectionery products. As of March 31, 2006 there were 9 Company-owned and 301 franchised Rocky Mountain Chocolate Factory stores operating in 40 states, Canada, Guam and the United Arab Emirates.

On average, approximately 40% of the products sold at Rocky Mountain Chocolate Factory stores are prepared on the premises. The Company believes this in-store preparation creates a special store ambiance and the aroma and sight of products being made attracts foot traffic and assures customers that products are fresh.

The Company believes that its principal competitive strengths lie in its brand name recognition, its reputation for the quality, variety and taste of its products; the special ambiance of its stores; its knowledge and experience in applying criteria for selection of new store locations; its expertise in the manufacture of chocolate candy products and the merchandising and marketing of chocolate and other candy products; and the control and training infrastructures it has implemented to assure consistent customer service and execution of successful practices and techniques at its stores. The Company believes its manufacturing expertise and reputation for quality has facilitated the sale of selected products through new distribution channels. The Company is currently selling its products in a select number of new distribution channels including wholesaling, fundraising, corporate sales, mail order and internet sales.

The Company's revenues are currently derived from three principal sources: (i) sales to franchisees and others of chocolates and other confectionery products manufactured by the Company (69-68-67%); (ii) sales at Company-owned stores of chocolates and other confectionery products (including product manufactured by the Company) (11-11-12%) and (iii) the collection of initial franchise fees and royalties from franchisees (20-21-21%). The figures in parentheses show the percentage of total revenues attributable to each source for fiscal years ended February 28 (29), 2006, 2005 and 2004, respectively.

According to the National Confectioners Association, the total U.S. candy market approximated \$27.9 billion of retail sales in 2005 with chocolate generating sales of approximately \$15.7 billion. According to the Department of Commerce, per capita consumption of chocolate in 2004 exceeded 13 pounds per year nationally and was consistent when compared to 2003.

Business Strategy

The Company's objective is to build on its position as a leading international franchiser and manufacturer of high quality chocolate and other confectionery products. The Company continually seeks opportunities to profitably expand its business. To accomplish this objective, the Company employs a business strategy that includes the following elements:

Product Quality and Variety

The Company maintains the unsurpassed taste and quality of its chocolate candies by using only the finest chocolate and other wholesome ingredients. The Company uses its own proprietary recipes, primarily developed by its master candy maker. A typical Rocky Mountain Chocolate Factory store offers up to 100 of the Company's chocolate candies throughout the year and as many as 200, including many packaged candies, during the holiday seasons. Individual stores also offer numerous varieties of premium fudge and gourmet caramel apples, as well as other products prepared in the store from Company recipes.

Store Atmosphere and Ambiance

The Company seeks to establish an enjoyable and inviting atmosphere in each Rocky Mountain Chocolate Factory store. Each store prepares numerous products, including fudge, barks and caramel apples, in the store. In-store preparation is designed both to be fun and entertaining for customers and to convey an image of freshness and homemade quality. The Company's design staff has developed easily replicable designs and specifications to ensure that the Rocky Mountain Chocolate Factory concept is consistently implemented throughout the system.

In February 2000, the Company retained a nationally recognized design firm to evaluate and update its existing store design. The objective of the store design project is threefold: (1) increase average revenue per unit thereby opening untapped real estate environments; (2) further emphasize the entertainment and freshness value of the Company's in-store confectionery factory; and (3) improve operational efficiency through optimal store layout. The Company completed the store redesign project and the testing of the new design in fiscal 2002. Through March 31, 2006, 127 stores incorporating the new design have been opened.

Site Selection

Careful selection of a site is critical to the success of a Rocky Mountain Chocolate Factory store. Many factors are considered by the Company in identifying suitable sites, including tenant mix, visibility, attractiveness, accessibility, level of foot traffic and occupancy costs. Final site selection occurs only after the Company's senior management has approved the site. The Company believes that the experience of its management team in evaluating a potential site is one of the Company's competitive strengths.

Customer Service Commitment

The Company emphasizes excellence in customer service and seeks to employ and to sell franchises to motivated and energetic people. The Company also fosters enthusiasm for its customer service philosophy and the Rocky Mountain Chocolate Factory concept through its annual franchisee convention, regional meetings and other frequent contacts with its franchisees.

Increase Same Store Retail Sales at Existing Locations

The Company seeks to increase profitability of its store system through increasing sales at existing store locations. Changes in system wide domestic same store retail sales are as follows:

| | |
|------|--------|
| 2002 | 0.0% |
| 2003 | (3.4%) |
| 2004 | (0.6%) |
| 2005 | 4.8% |
| 2006 | 2.4% |

The Company believes that the negative trend in fiscal 2003 and through the third fiscal quarter of 2004 was due to the overall weak economy and retail environment, especially in tourist areas where many of the stores operate. The Company experienced positive same store sales of 5.4% in its fiscal fourth quarter of 2004 and believes the positive trend is due primarily to a recovery in the United States economy through fiscal 2006.

In February 2000, the Company retained a nationally recognized packaging design firm to completely redesign the packaging featured in the Company's retail stores. The Company has designed a contemporary and coordinated line of packaged products that capture and convey the freshness, fun and excitement of the Rocky Mountain Chocolate Factory retail store experience. The Company completed the packaging redesign project during 2002. The Company also believes that the successful launch of new packaging has had a positive impact on same store sales.

Increase Same Store Pounds Purchased by Existing Locations

In fiscal 2006, same store pounds purchased were approximately the same as the prior fiscal year. The Company continues to add new products and focus its existing product lines in an effort to increase same store pounds purchased by existing locations.

Enhanced Operating Efficiencies

The Company seeks to improve its profitability by controlling costs and increasing the efficiency of its operations. Efforts in the last several years include the purchase of additional automated factory equipment, implementation of a comprehensive MRP II forecasting, planning, scheduling and reporting system, implementation of alternative manufacturing strategies and installation of enhanced Point-of-Sale (POS) systems in all of its Company-owned and 148 of its franchised stores through March 31, 2006. These measures have significantly improved the Company's ability to deliver its products to its stores safely, quickly and cost-effectively and impact store operations.

Additionally, the divestiture of substantially all of the Company-owned stores in fiscal 2002 has reduced the Company's exposure to real estate risk, improved the Company's operating margins and allowed the Company to increase its focus on franchising.

Expansion Strategy

Key elements of the Company's expansion strategy include:

Unit Growth

The cornerstone of the Company's growth strategy is to aggressively pursue unit growth opportunities in locations where the Company has traditionally been successful, to pursue new and developing real estate environments for franchisees which appear promising based on early sales results, and to improve and expand the retail store concept, such that previously untapped and unfeasible environments (such as most regional malls) generate sufficient revenue to support a successful Rocky Mountain Chocolate Factory location.

High Traffic Environments

The Company currently establishes franchised stores in the following environments: factory outlet malls, tourist environments, regional malls, street fronts and other entertainment oriented environments. The Company, over the last several years, has had a particular focus on regional mall locations. The Company is optimistic that its exciting new store design will allow it to continue targeting the over 1,100 regional malls in the United States. The Company has established a business relationship with most of the major developers in the United States and believes that these relationships provide it with the opportunity to take advantage of attractive sites in new and existing real estate environments.

Name Recognition and New Market Penetration

The Company believes the visibility of its stores and the high foot traffic at most of its locations has generated strong name recognition of Rocky Mountain Chocolate Factory and demand for its franchises. The Rocky Mountain Chocolate Factory system has historically been concentrated in the western and Rocky Mountain region of the United States, but recent growth has generated a gradual easterly momentum as new stores have been opened in the eastern half of the country. This growth has further increased the Company's name recognition and demand for its franchises. Distribution of Rocky Mountain Chocolate Factory products through new channels also increases name recognition and brand awareness in areas of the country in which the Company has not previously had a significant presence. The Company believes that by distributing selected Rocky Mountain Chocolate Factory products through new distribution channels its name recognition will improve and benefit its entire store system.

Store Concept

The Company seeks to establish a fun and inviting atmosphere in its Rocky Mountain Chocolate Factory store locations. Unlike most other confectionery stores, each Rocky Mountain Chocolate Factory store prepares certain products, including fudge and caramel apples, in the store. Customers can observe store personnel making fudge from start to finish, including the mixing of ingredients in old-fashioned copper kettles and the cooling of the fudge on large marble tables, and are often invited to sample the store's products. The Company believes that an average of approximately 40% of the revenues of franchised stores are generated by sales of products prepared on the premises. The Company believes the in-store preparation and aroma of its products enhance the ambiance at Rocky Mountain Chocolate Factory stores, are fun and entertaining for its customers and convey an image of freshness and homemade quality.

Rocky Mountain Chocolate Factory stores opened prior to fiscal 2002 have a distinctive country Victorian decor, which further enhances their friendly and enjoyable atmosphere. Each store includes finely crafted wood cabinetry, copper and brass accents, etched mirrors and large marble tables on which fudge and other products are made. To ensure that all stores conform to the Rocky Mountain Chocolate Factory image, the Company's design staff provides working drawings and specifications and approves the construction plans for each new store. The Company also controls the signage and building materials that may be used in the stores.

In fiscal 2002, the Company launched its revised store design concept intended specifically for high foot traffic regional shopping malls. The revised store design concept is modern with crisp and clean site lines and an even stronger emphasis on the Company's unique upscale kitchen. Based on results, the Company is requiring that all new Rocky Mountain Chocolate Factory stores incorporate the revised store design concept.

The average store size is approximately 1,000 square feet, approximately 650 square feet of which is selling space. Most stores are open seven days a week. Typical hours are 10 a.m. to 9 p.m., Monday through Saturday, and 12 noon to 6 p.m. on Sundays. Store hours in tourist areas may vary depending upon the tourist season.

Kiosk Concept

In fiscal 2002, the Company opened its first full service retail kiosk concept. The kiosk is a vehicle for retail environments where in-line real estate is unavailable or build-out costs and/or rent factors do not meet the Company's financial criteria. The kiosk, which ranges from 150 to 250 square feet, incorporates the Company's trademark cooking area where caramel apples, fudge and other popular confections are prepared in front of customers using traditional cooking utensils. The kiosk also includes the Company's core product and gifting lines in order to provide the customer with a full Rocky Mountain Chocolate Factory experience.

The Company believes the kiosk concept enhances its franchise opportunity by providing more flexibility in support of existing franchisees' expansion programs and allows new franchisees that otherwise would not qualify for an in-line location an opportunity to join the Rocky Mountain Chocolate Factory system. As of March 31, 2006 there were 22 kiosks in operation.

Products and Packaging

The Company typically produces approximately 300 chocolate candies and other confectionery products, using proprietary recipes developed primarily by the Company's master candy maker. These products include many varieties of clusters, caramels, creams, mints and truffles. The Company continues to engage in a major effort to expand its product line by developing additional exciting and attractive new products. During the Christmas, Easter and Valentine's Day holiday seasons, the Company may make as many as 100 additional items, including many candies offered in packages specially designed for the holidays. A typical Rocky Mountain Chocolate Factory store offers up to 100 of these candies throughout the year and up to an additional 100 during holiday seasons. Individual stores also offer more than 15 premium fudges and other products prepared in the store. The Company believes that, on average, approximately 50% of the revenues of Rocky Mountain Chocolate Factory stores are generated by products manufactured at the Company's factory, 40% by products made in the store using Company recipes and ingredients purchased from the Company or approved suppliers and the remaining 10% by products, such as ice cream, coffee and other sundries, purchased from approved suppliers.

The Company uses only the finest chocolates, nut meats and other wholesome ingredients in its candies and continually strives to offer new confectionery items in order to maintain the excitement and appeal of its products. The Company develops special packaging for the Christmas, Valentine's Day and Easter holidays, and customers can have their purchases packaged in decorative boxes and fancy tins throughout the year.

Chocolate candies manufactured by the Company are sold at prices ranging from \$13.20 to \$21.95 per pound, with an average price of \$17.40 per pound. Franchisees set their own retail prices, though the Company does recommend prices for all of its products.

Operating Environment

The Company currently establishes Rocky Mountain Chocolate Factory stores in five primary environments: regional malls, tourist areas, factory outlet malls, street fronts and other entertainment oriented shopping centers. Each of these environments has a number of attractive features, including high levels of foot traffic.

Factory Outlet Malls

There are approximately 225 factory outlet malls in the United States, and as of February 28, 2006, there were Rocky Mountain Chocolate Factory stores in approximately 70 of these malls in over 30 states. The Company has established business relationships with most of the major outlet mall developers in the United States. Although not all factory outlet malls provide desirable locations for the Company's stores, management believes the Company's relationships with these developers will provide it with the opportunity to take advantage of attractive sites in new and existing outlet malls.

Tourist Areas, Street Fronts and Other Entertainment Oriented Shopping Centers

As of February 28, 2006, there were approximately 70 Rocky Mountain Chocolate Factory stores in locations considered to be tourist areas, including Fisherman's Wharf in San Francisco, California and the Riverwalk in San Antonio, Texas. Tourist areas are very attractive locations because they offer high levels of foot traffic and favorable customer spending characteristics, and greatly increase the Company's visibility and name recognition. The Company believes significant opportunities exist to expand into additional tourist areas with high levels of foot traffic.

Regional Malls

There are approximately 1,100 regional malls in the United States, and as of February 28, 2006, there were Rocky Mountain Chocolate Factory stores in approximately 80 of these malls, including locations in the Mall of America in Bloomington, Minnesota; Escondido, California; Fort Collins, Colorado; and West Palm Beach, Florida. Although often providing favorable levels of foot traffic, regional malls typically involve more expensive rent structures and competing food and beverage concepts. The Company's new store concept is designed to unlock the potential of the regional mall environment.

The Company believes there are a number of other environments that have the characteristics necessary for the successful operation of Rocky Mountain Chocolate Factory stores such as airports and sports arenas. Six franchised Rocky Mountain Chocolate Factory stores exist at airport locations: two at Denver International Airport, one at Charlotte International Airport, one at Minneapolis International Airport, one at Salt Lake City International Airport and one at Vancouver International Airport in Canada.

Franchising Program

General

The Company's franchising philosophy is one of service and commitment to its franchise system, and the Company continuously seeks to improve its franchise support services. The Company's concept has consistently been rated as an outstanding franchise opportunity by publications and organizations rating such opportunities. In February 2006, Rocky Mountain Chocolate Factory was rated the number one franchise opportunity in the candy category by Entrepreneur Magazine. As of March 31, 2006, there were 301 franchised stores in the Rocky Mountain Chocolate Factory system.

Franchisee Sourcing and Selection

The majority of new franchises are awarded to persons referred by existing franchisees, to interested consumers who have visited Rocky Mountain Chocolate Factory stores and to existing franchisees. The Company also advertises for new franchisees in national and regional newspapers as suitable potential store locations come to the Company's attention. Franchisees are approved by the Company on the basis of the applicant's net worth and liquidity, together with an assessment of work ethic and personality compatibility with the Company's operating philosophy.

In fiscal 1992, the Company entered into a franchise development agreement covering Canada with Immaculate Confections, Ltd. of Vancouver, British Columbia. Pursuant to this agreement, Immaculate Confections purchased the exclusive right to franchise and operate Rocky Mountain Chocolate Factory stores in Canada. Immaculate Confections, as of March 31, 2006, operated 33 stores under the agreement.

In fiscal 2000, the Company entered into a franchise development agreement covering the Gulf Cooperation Council States of United Arab Emirates, Qatar, Bahrain, Saudi Arabia, Kuwait and Oman with Al Muhairy Group of United Arab Emirates. Pursuant to this agreement, Al Muhairy Group purchased the exclusive right to franchise and operate Rocky Mountain Chocolate Factory stores in the Gulf Cooperation Council States. Al Muhairy Group, as of March 31, 2006, operated 3 stores under this agreement.

Training and Support

Each domestic franchisee owner/operator and each store manager for a domestic franchisee is required to complete a 7-day comprehensive training program in store operations and management. The Company has established a training center at its Durango headquarters in the form of a full-sized replica of a properly configured and merchandised Rocky Mountain Chocolate Factory store. Topics covered in the training course include the Company's philosophy of store operation and management, customer service, merchandising, pricing, cooking, inventory and cost control, quality standards, record keeping, labor scheduling and personnel management. Training is based on standard operating policies and procedures contained in an operations manual provided to all franchisees, which the franchisee is required to follow by terms of the franchise agreement. Additionally, and importantly, trainees are provided with a complete orientation to Company operations by working in key factory operational areas and by meeting with members of the senior management of the Company.

The Company's operating objectives include providing Company knowledge and expertise in merchandising, marketing and customer service to all front-line store level employees to maximize their skills and ensure that they are fully versed in the Company's proven techniques.

The Company provides ongoing support to franchisees through its field consultants, who maintain regular and frequent communication with the stores by phone and by site visits. The field consultants also review and discuss with the franchisee store operating results and provide advice and guidance in improving store profitability and in developing and executing store marketing and merchandising programs. The Company has developed a handbook containing a pre-packaged local store marketing plan, which allows franchisees to implement cost-effective promotional programs that have proven successful in other Rocky Mountain Chocolate Factory stores.

Quality Standards and Control

The franchise agreement for Rocky Mountain Chocolate Factory franchisees requires compliance with the Company's procedures of operation and food quality specifications and permits audits and inspections by the Company.

Operating standards for Rocky Mountain Chocolate Factory stores are set forth in operating manuals. These manuals cover general operations, factory ordering, merchandising, advertising and accounting procedures. Through their regular visits to franchised stores, Company field consultants audit performance and adherence to Company standards. The Company has the right to terminate any franchise agreement for non-compliance with the Company's operating standards. Products sold at the stores and ingredients used in the preparation of products approved for on-site preparation must be purchased from the Company or from approved suppliers.

The Franchise Agreement: Terms and Conditions

The domestic offer and sale of Rocky Mountain Chocolate Factory franchises is made pursuant to the Uniform Franchise Offering Circular prepared in accordance with federal and state laws and regulations. States that regulate the sale and operation of franchises require a franchiser to register or file certain notices with the state authorities prior to offering and selling franchises in those states.

Under the current form of domestic Rocky Mountain Chocolate Factory franchise agreement, franchisees pay the Company (i) an initial franchise fee for each store, (ii) royalties based on monthly gross sales, and (iii) a marketing fee based on monthly gross sales. Franchisees are generally granted exclusive territory with respect to the operation of Rocky Mountain Chocolate Factory stores only in the immediate vicinity of their stores. Chocolate products not made on the premises by franchisees must be purchased from the Company or approved suppliers. The franchise agreements require franchisees to comply with the Company's procedures of operation and food quality specifications, to permit inspections and audits by the Company and to remodel stores to conform with standards in effect. The Company may terminate the franchise agreement upon the failure of the franchisee to comply with the conditions of the agreement and upon the occurrence of certain events, such as insolvency or bankruptcy of the franchisee or the commission by the franchisee of any unlawful or deceptive practice, which in the judgment of the Company is likely to adversely affect the Rocky Mountain Chocolate Factory system. The Company's ability to terminate franchise agreements pursuant to such provisions is subject to applicable bankruptcy and state laws and regulations. See Business Regulation.

The agreements prohibit the transfer or assignment of any interest in a franchise without the prior written consent of the Company. The agreements also give the Company a right of first refusal to purchase any interest in a franchise if a proposed transfer would result in a change of control of that franchise. The refusal right, if exercised, would allow the Company to purchase the interest proposed to be transferred under the same terms and conditions and for the same price as offered by the proposed transferee.

The term of each Rocky Mountain Chocolate Factory franchise agreement is ten years, and franchisees have the right to renew for one additional ten-year term.

Franchise Financing

The Company does not provide prospective franchisees with financing for their stores, but has developed relationships with several sources of franchisee financing to whom it will refer franchisees. Typically, franchisees have obtained their own sources of such financing and have not required the Company's assistance.

Company Store Program

As of March 31 2006, there were 9 Company-owned Rocky Mountain Chocolate Factory stores. Company-owned stores provide a training ground for Company-owned store personnel and district managers and a controllable testing ground for new products and promotions, operating and training methods and merchandising techniques. Managers of Company-owned stores are required to comply with all Company operating standards and undergo training and receive support from the Company similar to the training and support provided to franchisees. See Franchising Program-Training and Support and Franchising Program-Quality Standards and Control.

Manufacturing Operations

General

The Company manufactures its chocolate candies at its factory in Durango, Colorado. All products are produced consistent with the Company's philosophy of using only the finest, highest quality ingredients with no artificial preservatives to achieve its marketing motto of *the Peak of Perfection in Handmade Chocolate*®.

It has always been the belief of management that the Company should control the manufacturing of its own chocolate products. By controlling manufacturing, the Company can better maintain its high product quality standards, offer unique, proprietary products, manage costs, control production and shipment schedules and potentially pursue new or under-utilized distribution channels.

Manufacturing Processes

The manufacturing process primarily involves cooking or preparing candy centers, including nuts, caramel, peanut butter, creams and jellies, and then coating them with chocolate or other toppings. All of these processes are conducted in carefully controlled temperature ranges, and the Company employs strict quality control procedures at every stage of the manufacturing process. The Company uses a combination of manual and automated processes at its factory. Although the Company believes that it is currently preferable to perform certain manufacturing processes, such as dipping of some large pieces, by hand, automation increases the speed and efficiency of the manufacturing process. The Company has from time to time automated processes formerly performed by hand where it has become cost-effective for the Company to do so without compromising product quality or appearance.

The Company seeks to ensure the freshness of products sold in Rocky Mountain Chocolate Factory stores with frequent shipments. Most Rocky Mountain Chocolate Factory stores do not have significant space for the storage of inventory, and the Company encourages franchisees and store managers to order only the quantities that they can reasonably expect to sell within approximately two to four weeks. For these reasons, the Company generally does not have a significant backlog of orders.

Ingredients

The principal ingredients used by the Company are chocolate, nuts, sugar, corn syrup, cream and butter. The factory receives shipments of ingredients daily. To ensure the consistency of its products, the Company buys ingredients from a limited number of reliable suppliers. In order to assure a continuous supply of chocolate and certain nuts, the Company frequently enters into purchase contracts of between six to eighteen months for these products. 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. The Company has one or more alternative sources for all essential ingredients and therefore believes that the loss of any supplier would not have a material adverse effect on the Company and its results of operations. The Company currently also purchases small amounts of finished candy from third parties on a private label basis for sale in Rocky Mountain Chocolate Factory stores.

Trucking Operations

The Company operates eight trucks and ships a substantial portion of its products from the factory on its own fleet. The Company's trucking operations enable it to deliver its products to the stores quickly and cost-effectively. In addition, the Company back-hauls its own ingredients and supplies, as well as product from third parties, on return trips as a basis for increasing trucking program economics.

Marketing

The Company relies primarily on in-store promotion and point-of-purchase materials to promote the sale of its products. The monthly marketing fees collected from franchisees are used by the Company to develop new packaging and in-store promotion and point-of-purchase materials, and to create and update the Company's local store marketing handbooks.

The Company focuses on local store marketing efforts by providing customizable marketing materials, including advertisements, coupons, flyers and mail order catalogs generated by its in-house Creative Services department. The department works directly with franchisees to implement local store marketing programs.

The Company aggressively seeks low cost, high return publicity opportunities through participation in local and regional events, sponsorships and charitable causes. The Company has not historically and does not intend to engage in national advertising in the near future.

Competition

The retailing of confectionery products is highly competitive. The Company and its franchisees compete with numerous businesses that offer confectionery products. Many of these competitors have greater name recognition and financial, marketing and other resources than the Company. In addition, there is intense competition among retailers for real estate sites, store personnel and qualified franchisees. Competitive market conditions could adversely affect the Company and its results of operations and its ability to expand successfully.

The Company believes that its principal competitive strengths lie in its name recognition and its reputation for the quality, value, variety and taste of its products and the special ambiance of its stores; its knowledge and experience in applying criteria for selection of new store locations; its expertise in merchandising and marketing of chocolate and other candy products; and the control and training infrastructures it has implemented to assure execution of successful practices and techniques at its store locations. In addition, by controlling the manufacturing of its own chocolate products, the Company can better maintain its high product quality standards for those products, offer proprietary products, manage costs, control production and shipment schedules and pursue new or under-utilized distribution channels.

Trade Name and Trademarks

The trade name *Rocky Mountain Chocolate Factory*, the phrases, *The Peak of Perfection in Handmade Chocolates*, *America's Chocolatier*, *The World's Chocolatier* as well as all other trademarks, service marks, symbols, slogans, emblems, logos and designs used in the Rocky Mountain Chocolate Factory system, are proprietary rights of the Company. All of the foregoing are believed to be of material importance to the Company's business. The registration for the trademark *Rocky Mountain Chocolate Factory* has been granted in the United States and Canada. Applications have been filed to register the Rocky Mountain Chocolate Factory trademark and/or obtained in certain foreign countries.

The Company has not attempted to obtain patent protection for the proprietary recipes developed by the Company's master candy-maker and is relying upon its ability to maintain the confidentiality of those recipes.

Employees

At February 28, 2006, the Company employed approximately 235 people. Most employees, with the exception of store, factory and corporate management, are paid on an hourly basis. The Company also employs some people on a temporary basis during peak periods of store and factory operations. The Company seeks to assure that participatory management processes, mutual respect and professionalism and high performance expectations for the employee exist throughout the organization.

The Company believes that it provides working conditions, wages and benefits that compare favorably with those of its competitors. The Company's employees are not covered by a collective bargaining agreement. The Company considers its employee relations to be good.

Executive Officers

The executive officers of the Company and their ages at April 28, 2006 are as follows:

| Name | Age | Position |
|-------------------|------------|--|
| Franklin E. Crail | 64 | Chairman of the Board, President and Director |
| Bryan J. Merryman | 45 | Chief Operating Officer, Chief Financial Officer, Treasurer and Director |
| Gregory L. Pope | 39 | Sr. Vice President Franchise Development and Operations |
| Edward L. Dudley | 42 | Sr. Vice President Sales and Marketing |
| William K. Jobson | 50 | Chief Information Officer |
| Jay B. Haws | 56 | Vice President Creative Services |
| Virginia M. Perez | 68 | Corporate Secretary |

Mr. Crail co-founded the first Rocky Mountain Chocolate Factory store in May 1981. Since the incorporation of the Company in November 1982, he has served as its President and a Director. He was elected Chairman of the Board in March 1986. Prior to founding the Company, Mr. Crail was co-founder and president of CNI Data Processing, Inc., a software firm which developed automated billing systems for the cable television industry.

Mr. Merryman joined the Company in December 1997 as Vice President Finance and Chief Financial Officer. Since April 1999 Mr. Merryman has also served the Company as the Chief Operating Officer and as a Director, and since January 2000 as its Treasurer. Prior to joining the Company, Mr. Merryman was a principal in Knightsbridge Holdings, Inc. (a leveraged buyout firm) from January 1997 to December 1997. Mr. Merryman also served as Chief Financial Officer of Super Shops, Inc., a retailer and manufacturer of aftermarket auto parts from July 1996 to November 1997 and was employed for more than eleven years by Deloitte and Touche LLP, most recently as a senior manager.

Mr. Pope became Sr. Vice President of Franchise Development and Operations in May 2004. Since joining the Company in October 1990, he has served in various positions including store manager, new store opener and franchise field consultant. In March 1996 he became Director of Franchise Development and Support. In June 2001 he became Vice President of Franchise Development, a position he held until he was promoted to his present position.

Mr. Dudley joined the Company in January 1997 to spearhead the Company's newly formed Product Sales Development function as Vice President Sales and Marketing, with the goal of increasing the Company's factory and retail sales. He was promoted to Senior Vice President in June 2001. During his 10 year career with Baxter Healthcare Corporation, Mr. Dudley served in a number of senior marketing and sales management capacities, including most recently that of Director, Distribution Services from March 1996 to January 1997.

Mr. Jobson joined the Company in July 1998 as Director of Information Technology. In June 2001, he was promoted to Chief Information Officer, a position created to enhance the Company's strategic focus on information and information technology. From July 1995 to July 1998, Mr. Jobson worked for ADAC Laboratories in Durango, Colorado, a leading provider of diagnostic imaging and information systems solutions in the healthcare industry, as Manager of Technical Services and before that, Regional Manager.

Mr. Haws joined the Company in August 1991 as Vice President of Creative Services. Since 1981, Mr. Haws had been closely associated with the Company both as a franchisee and marketing/graphic design consultant. From 1986 to 1991 he operated two Rocky Mountain Chocolate Factory franchises located in San Francisco, California. From 1983 to 1989 he served as Vice President of Marketing for Image Group, Inc., a marketing communications firm based in Northern California. Concurrently, Mr. Haws was co-owner of two other Rocky Mountain Chocolate Factory franchises located in Sacramento, and Walnut Creek California. From 1973 to 1983 he was principal of Jay Haws and Associates, an advertising and graphic design agency.

Ms. Perez joined the Company in June 1996 and has served as the Company's corporate secretary since February, 1997. From 1992 until joining the Company, she was employed by Huettig & Schromm, Inc., a property management and development firm in Palo Alto, California as executive assistant to the president and owner. Huettig & Schromm developed, owned and managed over 1,000,000 square feet of office space in business parks and office buildings on the San Francisco peninsula. Ms. Perez is a paralegal and has held various administrative positions during her career

including executive assistant to the Chairman and owner of Sunset Magazine & Books, Inc.

Seasonal Factors

The Company's sales and earnings are seasonal, with significantly higher sales and earnings occurring during the Christmas holiday and summer vacation seasons than at other times of the year, which causes fluctuations in the Company's quarterly results of operations. In addition, quarterly results have been, and in the future are likely to be, affected by the timing of new store openings and the sale 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 the results that may be achieved in other quarters or for a full fiscal year.

Regulation

Each of the Company-owned and franchised stores is subject to licensing and regulation by the health, sanitation, safety, building and fire agencies in the state or municipality where located. Difficulties or failures in obtaining the required licensing or approvals could delay or prevent the opening of new stores. New stores must also comply with landlord and developer criteria.

Many states have laws regulating franchise operations, including registration and disclosure requirements in the offer and sale of franchises. The Company is also subject to the Federal Trade Commission regulations relating to disclosure requirements in the sale of franchises and ongoing disclosure obligations.

Additionally, certain states have enacted and others may enact laws and regulations governing the termination or non-renewal of franchises and other aspects of the franchise relationship that are intended to protect franchisees. Although these laws and regulations, and related court decisions, may limit the Company's ability to terminate franchises and alter franchise agreements, the Company does not believe that such laws or decisions will have a material adverse effect on its franchise operations. However, the laws applicable to franchise operations and relationships continue to develop, and the Company is unable to predict the effect on its intended operations of additional requirements or restrictions that may be enacted or of court decisions that may be adverse to franchisers. Federal and state environmental regulations have not had a material impact on the Company's operations but more stringent and varied requirements of local governmental bodies with respect to zoning, land use and environmental factors could delay construction of new stores.

Companies engaged in the manufacturing, packaging and distribution of food products are subject to extensive regulation by various governmental agencies. A finding of a failure to comply with one or more regulations could result in the imposition of sanctions, including the closing of all or a portion of the Company's facilities for an indeterminate period of time. The Company's product labeling is subject to and complies with the Nutrition Labeling and Education Act of 1990 and the Food Allergen Labeling and Consumer Protection Act of 2004.

The Company provides a limited amount of trucking services to third parties, to fill available space on the Company's trucks. The Company's trucking operations are subject to various federal and state regulations, including regulations of the Federal Highway Administration and other federal and state agencies applicable to motor carriers, safety requirements of the Department of Transportation relating to interstate transportation and federal, state and Canadian provincial regulations governing matters such as vehicle weight and dimensions.

The Company believes it is operating in substantial compliance with all applicable laws and regulations.

The Internet address of the Company's website is www.rmcf.com.

The Company makes available free of charge, through the Company's Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange act, as soon as reasonably practicable after we file such material with, or furnish it to, the Securities and Exchange Commission (the "SEC").

Item 1A. Risk Factors

Ingredients Subject to the Price Fluctuations

Several of the principal ingredients used in our products, including chocolate and nuts, are subject to significant price fluctuations. Although cocoa beans, the primary raw material used in the production of chocolate, are grown commercially in Africa, Brazil and several other countries around the world, cocoa beans are traded in the commodities market, and their supply and price are therefore subject to volatility. We believe our principal chocolate supplier purchases most of its beans at negotiated prices from African growers, often at a premium to commodity prices. Although the price of chocolate has been relatively stable in recent years, the supply and price of cocoa beans, and in turn of chocolate, are affected by many factors, including monetary fluctuations and economic, political and weather conditions in countries in which cocoa beans are grown. We purchase most of our nut meats from domestic suppliers who procure their products from growers around the world. The price and supply of nuts are also affected by many factors, including weather conditions in the various regions in which the nuts we use are grown. Although we often enter into purchase contracts for these products, significant or prolonged increases in the prices of chocolate or of one or more types of nuts, or the unavailability of adequate supplies of chocolate or nuts of the quality sought by us, could have a material adverse effect on us and our results of operations.

Suitable Sites for Franchised Stores at Reasonable Occupancy Costs

Our expansion plans are critically dependent on our ability to obtain suitable sites at reasonable occupancy costs for our franchised stores and kiosks in the regional mall environment. There is no assurance that we will be able to obtain suitable locations for our franchised stores and kiosks in this environment at a cost that will allow such stores to be economically viable.

Growth Dependent Upon Attracting and Retaining Qualified Franchisees

Our continued growth and success is dependent in part upon our ability to attract, retain and contract with qualified franchisees and the ability of those franchisees to operate their stores successfully and to promote and develop the Rocky Mountain Chocolate Factory store concept and our reputation for an enjoyable in-store experience and product quality. Although we have established criteria to evaluate prospective franchisees and have been successful in attracting franchisees, there can be no assurance that franchisees will be able to operate successfully Rocky Mountain Chocolate Factory stores in their franchise areas in a manner consistent with our concepts and standards.

Federal, State and Local Regulation

We are subject to regulation by the Federal Trade Commission and must comply with certain state laws governing the offer, sale and termination of franchises and the refusal to renew franchises. Many state laws also regulate substantive aspects of the franchisor-franchisee relationship by, for example, requiring the franchisor to deal with its franchisees in good faith, prohibiting interference with the right of free association among franchisees and regulating discrimination among franchisees in charges, royalties or fees. Franchise laws continue to develop and change, and changes in such laws could impose additional costs and burdens on franchisors. Our failure to obtain approvals to sell franchises and the adoption of new franchise laws, or changes in existing laws, could have a material adverse effect on us and our results of operations.

Each of our Company-owned and franchised stores is subject to licensing and regulation by the health, sanitation, safety, building and fire agencies in the state or municipality where located. Difficulties or failures in obtaining required licenses or approvals from such agencies could delay or prevent the opening of a new store. We and our franchisees are also subject to laws governing our relationships with employees, including minimum wage requirements, overtime, working and safety conditions and citizenship requirements. Because a significant number of our employees are paid at rates related to the federal minimum wage, increases in the minimum wage would increase our labor costs. The failure to obtain required licenses or approvals, or an increase in the minimum wage rate, employee benefits costs (including costs associated with mandated health insurance coverage) or other costs associated with employees, could have a material adverse effect on us and our results of operations.

Companies engaged in the manufacturing, packaging and distribution of food products are subject to extensive regulation by various governmental agencies. A finding of a failure to comply with one or more regulations could result in the imposition of sanctions, including the closing of all or a portion of our facilities for an indeterminate period of time, and could have a material adverse effect on us and our results of operations.

Competition

The retailing of confectionery products is highly competitive. We and our franchisees compete with numerous businesses that offer confectionery products. Many of these competitors have greater name recognition and financial, marketing and other resources than we do. In addition, there is intense competition among retailers for real estate sites, store personnel and qualified franchisees. Competitive market conditions could have a material adverse effect on us and our results of operations and our ability to expand successfully.

Consumer Tastes and Trends

The sale of our products is affected by changes in consumer tastes and eating habits, including views regarding consumption of chocolate. Numerous other factors that we cannot control, such as economic conditions, demographic trends, traffic patterns and weather conditions, influence the sale of our products. Changes in any of these factors could have a material adverse effect on us and our results of operations.

Company Manufactured Products

We believe that approximately 50% of franchised stores' revenues are generated by sales of products manufactured by and purchased from us, 40% by sales of products made in the stores with ingredients purchased from us or approved suppliers and 10% by sales of products purchased from approved suppliers for resale in the stores. Franchisees' sales of products manufactured by us generate higher revenues to us than sales of store-made or other products. A significant decrease in the amount of products franchisees purchase from us, therefore, could adversely affect our total revenues and results of operations. Such a decrease could result from franchisees' decisions to sell more store-made products or products purchased from third party suppliers.

Inflation Costs of Ingredients and Labor

Inflationary factors such as increases in the costs of ingredients, energy 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 reflect potentially escalating costs of real estate and construction. There is no assurance that we will be able to pass on our increased costs to our customers.

Seasonality of Sales

Our sales and earnings are seasonal, with significantly higher sales and earnings occurring during the Christmas and summer vacation seasons than at other times of the year, which causes fluctuations in our quarterly results of operations. In addition, quarterly results have been, and in the future are likely to be, affected by the timing of new store openings and the sale 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 the results that may be achieved in other quarters or for a full fiscal year. See Management's Discussion and Analysis of Financial Condition and Results of Operations

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company's manufacturing operations and corporate headquarters are located at its 53,000 square foot manufacturing facility, which it owns, in Durango, Colorado. During fiscal 2006, the Company's factory produced approximately 2.5 million pounds of chocolate candies, an increase of 11.0% from the approximately 2.2 million pounds produced in fiscal 2005. The factory has the capacity to produce approximately 3.5 million pounds per year. In January 1998, the Company acquired a two-acre parcel adjacent to its factory to ensure the availability of adequate space to expand the factory as volume demands.

As of March 31, 2006, all of the 9 Company-owned stores were occupied pursuant to non-cancelable leases of five to ten years having varying expiration dates from August 2006 to January 2011, some of which contain optional five-year renewal rights. The Company does not deem any individual store lease to be significant in relation to its overall operations.

The Company acts as primary lessee of some franchised store premises, which it then subleases to franchisees, but the majority of existing locations, are leased by the franchisee directly. Current Company policy is not to act as primary lessee on any further franchised locations. At March 31, 2006, the Company was the primary lessee at 5 of its 301 franchised stores. The subleases for such stores are on the same terms as the Company's leases of the premises. For information as to the amount of the Company's rental obligations under leases on both Company-owned and franchised stores, see Note 5 of Notes to financial statements.

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

Part II.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

The Company's Common Stock trades on the National Market System of The Nasdaq Stock Market under the trading symbol RMCF. On May 18, 2005 the Board of Directors approved a four-for-three stock split payable on June 13, 2005 to shareholders of record as of May 31, 2005. On February 15, 2005 the Board of Directors declared a 5% stock dividend payable on March 10, 2005 to shareholders of record as of February 28, 2005. On May 4, 2004 the Board of Directors declared a 10 percent stock dividend payable on May 27, 2004 to shareholders of record as of May 13, 2004. On December 17, 2003 the Board of Directors declared a three-for-two stock split payable on February 2, 2004 to shareholders of record on January 20, 2004. On February 22, 2006, the Board of Directors declared a fourth quarter cash dividend of \$0.08 cents per common share outstanding. The cash dividend was paid March 16, 2006 to shareholders of record as of March 8, 2006.

The Company declared these stock dividends and these stock splits because the Company felt that its Common Stock lacked sufficient shares and related liquidity to satisfy an increasing number of investors interested in purchasing the Company's Common Stock. All of the following items in Item 5. have been adjusted, where necessary, for the effects of the dividend and splits.

Between March 24, 2006 and April 28, 2006 the Company repurchased 70,713 shares at an average price of \$15.65 per share. Between October 7, 2005 and February 3, 2006 the Company repurchased 176,599 Company shares at an average price of \$15.36 per share. Between April 18 and April 20, 2005, the Company repurchased 17,647 Company 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.

The Company made these purchases because the Company felt that its Common Stock was undervalued and that such purchases would therefore be in the best interest of the Company and its stockholders.

The table below sets forth high and low price information for the Common Stock for each quarter of fiscal years 2006 and 2005, and dividend information.

| Fiscal Year Ended February 28, 2006 | HIGH | LOW | Dividends declared |
|--|-------------|------------|---------------------------|
| Fourth Quarter | 17.76 | 13.40 | .0800 |
| Third Quarter | 18.56 | 13.76 | .0700 |
| Second Quarter | 25.70 | 16.50 | .0675 |
| First Quarter | 18.75 | 12.89 | .0675 |

| Fiscal Year Ended February 28, 2005 | HIGH | LOW | Dividends declared |
|--|----------|---------|-----------------------|
| Fourth Quarter | \$ 16.50 | \$ 9.65 | \$.0675 |
| Third Quarter | 10.71 | 7.26 | .0571 |
| Second Quarter | 11.35 | 6.79 | .0429 |
| First Quarter | 7.57 | 6.10 | .0429 |

On April 28, 2006 the closing price for the Common Stock was \$15.45.

On September 27, 2005, pursuant to and as partial consideration for either the extension of that certain I Love Lucy® Merchandising License Agreement or marketing coordination of the I Love Lucy® product line, the Company issued to the persons identified below that number of shares of common stock of the Company set forth across from such person's name:

| Name | Shares |
|---|--------|
| Desilu too, LLC | 483 |
| CBS Broadcasting, Inc. | 483 |
| Bruce Bronn (designee of Unforgettable Enterprises, Inc.) | 109 |
| Mark Shactman (designee of Unforgettable Enterprises, Inc.) | 109 |
| Brian B. Eich (designee of Unforgettable Enterprises, Inc.) | 74 |
| David R. and Deborah A. McAuliffe | 584 |

All of the shares referenced in the table above were not registered under the Securities Act of 1933, as amended (the Act) when issued and constitute restricted securities as that term is defined pursuant to Rule 144 promulgated under the Act.

On March 7, 2006, pursuant to the terms of the I Love Lucy® Merchandising License Agreement, the Company issued an additional 584 shares of common stock of the Company to David R. and Deborah A. McAuliffe. Such shares were not registered under the Act and constitute restricted securities.

These unregistered securities were issued in reliance on Section 4(2) of the Act. No advertising or general solicitation was employed in the offering of the securities. The offerings and sales of the above referenced securities were made to a limited number of persons, all of whom were sophisticated investors who did not need the protections of the Act, and transfer was restricted by us in accordance with the requirements of the Act. Further each investor had access to adequate information with respect to us.

Holders

On April 13, 2006 there were approximately 409 record holders of the Company's Common Stock. The Company believes that there are more than 800 beneficial owners of its Common Stock.

Repurchases

Issuer Purchases of Equity Securities

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs ⁽¹⁾ | (d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs ⁽²⁾ |
|---------------|---|--|---|--|
| December 2005 | 38,989 | \$15.86 | 38,989 | \$2,362,938 |
| January 2006 | 61,960 | 14.95 | 61,960 | 1,436,698 |

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| | | | | |
|---------------|---------|---------|---------|-------------|
| February 2006 | 10,650 | 14.00 | 10,650 | 1,287,554 |
| Total | 111,599 | \$15.18 | 111,599 | \$1,287,554 |

(1) During the fourth quarter of Fiscal 2006 ending February 28, 2006, the Company purchased 111,599 shares in the open market.

(2) On October 5, 2005, the Company announced a plan to repurchase up to \$2,000,000 of the Company's common stock in the open market or in private transactions, whenever deemed appropriate by management. On January 5, 2006, the Company announced a plan to repurchase up to \$2,000,000 of the Company's common stock in the open market or in private transactions, whenever deemed appropriate by management. On May 4, 2006, the

Company announced a plan to repurchase up to \$2,000,000 of the Company's common stock in the open market or in private transactions, whenever deemed appropriate by management. The plans are only to expire once the designated amounts are reached. The Company intends to continue the plans until they have been fulfilled.

ITEM 6. SELECTED FINANCIAL DATA

The selected financial data presented below for the fiscal years ended February 28 or 29, 2002 through 2006, are derived from the Financial Statements of the Company, which have been audited by Ehrhardt Keefe Steiner & Hottman PC or Grant Thornton LLP, independent registered public accounting firms. The selected financial data should be read in conjunction with the Financial Statements and related Notes thereto included elsewhere in this Report and Management's Discussion and Analysis of Financial Condition and Results of Operations.

(Amounts in thousands, except per share data)

| | YEARS ENDED FEBRUARY 28 or 29, | | | | |
|---|--------------------------------|-----------|-----------|-----------|-----------|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| Selected Statement of Operations Data | | | | | |
| Total revenues | \$ 28,074 | \$ 24,524 | \$ 21,133 | \$ 19,461 | \$ 19,439 |
| Operating income | 6,459 | 5,339 | 3,779 | 1,496 | 3,370 |
| Net income | \$ 4,065 | \$ 3,317 | \$ 2,319 | \$ 852 | \$ 1,995 |
| Basic Earnings per Common Share | | | | | |
| | \$.65 | \$.55 | \$.40 | \$.15 | \$.35 |
| Diluted Earnings per Common Share | | | | | |
| | \$.61 | \$.51 | \$.37 | \$.14 | \$.33 |
| Weighted average common shares outstanding | 6,268 | 6,007 | 5,854 | 5,764 | 5,713 |
| Weighted average common shares outstanding, assuming dilution | 6,676 | 6,481 | 6,304 | 6,249 | 6,090 |
| Selected Balance Sheet Data | | | | | |
| Working capital | \$ 7,533 | \$ 8,008 | \$ 6,394 | \$ 4,765 | \$ 3,940 |
| Total assets | 19,057 | 19,248 | 17,967 | 16,084 | 16,795 |
| Long-term debt | | 1,539 | 1,986 | 3,073 | 4,325 |
| Stockholders' equity | 15,486 | 13,894 | 11,590 | 9,891 | 8,821 |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

The Company is a product-based international franchisor. 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 have traditionally been located in resort or tourist locations. As the Company expands its geographical diversity to include regional malls, it has seen some moderation to its seasonal sales mix. Seasonal fluctuation in sales causes 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 the receptivity of the Company's franchise system to its product introductions and promotional programs.

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

Critical Accounting Policies and Estimates

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosures. Estimates and assumptions include, but are not limited to, the carrying value of accounts and notes receivable from franchisees, inventories, the useful lives of fixed assets, goodwill, and other intangible assets, income taxes, contingencies and litigation. The Company bases its estimates on analyses, of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We believe that the following represent our more critical estimates and assumptions used in the preparation of our financial statements, although not all inclusive.

Accounts and Notes Receivable In the normal course of business, the Company extends credit to customers, primarily franchisees, that satisfy pre-defined credit criteria. The Company believes that it has limited concentration of credit risk primarily because its receivables are often secured by the assets of the franchisees to which the Company ordinarily extends credit, including, but not limited to, their franchise rights and inventories. An allowance for doubtful accounts is determined through analysis of the aging of accounts receivable, assessments of collectibility based on historical trends, and an evaluation of the impact of current and projected economic conditions. The process by which the Company performs its analysis is conducted on a customer by customer, or franchisee by franchisee, basis and takes into account, among other relevant factors, sales history, outstanding receivables, customer financial strength, as well as customer specific and geographic market factors relevant to projected performance. The Company monitors the collectibility of its accounts receivable on an ongoing basis by assessing the credit worthiness of its customers and evaluating the impact of reasonably likely changes in economic conditions that may impact credit risks. Estimates with regard to the collectibility of accounts receivable are reasonably likely to change in the future.

The Company recorded expense of approximately \$25,000 per year for potential uncollectible accounts over the three-year period ended February 28, 2006. Write-offs of uncollectible accounts net of recoveries averaged approximately \$33,000 over the same period. The provision for uncollectible accounts is recognized as general and administrative expense in the Statements of Income. Over the past three years, the allowances for doubtful notes and accounts have ranged from 2.6% to 3.5% of gross receivables.

Revenue Recognition The Company recognizes revenue on sales of products to franchisees and other customers at the time of shipment. Franchise fee revenue is recognized upon completion of all significant initial services provided to the franchisee and upon satisfaction of all material conditions of the franchise agreement. The initial \$5,000 portion of the fee is recognized upon signing of the franchise agreement. The balance of the fee is recognized upon the franchisee's commitment to a property lease. The Company also recognizes a royalty fee of five percent (5%) and a marketing and promotion fee of one percent (1%) of the Rocky Mountain Chocolate Factory franchised stores' gross retail sales. Sales of products at retail stores are recognized at the time of sale.

Inventories The Company's inventories are stated at the lower of cost or market value and are reduced by an allowance for slow-moving, excess, discontinued and shelf-life expired inventories. Our estimate for such allowance is based on our review of inventories on hand compared to estimated future usage and demand for our products. Such review encompasses not only potentially perishable inventories but also specialty packaging, much of it specific to certain holiday seasons. If actual future usage and demand for our products are less favorable than those projected by our review, inventory write-downs may be required. We closely monitor our inventory, both perishable and non-perishable, and related shelf and product lives. Historically we have experienced low levels of obsolete inventory or returns of products that have exceeded their shelf life. Over the three-year period ended February 28, 2006, the Company recorded expense averaging approximately \$63,000 per year for potential inventory losses, or approximately 0.5% of total cost of sales for that period.

Goodwill Goodwill consists of the excess of purchase price over the fair market value of acquired assets and liabilities. Effective March 1, 2002, under SFAS 142 all goodwill with indefinite lives is no longer subject to amortization. SFAS 142 requires that an impairment test be conducted annually or in the event of an impairment indicator. Our test conducted in fiscal 2006 showed no impairment of our goodwill.

Other accounting estimates inherent in the preparation of the Company's financial statements include estimates associated with its evaluation of the recoverability of deferred tax assets, as well as those used in the determination of liabilities related to litigation and taxation. Various assumptions and other factors underlie the determination of these significant estimates. The process of determining significant estimates is fact specific and takes into account factors such as historical experience, current and expected economic conditions, and product mix. The Company constantly re-evaluates these significant factors and makes adjustments where facts and circumstances dictate. Historically, actual results have not significantly deviated from those determined using the estimates described above.

As discussed in Note 5 to the financial statements, the Company is involved in litigation incidental to its business, the disposition of which is expected to have no material effect on the Company's financial position or results of operations. It is possible, however, that future results of operations for any particular quarterly or annual period could be materially affected by changes in the Company's assumptions related to these proceedings.

Results of Operations

Fiscal 2006 Compared To Fiscal 2005

Results Summary

Basic earnings per share increased 18.2% from \$.55 in fiscal 2005 to \$.65 in fiscal 2006. Revenues increased 14.5% from fiscal 2005 to fiscal 2006. Operating income increased 21.0% from \$5.3 million in fiscal 2005 to \$6.5 million in fiscal 2006. Net income increased 22.6% from \$3.3 million in fiscal 2005 to \$4.1 million in fiscal 2006. The increase in revenue, earnings per share, operating income, and net income in fiscal 2006 from 2005 was due primarily to increased number of franchised stores in operation, increased same store sales at franchised units and increased sales to customers outside the Company's system of franchised retail stores.

Revenues

| (\$ s in thousands) | 2006 | 2005 | Change | % Change |
|----------------------------|-------------|-------------|------------|-------------|
| Factory sales | \$ 19,297.2 | \$ 16,654.4 | \$ 2,642.8 | 15.9% |
| Retail sales | 3,046.0 | 2,726.4 | 319.6 | 11.7% |
| Royalty and marketing fees | 5,047.9 | 4,577.5 | 470.4 | 10.3% |
| Franchise fees | 682.5 | 565.3 | 117.2 | 20.7% |
| Total | \$ 28,073.6 | \$ 24,523.6 | \$ 3,550.0 | 14.5% |

Factory Sales

This increase in factory sales was due to an increase in the average number of franchised stores in operation to 285 in fiscal 2006 from 263 in fiscal 2005 and an increase in factory sales to customers outside the Company's system of franchised retail stores of 46.3% in fiscal 2006 versus a 17% increase in fiscal 2005. Same store pounds purchased by franchised stores in fiscal 2006 were approximately the same as the prior fiscal year.

Retail Sales

The increase in retail sales resulted primarily from an increase in the average number of Company-owned stores in operation from 8 in fiscal 2005 to 9 in fiscal 2006 plus an increase in same-store sales at Company-owned stores of 0.3%.

Royalties, Marketing Fees and Franchise Fees

This increase in royalties and marketing fees resulted from growth in the average number of domestic units in operation from 233 in fiscal 2005 to 251 in fiscal 2006 plus an increase in same store sales of 2.5%. Franchise fee revenues increased due to an increase in the franchise fee of approximately 25% partially offset by a decrease in the number of franchises sold during the same period last year.

Costs and Expenses

| (\$ s in thousands) | 2006 | 2005 | Change | % Change |
|----------------------------|-------------|-------------|------------|-------------|
| Cost of sales factory | \$ 12,732.3 | \$ 10,704.8 | \$ 2,027.5 | 18.9% |
| Cost of sales retail | 1,224.3 | 1,036.4 | 187.9 | 18.1% |
| Franchise costs | 1,466.3 | 1,411.9 | 54.4 | 3.9% |
| Sales and marketing | 1,321.0 | 1,294.7 | 26.3 | 2.0% |
| General and administrative | 2,239.1 | 2,497.7 | (258.6) | (10.4%) |
| Retail operating | 1,755.7 | 1,453.8 | 301.9 | 20.8% |
| Total | \$ 20,738.7 | \$ 18,399.3 | \$ 2,339.4 | 12.7% |
| Gross margin | | | | |

| (\$ s in thousands) | 2006 | 2005 | Change | % Change |
|---------------------|------------|------------|----------|-------------|
| Factory | \$ 6,564.9 | \$ 5,949.6 | \$ 615.3 | 10.3% |
| Retail | 1,821.7 | 1,690.0 | 131.7 | 7.8% |
| Total | \$ 8,386.6 | \$ 7,639.6 | \$ 747.0 | 9.8% |

(Percent)

| | | | | |
|---------|-------|-------|--------|--------|
| Factory | 34.0% | 35.7% | (1.7%) | (4.8%) |
| Retail | 59.8% | 62.0% | (2.2%) | (3.5%) |
| Total | 37.5% | 39.4% | (1.9%) | (4.8%) |

Cost of Sales

Factory margins declined 170 basis points from fiscal 2005 to fiscal 2006 due to a shift in product mix sold, increased fuel and commodity prices, and slightly lower factory efficiencies. Reduction in Company-owned store margin is due to changes in mix of product sold and increased promotional costs.

Franchise Costs

The increase in franchise costs is due to a planned increase in personnel costs and related support expenditures. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 25.6% in fiscal 2006 from 27.5% in fiscal 2005. This decrease as a percentage of royalty, marketing and franchise fees is primarily a result of higher franchise revenues relative to costs.

Sales and Marketing

The increase in sales and marketing was due primarily to increased promotional costs.

General and Administrative

The decrease in general and administrative costs is due primarily to decreased incentive compensation costs. An increase in professional fees partially offset this decrease. As a percentage of total revenues, general and administrative expenses decreased to 8.0% in fiscal 2006 compared to 10.2% in fiscal 2005. This decrease resulted from a higher increase in total revenues relative to the decrease in general and administrative costs.

Retail Operating Expenses

The increase in retail operating expenses was due primarily to an increase in the average number of Company-owned stores during fiscal 2006 versus fiscal 2005. Retail operating expenses, as a percentage of retail sales, increased from 53.3% in fiscal 2005 to 57.6% in fiscal 2006 due to a larger increase in costs relative to the increase in revenues.

Depreciation and Amortization

Depreciation and amortization of \$876,000 in fiscal 2006 increased 11.6% from the \$785,000 incurred in fiscal 2005 due primarily to increased capital expenditures related to the remodel of the Company's manufacturing and administrative facilities.

Other, Net

Other, net of \$76,000 income realized in fiscal 2006 represents an increase of \$83,000 from the \$7,000 incurred in fiscal 2005, due primarily to lower interest expense on lower average outstanding balances of long-term debt plus interest income on invested cash and lower average outstanding amounts of notes receivable.

Income Tax Expense

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

Fiscal 2005 Compared To Fiscal 2004**Results Summary**

Basic earnings per share increased 39.6% from \$.40 in fiscal 2004 to \$.55 in fiscal 2005. Revenues increased 16.0% from fiscal 2004 to fiscal 2005. Operating income increased 41.3% from \$3.8 million in fiscal 2004 to \$5.3 million in fiscal 2005. Net income increased 43.0% from \$2.3 million in fiscal 2004 to \$3.3 million in fiscal 2005. The increase in revenue, earnings per share, operating income, and net income in fiscal 2005 from 2004 was due primarily to increased number of franchised stores in operation, increased same store sales at franchised units and increased same store pounds purchased from the factory by franchised units.

Revenues

| (\$ s in thousands) | 2005 | 2004 | Change | % Change |
|----------------------------|-------------|-------------|------------|-------------|
| Factory sales | \$ 16,654.4 | \$ 14,103.4 | \$ 2,551.0 | 18.1% |
| Retail sales | 2,726.4 | 2,564.8 | 161.6 | 6.3% |
| Royalty and marketing fees | 4,577.5 | 3,875.9 | 701.6 | 18.1% |
| Franchise fees | 565.3 | 588.7 | (23.4) | (4.0%) |
| Total | \$ 24,523.6 | \$ 21,132.8 | \$ 3,390.8 | 16.0% |

Factory Sales

This increase in factory sales was due to an increase in the average number of franchised stores in operation to 263 in fiscal 2005 from 231 in fiscal 2004 as well as an increase in same store pounds purchased from the factory by franchised stores of 5.0% and an increase in factory sales to customers outside the Company's system of franchised retail stores of 17.0%.

Retail Sales

This increase in retail sales resulted primarily from an increase in same-store sales at Company-owned stores of 5.7%.

Royalties, Marketing Fees and Franchise Fees

This increase in royalties and marketing fees resulted from growth in the average number of domestic units in operation from 205 in fiscal 2004 to 233 in fiscal 2005 plus an increase in same store sales of 4.7%. Franchise fee revenues decreased due to a decrease in the number of franchises sold.

Costs and Expenses

| (\$ s in thousands) | 2005 | 2004 | Change | % Change |
|----------------------------|-------------|-------------|------------|-------------|
| Cost of sales factory | \$ 10,704.8 | \$ 9,579.9 | \$ 1,124.9 | 11.7% |
| Cost of sales retail | 1,036.4 | 955.5 | 80.9 | 8.5% |
| Franchise costs | 1,411.9 | 1,135.7 | 276.2 | 24.3% |
| Sales and marketing | 1,294.7 | 1,220.5 | 74.2 | 6.1% |
| General and administrative | 2,497.7 | 2,235.5 | 262.2 | 11.7% |
| Retail operating | 1,453.8 | 1,430.1 | 23.7 | 1.7% |
| Total | \$ 18,399.3 | \$ 16,557.2 | \$ 1,842.1 | 11.1% |

Gross margin

| (\$ s in thousands) | 2005 | 2004 | Change | % Change |
|---------------------|------------|------------|------------|-------------|
| Factory | \$ 5,949.6 | \$ 4,523.5 | \$ 1,426.1 | 31.5% |
| Retail | 1,690.0 | 1,609.3 | 80.7 | 5.0% |
| Total | \$ 7,639.6 | \$ 6,132.8 | \$ 1,506.8 | 24.6% |

(Percent)

| | | | | |
|---------|-------|-------|--------|--------|
| Factory | 35.7% | 32.1% | 3.6% | 11.2% |
| Retail | 62.0% | 62.7% | (0.7%) | (1.1%) |
| Total | 39.4% | 36.8% | 2.6% | 7.1% |

Cost of Sales

Factory margins increased to 35.7% in fiscal 2005 from 32.1% in fiscal 2004. This improvement in factory margins is due primarily to increased production efficiencies related to higher production volume. The decline in Company-owned store margin is due to increased operating expenses partially offset by changes in mix of products sold.

Franchise Costs

The increase in franchise costs is due to a planned increase in personnel costs and related support expenditures as well as costs incurred related to the Company's bi-annual franchisee convention. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs increased to 27.5% in fiscal 2005 from 25.4% in fiscal 2004. This increase as a percentage of royalty, marketing and franchise fees is primarily a result of higher franchise costs relative to revenues.

Sales & Marketing

The increase in sales and marketing costs was due primarily to a planned increase in personal costs of 17.8% related to the Company's ongoing customer service efforts and franchise support.

General and Administrative

The increase in general and administrative costs was due primarily to increased personnel costs, incentive compensation costs and professional fees. Personnel costs increased and are related to both annual increases as well as the Company's continued commitment to utilize and expand its information technology capabilities. Incentive compensation costs are linked to the Company's net income performance and increased 44.1%. The 18.1% increase in professional fees was due to the rising costs of being a public company as a result of the Sarbanes-Oxley Act of 2002, and the rules and regulations promulgated thereunder. The Company expects that future costs of incentive compensation will continue to be linked to the Company's performance. The Company also expects that costs of being a public company will continue to increase. As a percentage of total revenues, general and administrative expense decreased to 10.2% in fiscal 2005 from 10.6% in fiscal 2004.

Retail Operating Expenses

This increase was due primarily to a 5.8% increase in compensation expense during fiscal 2005 versus fiscal 2004 and is related to both expected wage increases as well as sales and customer volume. Retail operating expenses, as a percentage of retail sales, decreased from 55.8% in fiscal 2004 to 53.3% in fiscal 2005 due to a higher increase in revenue relative to the increase in costs. The Company expects that retail operating expenses in the future will continue to fluctuate depending on the success of retail environments in which stores operate and fluctuations in sales and customer volume.

Depreciation and Amortization

Depreciation and amortization of \$785,000 in fiscal 2005 approximated the \$796,000 incurred in fiscal 2004. The Company expects this expense to increase in fiscal 2006 due to some remodeling in progress and planned capital expenditures.

Other Expense, Net

Other expense, net of \$7,000 incurred in fiscal 2005 decreased 86.2% from the \$51,000 incurred in fiscal 2004 due primarily to lower interest expense on lower average rates and outstanding amounts of both short-term and long-term debt.

Income Tax Expense

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

Liquidity and Capital Resources

As of February 28, 2006, working capital was \$7.5 million compared with \$8.0 million as of February 28, 2005, a \$0.5 million decrease. The decrease in working capital was due primarily to the payment of \$1.7 million in cash dividends, the repurchase and retirement of \$3.0 million of the Company's common stock, the expenditure of approximately \$1.3 million for capital assets and payment of \$1.7 million to extinguish 100% of the Company's long-term debt.

Cash and cash equivalent balances decreased from \$4.4 million as of February 28, 2005 to \$3.5 million as of February 28, 2006 as a result of cash flows generated by operating activities being less than cash flows used in financing and investing activities. The Company's current ratio was 3.59 to 1 at February 28, 2006 in comparison with 3.57 to 1 at February 28, 2005. The Company monitors current and anticipated future levels of cash and cash equivalents in relation to anticipated operating, financing and investing requirements.

The Company has a \$5.0 million credit line, of which \$5.0 million was available (subject to certain borrowing base limitations) as of February 28, 2006, secured by substantially all of the Company's assets except retail store assets. The credit line is subject to renewal in July, 2006.

The table below presents significant contractual obligations of the Company at February 28, 2006.

| (Amounts in thousands) | Less than | | | After 5 years | Total |
|------------------------------------|-----------|-----------|-----------|---------------|-------|
| | 1 year | 1-3 Years | 4-5 years | | |
| Contractual Obligations | | | | | |
| Line of credit | | | | | |
| Notes payable | | | | | |
| Operating leases | 467 | 709 | 226 | | 1,402 |
| Other long-term obligations | 108 | 72 | | | 180 |
| Total Contractual cash obligations | 575 | 781 | 226 | | 1,582 |

For fiscal 2007, the Company anticipates making capital expenditures of approximately \$750,000, which will be used to maintain and improve existing factory and administrative infrastructure and update certain Company-owned stores. The Company believes that cash flow from operations will be sufficient to fund capital expenditures and working capital requirements for fiscal 2007. If necessary, the Company has available bank lines of credit to help meet these requirements.

Impact of Inflation

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

Depreciation expense is based on the historical cost to the Company of its fixed assets, and is therefore potentially less than it would be if it were based on current replacement cost. While property and equipment acquired in prior years

will ultimately have to be replaced at higher prices, it is expected that replacement will be a gradual process over many years.

Seasonality

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

New Accounting Pronouncements

In March 2005, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143* (FIN 47), which clarifies the impact that uncertainty surrounding the timing or method of settling an obligation should have on accounting for that obligation under SFAS No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143). FIN 47 is effective no later than the end of the fiscal year ending after December 15, 2005, or December 31, 2005 for calendar year companies. The Company adopted this standard as of February 28, 2006. The adoption of this statement had no impact on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* (SFAS 154). SFAS 154 replaces Accounting Principles Board Opinion No. 20 (APB 20), *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, APB 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods' financial statements of direct effects of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 carries forward without change the guidance for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted this standard as of March 1, 2006. The adoption of this statement had no impact on the Company's financial statements.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), *Share-Based Payment* (SFAS No. 123R) which replaces SFAS No. 123, supersedes Accounting Principles Board (APB) No. 25 and related interpretations and amends SFAS No. 95, *Statement of Cash Flows*. The provisions of SFAS No. 123R are similar to those of SFAS No. 123; however, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statement as compensation cost based on their fair value on the date of the grant. The fair value of the share-based awards will be determined using an option-pricing model on the grant date. SFAS No. 123R is effective at the beginning of the first fiscal year beginning after June 15, 2005. The Company adopted SFAS No. 123R effective March 1, 2006.

Through fiscal 2006, the Company accounted for stock-based employee compensation under the recognition and measurement principles of APB Opinion No. 25. In accordance with that standard, no stock-based employee compensation cost for stock options has been reflected in the statements of income except in fiscal 2006 upon acceleration of options. In accordance with the provisions of the original SFAS No. 123, the Company has disclosed, on a pro forma basis, the effect on net income had the Company applied the provisions of that statement to stock-based employee compensation.

SFAS No. 123R requires the Company to recognize stock option expense in the statements of income beginning in the first quarter of fiscal 2007 and to estimate the effect of stock option forfeitures. Through fiscal 2006, as permitted by the original SFAS No. 123, the Company has accounted for forfeitures as they occur. In addition, SFAS 123R amends FASB Statement No. 95, *Statements of Cash Flows*, to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

As of the beginning of the first quarter in fiscal 2007 (the required effective date), the Company will apply the provisions of SFAS 123R to new stock awards and to awards modified, repurchased or canceled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the service is rendered on or after that date. The compensation cost for that portion of awards will be based on the fair value of those awards as calculated for pro forma disclosure purposes under the original SFAS No. 123.

The Company estimates that stock option expense in fiscal 2007 will be approximately \$30,000 to \$60,000 post-tax. The actual amount of stock option expense may vary materially from this estimate, due to certain factors, including number of options that will actually be issued, the timing of option grants, and the market price of our stock on the date of grant.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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

The Company has a \$5.0 million bank line of credit that bears interest at a variable rate. As of February 28, 2006, 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 has primary responsibility over the Company's long-term and short-term debt and has primary responsibility for determining the timing and duration of commodity purchase contracts and negotiating the terms and conditions of those contracts.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Rocky Mountain Chocolate Factory, Inc.

Durango, Colorado

We have audited the accompanying balance sheets of Rocky Mountain Chocolate Factory, Inc. (the Company) as of February 28, 2006 and 2005, and the related statements of income, changes in stockholders' equity and cash flows for the years ended February 28 (29), 2006, 2005 and 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Rocky Mountain Chocolate Factory, Inc. as of February 28, 2006 and 2005, and the results of their operations and their cash flows for each of the years ended February 28 (29), 2006, 2005 and 2004, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of February 28, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated April 28, 2006 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

Ehrhardt Keefe Steiner & Hottman PC

April 28, 2006

Denver, Colorado

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF INCOME

| | FOR THE YEARS ENDED FEBRUARY 28 or | | |
|--|------------------------------------|---------------|---------------|
| | 29, | | |
| | 2006 | 2005 | 2004 |
| Revenues | | | |
| Sales | \$ 22,343,209 | \$ 19,380,861 | \$ 16,668,210 |
| Franchise and royalty fees | 5,730,403 | 5,142,758 | 4,464,618 |
| Total revenues | 28,073,612 | 24,523,619 | 21,132,828 |
| Costs and Expenses | | | |
| Cost of sales | 13,956,550 | 11,741,205 | 10,535,352 |
| Franchise costs | 1,466,322 | 1,411,901 | 1,135,686 |
| Sales & marketing | 1,320,979 | 1,294,702 | 1,220,585 |
| General and administrative | 2,239,109 | 2,497,718 | 2,235,499 |
| Retail operating | 1,755,738 | 1,453,740 | 1,430,124 |
| Depreciation and amortization | 875,940 | 785,083 | 796,271 |
| Total costs and expenses | 21,614,638 | 19,184,349 | 17,353,517 |
| Operating Income | 6,458,974 | 5,339,270 | 3,779,311 |
| Other Income (Expense) | | | |
| Interest expense | (19,652) | (99,988) | (144,787) |
| Interest income | 95,360 | 92,938 | 93,847 |
| Other, net | 75,708 | (7,050) | (50,940) |
| Income Before Income Taxes | 6,534,682 | 5,332,220 | 3,728,371 |
| Income Tax Expense | 2,470,110 | 2,015,580 | 1,409,325 |
| Net Income | \$ 4,064,572 | \$ 3,316,640 | \$ 2,319,046 |
| Basic Earnings per Common Share | \$.65 | \$.55 | \$.40 |
| Diluted Earnings per Common Share | \$.61 | \$.51 | \$.37 |
| Weighted Average Common Shares Outstanding | 6,268,202 | 6,006,883 | 5,854,060 |
| Dilutive Effect of Employee Stock Options | 407,411 | 474,499 | 449,720 |
| Weighted Average Common Shares Outstanding, Assuming Dilution | 6,675,613 | 6,481,382 | 6,303,780 |

The accompanying notes are an integral part of these statements.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
BALANCE SHEETS

| | AS OF FEBRUARY 28, | |
|---|--------------------|---------------|
| | 2006 | 2005 |
| Assets | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 3,489,750 | \$ 4,438,876 |
| Accounts receivable, less allowance for doubtful accounts of \$46,920 and \$80,641 | 3,296,690 | 2,943,835 |
| Notes receivable | 116,997 | 451,845 |
| Refundable income taxes | | 364,630 |
| Inventories, less reserve for slow moving inventory of \$61,032 and \$127,345 | 2,938,234 | 2,518,212 |
| Deferred income taxes | 117,715 | 156,623 |
| Other | 481,091 | 250,886 |
| Total current assets | 10,440,477 | 11,124,907 |
| Property and Equipment, Net | 6,698,604 | 6,125,981 |
| Other Assets | | |
| Notes receivable, less valuation allowance of \$52,005 | 278,741 | 400,084 |
| Goodwill, net | 1,133,751 | 1,133,751 |
| Intangible assets, net | 402,469 | 426,827 |
| Other | 103,438 | 36,424 |
| Total other assets | 1,918,399 | 1,997,086 |
| Total assets | \$ 19,057,480 | \$ 19,247,974 |
| Liabilities and Stockholders Equity | | |
| Current Liabilities | | |
| Current maturities of long-term debt | \$ | \$ 126,000 |
| Accounts payable | 1,145,410 | 1,088,476 |
| Accrued salaries and wages | 507,480 | 1,160,937 |
| Other accrued expenses | 750,733 | 324,215 |
| Dividend payable | 504,150 | 417,090 |
| Total current liabilities | 2,907,773 | 3,116,718 |
| Long-Term Debt, Less Current Maturities | | 1,539,084 |
| Deferred Income Taxes | 663,889 | 698,602 |
| Commitments and Contingencies | | |
| Stockholders Equity | | |
| Common stock, \$.03 par value; 100,000,000 shares authorized; 6,281,920 and 6,136,528 shares issued and outstanding | 188,458 | 184,096 |
| Additional paid-in capital | 10,372,530 | 11,051,176 |
| Retained earnings | 4,924,830 | 2,658,298 |
| Total stockholders equity | 15,485,818 | 13,893,570 |

| | | |
|--|---------------|---------------|
| Total liabilities and stockholders' equity | \$ 19,057,480 | \$ 19,247,974 |
|--|---------------|---------------|

The accompanying notes are an integral part of these statements.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

FOR THE YEARS ENDED FEBRUARY 28 or
29,

| | 2006 | 2005 | 2004 |
|--|----------------------|----------------------|----------------------|
| Common Stock | | | |
| Balance at beginning of year | \$ 184,096 | \$ 179,458 | \$ 173,259 |
| Repurchase and retirement of common stock | (5,827) | (3,756) | (5,052) |
| Issuance of common stock | 53 | 18 | |
| Exercise of stock options and other | 10,136 | 8,376 | 11,251 |
| Balance at end of year | 188,458 | 184,096 | 179,458 |
| Additional Paid-In Capital | | | |
| Balance at beginning of year | 11,051,176 | 2,631,358 | 2,623,178 |
| Repurchase and retirement of common stock | (2,952,614) | (840,450) | (904,543) |
| Stock dividends declared | | 8,156,857 | |
| Costs related to stock splits and dividends | (8,902) | (15,638) | (10,002) |
| Issuance of common stock | 37,447 | 4,939 | |
| Exercise of stock options and other | 1,062,593 | 582,750 | 744,350 |
| Tax benefit from employee stock transactions | 1,182,830 | 531,360 | 178,375 |
| Balance at end of year | 10,372,530 | 11,051,176 | 2,631,358 |
| Retained Earnings | | | |
| Balance at beginning of year | 2,658,298 | 8,779,136 | 7,094,554 |
| Net income | 4,064,572 | 3,316,640 | 2,319,046 |
| Stock dividends declared | | (8,156,857) | |
| Cash dividends declared | (1,798,040) | (1,280,621) | (634,464) |
| Balance at end of year | 4,924,830 | 2,658,298 | 8,779,136 |
| Total Stockholders Equity | \$ 15,485,818 | \$ 13,893,570 | \$ 11,589,952 |
| Common Shares | | | |
| Balance at beginning of year | 6,136,528 | 5,981,948 | 5,775,285 |
| Repurchase and retirement of common stock | (194,246) | (125,216) | (168,399) |
| Issuance of common stock | 1,752 | 616 | |
| Exercise of stock options and other | 337,886 | 279,180 | 375,062 |
| Balance at end of year | 6,281,920 | 6,136,528 | 5,981,948 |

The accompanying notes are an integral part of these statements.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF CASH FLOWS

| | FOR THE YEARS ENDED FEBRUARY 28 or | | |
|---|------------------------------------|--------------|--------------|
| | | 29, | |
| | 2006 | 2005 | 2004 |
| Cash Flows From Operating Activities: | | | |
| Net income | \$ 4,064,572 | \$ 3,316,640 | \$ 2,319,046 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 875,940 | 785,083 | 796,271 |
| Provision for loss on accounts and notes receivable and related foreclosure costs | | 25,000 | 50,000 |
| Provision for inventory loss | 45,000 | 90,000 | 55,000 |
| Loss on sale of assets | 37,411 | 44,789 | 87,136 |
| Deferred income taxes | 4,195 | 135,716 | 348,664 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (445,921) | (453,255) | (417,457) |
| Refundable income taxes | 364,630 | (364,630) | 548,490 |
| Inventories | (461,207) | (136,402) | 535,325 |
| Other assets | (236,640) | 89,661 | (92,541) |
| Accounts payable | 56,934 | 135,934 | 339,772 |
| Income taxes payable | 357,970 | 409,957 | 299,778 |
| Accrued liabilities | 602,187 | 23,726 | 391,072 |
| Net cash provided by operating activities | 5,265,071 | 4,102,219 | 5,260,556 |
| Cash Flows From Investing Activities: | | | |
| Additions to notes receivable | | (236,142) | (53,676) |
| Proceeds received on notes receivable | 345,442 | 172,776 | 227,790 |
| Proceeds from sale of assets | (4,395) | 23,834 | 84,572 |
| Decrease in other assets | 15,748 | 451 | 6,938 |
| Purchase of property and equipment | (1,300,314) | (1,406,698) | (469,893) |
| Net cash used in investing activities | (943,519) | (1,445,779) | (204,269) |
| Cash Flows From Financing Activities: | | | |
| Payments on long-term debt | (1,665,084) | (1,401,490) | (1,224,624) |
| Costs of stock split or dividend | (8,902) | (15,638) | (10,002) |
| Issuance of common stock | 1,072,729 | 591,126 | 755,601 |
| Repurchase and redemption of common stock | (2,958,441) | (844,206) | (909,595) |
| Dividends paid | (1,710,980) | (1,099,639) | (398,356) |
| Net cash used in financing activities | (5,270,678) | (2,769,847) | (1,786,976) |
| Net (Decrease) Increase In Cash And Cash Equivalents | (949,126) | (113,407) | 3,269,311 |
| Cash And Cash Equivalents At Beginning Of Year | 4,438,876 | 4,552,283 | 1,282,972 |
| Cash And Cash Equivalents At End Of Year | \$ 3,489,750 | \$ 4,438,876 | \$ 4,552,283 |

The accompanying notes are an integral part of these statements.

NOTE 1 NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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 February 28, 2006:

| | Sold, Not Yet Open | Open | Total |
|----------------------------------|--------------------------|------|-------|
| Company owned stores | | 9 | 9 |
| Franchise stores Domestic stores | 18 | 243 | 261 |
| Franchise stores Domestic kiosks | 2 | 21 | 23 |
| Franchise stores International | 1 | 35 | 36 |
| | 21 | 308 | 329 |

Cash Equivalents

The Company considers all highly liquid instruments purchased with an original maturity of six months or less to be cash equivalents. The Company continually monitors its positions with, and the credit quality of, the financial institutions it invests with. As of the balance sheet date, and periodically throughout the year, the Company has maintained balances in various operating accounts in excess of federally insured limits, approximately \$3.1 million at February 28, 2006.

Insurance and Self-Insurance Reserves

The Company uses a combination of insurance and self-insurance plans to provide for the potential liabilities for workers' compensation, general liability, property insurance, director and officers' liability insurance, vehicle liability and employee health care benefits. Liabilities associated with the risks that are retained by the Company are estimated, in part, by considering historical claims experience, demographic factors, severity factors and other assumptions. While the Company believes that its assumptions are appropriate, the estimated accruals for these liabilities could be significantly affected if future occurrences and claims differ from these assumptions and historical trends.

Accounts and Notes Receivable

At the time that accounts, notes and royalties receivable are originated, the Company considers a reserve for doubtful accounts. The provision for uncollectible amounts is continually reviewed and adjusted to maintain the allowance at a level considered adequate to cover future losses. The allowance is management's best estimate of uncollectible amounts and is determined based on historical performance that is tracked by the Company on an ongoing basis. The losses ultimately incurred could differ materially in the near term from the amounts estimated in determining the allowance. At February 28, 2006, the Company has \$448,000 of notes receivable outstanding. The notes require monthly payments and bear interest at rates ranging from 7.25% to 12.5%. The notes mature through November 2009 and are secured by the assets financed.

Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property and Equipment and Other Assets

Property and equipment are recorded at cost. Depreciation and amortization are computed using the straight-line method based upon the estimated useful life of the asset, which range from five to thirty-nine years. Leasehold improvements are amortized on the straight-line method over the lives of the respective leases or the service lives of the improvements, whichever is shorter.

The Company reviews its long-lived assets through analysis of estimated fair value, including identifiable intangible assets, whenever events or changes indicate the carrying amount of such assets may not be recoverable. The Company's policy is to review the recoverability of all assets, at a minimum, on an annual basis.

Income Taxes

The Company recognizes deferred tax liabilities and assets based on the differences between the tax basis of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years. The Company's temporary differences are listed in Note 6.

Goodwill

Goodwill arose from two transaction types. The first type was the result of the incorporation of the Company after its inception as a partnership. The goodwill recorded was the excess of the purchase price of the Company over the fair value of its assets. The Company has allocated this goodwill equally between its Franchising and Manufacturing operations. The second type was the purchase of various retail stores, either individually or as a group, for which the purchase price was in excess of the fair value of the assets acquired.

Sales

Sales of products to franchisees and other customers are recognized at the time of shipment. Sales of products at retail stores are recognized at the time of sale.

Shipping Fees

Shipping fees charged to customers by the Company's trucking department are reported as sales. Shipping costs incurred by the Company's trucking department are reported as cost of sales.

Franchise and Royalty Fees

Franchise fee revenue is recognized upon completion of all significant initial services provided to the franchisee and upon satisfaction of all material conditions of the franchise agreement. In addition to the initial franchise fee, the Company receives a royalty fee of approximately five percent (5%) and a marketing and promotion fee of one percent (1%) of the Rocky Mountain Chocolate Factory franchised stores' gross sales.

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, the disclosure of contingent assets and liabilities, at the date of the financial statements, and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Vulnerability Due to Certain Concentrations

As of February 28, 2006, the Company had notes receivable of approximately \$400,000 due from three franchisees. The notes are collateralized by the underlying store assets. The Company is, therefore, vulnerable to changes in the cash flow from these locations.

Stock-Based Compensation

In accordance with Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, the Company continues to apply Accounting Principles Board Opinion No. 25 (APB No. 25), Accounting for Stock Issued to Employees and related interpretations in accounting for our stock option grants. APB No. 25 provides that the compensation expense relative to stock options is measured based on the intrinsic value of the stock option at date of grant.

Stock-Based Compensation CONTINUED

On February 21, 2006, the Company accelerated the vesting of all outstanding stock options in order to prevent past option grants from having an impact on future results. The Company recognized a share-based compensation charge totaling approximately \$71,000 related to this acceleration, which was determined by measuring the intrinsic value on the date of the acceleration for all options that would have expired in the future unexercisable had the acceleration not occurred. The calculation of this charge required that management make estimates and assumptions concerning future employee turnover. Adjustments in future periods may be necessary as actual results could differ from these estimates and assumptions.

The Company has adopted the disclosure-only provisions of SFAS 123. In accordance with those provisions, the Company applies APB 25 and related interpretations in accounting for its stock option plans and, accordingly, does not recognize compensation cost if the exercise price is not less than market at date of grant. The fiscal year 2006 pro forma fair value expense includes the impact of the February 21, 2006 accelerated vesting of stock options. No compensation expense was recognized during the fiscal years ended February 28, 2005 or February 29, 2004. If the Company had elected to recognize compensation cost based on the fair value of the options granted at grant dates as prescribed by SFAS 123, net income and earnings per share would have been reduced to the pro-forma amounts indicated in the table below for the years ending February 28 (29)(in 000 s except per share amounts):

| | 2006 | 2005 | 2004 |
|--|----------|----------|----------|
| Net Income as reported | \$ 4,065 | \$ 3,317 | \$ 2,319 |
| Stock-based compensation expense included in reported net income, net of tax | 43 | | |
| Deduct stock-based compensation expense determined under fair value based method, net of tax | (676) | (120) | (73) |
| Net Income pro forma | 3,432 | 3,197 | 2,246 |
| Basic Earnings per Share-as reported | .65 | .55 | .40 |
| Diluted Earnings per Share-as reported | .61 | .51 | .37 |
| Basic Earnings per Share-pro forma | .55 | .53 | .38 |
| Diluted Earnings per Share-pro forma | .51 | .50 | .36 |

The above pro forma results are not indicative of future results under the requirements of SFAS No. 123R,

Share-based Payments.

Earnings Per Share

Basic earnings per share is computed as net earnings divided by the weighted average number of common shares outstanding during each year. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through stock options. During 2006, 2005 and 2004, 137,320, 0 and 148,286 stock options were excluded from diluted shares as their affect was anti-dilutive.

Advertising and Promotional Expenses

The Company expenses advertising costs as incurred. Total advertising expense amounted to approximately \$354,367, \$296,985 and \$334,885 for the fiscal years ended February 28 (29), 2006, 2005 and 2004, respectively.

Fair Value of Financial Instruments

The Company's financial instruments consist of cash and cash equivalents, trade receivables, payables, notes receivable, and debt. The fair value of all instruments approximates the carrying value.

NOTE 2 INVENTORIES

Inventories consist of the following at February 28:

| | 2006 | 2005 |
|--------------------------|--------------|--------------|
| Ingredients and supplies | \$ 1,507,193 | \$ 1,365,421 |
| Finished candy | 1,431,041 | 1,152,791 |
| | \$ 2,938,234 | \$ 2,518,212 |

NOTE 3 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following at February 28:

| | 2006 | 2005 |
|-------------------------------|--------------|--------------|
| Land | \$ 513,618 | \$ 513,618 |
| Building | 4,705,242 | 3,962,051 |
| Machinery and equipment | 6,252,011 | 7,553,261 |
| Furniture and fixtures | 817,137 | 611,930 |
| Leasehold improvements | 641,637 | 484,385 |
| Transportation equipment | 331,640 | 180,723 |
| Construction in progress | | 527,658 |
| | 13,261,285 | 13,833,626 |
| Less accumulated depreciation | 6,562,681 | 7,707,645 |
| Property and equipment, net | \$ 6,698,604 | \$ 6,125,981 |

NOTE 4 LINE OF CREDIT AND LONG-TERM DEBT**Line of Credit**

At February 28, 2006 the Company had a \$5.0 million line of credit from a bank, collateralized by substantially all of the Company's assets with the exception of the Company's retail store assets. Draws may be made under the line at 75% of eligible accounts receivable plus 50% of eligible inventories. Interest on borrowings is at prime less 50 basis points (7.0% at February 28, 2006). At February 28, 2006, \$5.0 million was available for borrowings under the line of credit, subject to borrowing base limitations. Terms of the line require that the line be rested (that is, that there be no outstanding balance) for a period of 30 consecutive days during the term of the loan. Additionally, the line of credit is subject to various financial ratio and leverage covenants. At February 28, 2006 the Company was in compliance with all such covenants. The credit line is subject to renewal in July, 2006.

Long-term debt

Long-term debt consists of the following at February 28:

| | 2006 | 2005 |
|--|------|--------------|
| Mortgage note payable, paid in full during fiscal 2006 | \$ | \$ 1,665,084 |
| Less current maturities | | 126,000 |
| | \$ | \$ 1,539,084 |

NOTE 5 COMMITMENTS AND CONTINGENCIES**Operating leases**

The Company conducts its retail operations in facilities leased under five to ten-year noncancelable operating leases. Certain leases contain renewal options for between two and ten additional years at increased monthly rentals. The majority of the leases provide for contingent rentals based on sales in excess of predetermined base levels. The following is a schedule by year of future minimum rental payments required under such leases for the years ending February 28 or 29:

| | |
|------|------------|
| 2007 | \$ 277,400 |
| 2008 | 259,700 |
| 2009 | 202,500 |
| 2010 | 151,200 |
| 2011 | 74,100 |
| | \$ 964,900 |

In some instances, in order to retain the right to site selection or because of requirements imposed by the lessor, the Company has leased space for its proposed franchise outlets. When a franchise was sold, the store was subleased to the franchisee who is responsible for the monthly rent and other obligations under the lease. The Company's liability as primary lessee on sublet franchise outlets, all of which is offset by sublease rentals, is as follows for the years ending February 28 or 29:

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NOTE 5 COMMITMENTS AND CONTINGENCIES CONTINUED

| | |
|------|------------|
| 2007 | \$ 108,200 |
| 2008 | 52,400 |
| 2009 | 19,700 |
| | \$ 180,300 |

The following is a schedule of lease expense for all retail operating leases for the three years ended February 28 or 29:

| | 2006 | 2005 | 2004 |
|-----------------------|------------|------------|------------|
| Minimum rentals | \$ 611,535 | \$ 616,669 | \$ 753,314 |
| Less sublease rentals | (239,300) | (313,800) | (427,600) |
| Contingent rentals | 23,921 | 28,949 | 11,187 |
| | \$ 396,156 | \$ 331,818 | \$ 336,901 |

The Company also leases trucking equipment under operating leases. The following is a schedule by year of future minimum rental payments required under such leases for the years ending February 28 or 29:

| | |
|------|------------|
| 2007 | \$ 189,600 |
| 2008 | 148,200 |
| 2009 | 98,800 |
| | \$ 436,600 |

The following is a schedule of lease expense for trucking equipment operating leases for the three years ended February 28 or 29:

| | 2006 | 2005 | 2004 |
|--------------------|---------|---------|------------|
| Purchase contracts | 308,719 | 304,515 | \$ 301,600 |

The Company frequently enters into purchase contracts of between six to eighteen months for chocolate and certain nuts. These contracts permit the Company to purchase the specified commodity at a fixed price on an as-needed basis during the term of the contract. Because prices for these products may fluctuate, the Company may benefit if prices rise during the terms of these contracts, but it may be required to pay above-market prices if prices fall and it is unable to renegotiate the terms of the contract. Currently the Company has contracted for approximately \$3,167,000 of raw materials under such agreements.

Contingencies

The Company is party to various legal proceedings arising in the ordinary course of business. Management believes that the resolution of these matters will not have a significant adverse effect on the Company's financial position, results of operations or cash flows.

NOTE 6 INCOME TAXES

Income tax expense is comprised of the following for the years ending February 28 or 29:

| | 2006 | 2005 | 2004 |
|----------------|--------------|--------------|------------|
| Current | | | |
| Federal | \$ 2,147,826 | \$ 1,586,493 | \$ 878,546 |
| State | 318,089 | 293,371 | 182,115 |
| Total Current | 2,465,915 | 1,879,864 | 1,060,661 |
| Deferred | | | |
| Federal | 3,774 | 122,072 | 313,613 |
| State | 421 | 13,644 | 35,051 |
| Total Deferred | 4,195 | 135,716 | 348,664 |

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Total \$ 2,470,110 \$ 2,015,580 \$ 1,409,325

A reconciliation of the statutory federal income tax rate and the effective rate as a percentage of pretax income is as follows for the years ending February 28 or 29:

| | 2006 | 2005 | 2004 |
|--|-------|-------|-------|
| Statutory rate | 34.0% | 34.0% | 34.0% |
| State income taxes, net of federal benefit | 3.2% | 3.8% | 3.7% |
| Other | .6% | | .1% |
| Effective Rate | 37.8% | 37.8% | 37.8% |

NOTE 6 INCOME TAXES CONTINUED

The components of deferred income taxes at February 28 are as follows:

| | 2006 | 2005 |
|---|--------------|--------------|
| Deferred Tax Assets | | |
| Allowance for doubtful accounts and notes | 37,394 | 50,140 |
| Inventories | 23,070 | 48,136 |
| Accrued compensation | 49,632 | 44,066 |
| Loss provisions and deferred income | 49,173 | 49,472 |
| Self insurance accrual | 15,370 | 24,488 |
| Amortization, design costs | 60,355 | 49,980 |
| | 234,994 | 266,282 |
| Deferred Tax Liabilities | | |
| Depreciation and amortization | (781,168) | (808,261) |
| Net deferred tax liability | (546,174) | (541,979) |
| Current deferred tax assets | \$ 117,715 | \$ 156,623 |
| Non-current deferred tax liabilities | (663,889) | (698,602) |
| Net deferred tax liability | \$ (546,174) | \$ (541,979) |

NOTE 7 STOCKHOLDERS EQUITY

Stock Issuance

In September 2005, the Company issued 1,752 shares of stock, valued at \$37,500, for certain licensing rights for five years and partial payment of certain sales services for one year.

Stock Dividends

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

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

Stock Splits

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.

On December 17, 2003 the Board of Directors approved a three-for-two stock split payable February 2, 2004 to shareholders of record at the close of business on January 20, 2004. Shareholders received one additional share of Common Stock for every two shares owned prior to the record date. Immediately prior to the split there were 2,618,954 shares outstanding. Subsequent to the split there were 3,928,782 shares outstanding.

All share and per share data have been restated in all years presented to give effect to the stock dividends and stock splits.

Stock Repurchases

Between March 24, 2006 and April 28, 2006 the Company repurchased 70,713 shares at an average price of \$15.65 per share. Between October 7, 2005 and February 3, 2006 the Company repurchased 176,599 Company 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. Between October 3, 2003 and February 19, 2004 the Company repurchased 168,399 Company shares at an average price of \$5.40 per share.

NOTE 7 STOCKHOLDERS EQUITY CONTINUED

Cash Dividend

The Company paid an initial quarterly cash dividend of \$0.0325 per common share on September 16, 2003 to shareholders of record on September 2, 2003. The Company paid a quarterly cash dividend of \$0.0352 per common share on December 16, 2003 to shareholders of record on December 2, 2003. The Company paid a quarterly cash dividend of \$0.0390 per common share on March 16, 2004 to shareholders of record on March 3, 2004. The Company paid a quarterly cash dividend of \$0.0429 per common share on June 16, 2004 and September 16, 2004 to shareholders of record on June 3, 2004 and September 2, 2004, respectively. The Company paid a quarterly cash dividend of \$0.0571 per common share on December 16, 2004 to shareholders of record on December 2, 2004. The Company paid a quarterly cash dividend of \$0.0675 per common share on March 16, 2005, June 16, 2005 and September 16, 2005 to shareholders of record on March 11, 2005, June 3, 2005 and September 1, 2005 respectively. The Company paid a quarterly cash dividend of \$0.07 per common share on December 16, 2005 to shareholders of record on December 1, 2005. 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.

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 8 STOCK OPTION PLANS

Under the 1995 Stock Option Plan (the "1995 Plan"), the 2004 Stock Option Plan (the "2004 Plan") the Nonqualified Stock Option Plan for Nonemployee Directors (the "Director's Plan") and the 2000 Nonqualified Stock Option Plan for Nonemployee Directors (the "2000 Director's Plan"), options to purchase up to 924,000, 420,000, 277,200 and 266,400 shares, respectively, of the Company's common stock may be granted at prices not less than market value at the date of grant. Options granted may not have a term exceeding ten years under the 1995 plan, the 2004 plan and the Director's Plan. Options granted may not have a term exceeding five years under the 2000 Director's Plan. Options representing the right to purchase 171,066, 374,010, 0 and 30,800 shares of the Company's common stock were outstanding under the 1995 Plan, the 2004 Plan, the Director's Plan, and the 2000 Director's Plan, respectively, at February 28, 2006. On February 21, 2006, the Company accelerated the vesting of all outstanding stock options in order to prevent past option grants from having an impact on future results. The options outstanding under these plans will expire, if not exercised through February 2016.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model utilizing the following weighted average assumptions:

| | 2006 | 2005 | 2004 |
|---------------------------------|---------|---------|---------|
| Expected dividend yield | 2.18% | 2.16% | 3.09% |
| Expected stock price volatility | 30% | 30% | 30% |
| Risk-free interest rate | 4.5% | 3.8% | 2.4% |
| Expected life of options | 5 years | 5 years | 5 years |

Information with respect to options outstanding under the Plans at February 28, 2006, and changes for the three years then ended was as follows:

| | 2006 | |
|----------------------------------|-----------|---------------------------------|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 770,000 | \$ 4.69 |
| Granted | 149,640 | 18.14 |
| Exercised | (337,884) | 3.17 |
| Forfeited | (5,880) | 7.78 |
| Outstanding at end of year | 575,876 | \$ 9.04 |

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| | | | |
|--|-----------|----|---------------------------------------|
| Options exercisable at February 28, 2006 | 575,876 | \$ | 9.04 |
| | | | 2005 |
| | Shares | | Weighted Average Exercise Price |
| Outstanding at beginning of year | 758,142 | \$ | 2.52 |
| Granted | 300,720 | | 7.71 |
| Exercised | (278,542) | | 2.12 |
| Forfeited | (10,320) | | 2.54 |
| Outstanding at end of year | 770,000 | \$ | 4.69 |
| Options exercisable at February 28, 2005 | 284,020 | \$ | 2.76 |

NOTE 8 STOCK OPTION PLANS CONTINUED

| | | 2004 |
|--|-----------|---------------------------------------|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 1,062,600 | \$ 2.29 |
| Granted | 70,070 | 3.37 |
| Exercised | (374,528) | 2.03 |
| Outstanding at end of year | 758,142 | \$ 2.52 |
| Options exercisable at February 29, 2004 | 474,474 | \$ 2.28 |

Weighted average fair value per share of options granted during 2006, 2005 and 2004 were \$3.03, \$2.05 and \$0.77, respectively.

Additional information about stock options outstanding at February 28, 2006 is summarized as follows:

| | Number exercisable | Options Outstanding Weighted average remaining contractual life | Weighted average exercise price |
|--------------------------|-----------------------|--|---------------------------------------|
| Range of exercise prices | | | |
| \$1.603 to 3.935 | 175,826 | 5.75 | 3.25 |
| \$6.149 to 7.807 | 253,490 | 8.25 | 7.76 |
| \$14.955 to 21.600 | 146,560 | 9.19 | 18.21 |

NOTE 9 OPERATING SEGMENTS

The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. Previously the Company segregated Retail as a third reportable segment. The Company has phased out its Company-owned store program to nine remaining stores. The remaining stores provide an environment for testing new products and promotions, operating and training methods and merchandising techniques. Company management evaluates these stores in relation to their contribution to franchising efforts. The previously reported Retail segment is now included in the Franchising segment and all previously reported periods have been restated. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1. The Company evaluates performance and allocates resources based on operating contribution, which excludes unallocated corporate general and administrative costs, provision for loss on accounts and notes receivable and related foreclosure 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 |
|-----------------------------------|--------------|---------------|-------------|---------------|
| FY 2006 | | | | |
| Total revenues | \$ 8,776,429 | \$ 21,035,748 | \$ | \$ 29,812,177 |
| Intersegment revenues | | (1,738,565) | | (1,738,565) |
| Revenue from external customers | 8,776,429 | 19,297,183 | | 28,073,612 |
| Segment profit (loss) | 2,986,944 | 5,884,990 | (2,337,252) | 6,534,682 |
| Total assets | 2,964,486 | 10,209,790 | 5,883,204 | 19,057,480 |
| Capital expenditures | 90,757 | 878,871 | 330,686 | 1,300,314 |
| Total depreciation & amortization | 264,658 | 406,494 | 204,788 | 875,940 |

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FY 2005

| | | | | |
|-----------------------------------|--------------|---------------|-------------|---------------|
| Total revenues | \$ 7,869,207 | \$ 18,058,455 | \$ | \$ 25,927,662 |
| Intersegment revenues | | (1,404,043) | | (1,404,043) |
| Revenue from external customers | 7,869,207 | 16,654,412 | | 24,523,619 |
| Segment profit (loss) | 2,714,261 | 5,256,713 | (2,638,754) | 5,332,220 |
| Total assets | 2,809,651 | 9,043,385 | 7,394,938 | 19,247,974 |
| Capital expenditures | 462,088 | 687,632 | 256,978 | 1,406,698 |
| Total depreciation & amortization | 223,561 | 384,291 | 177,231 | 785,083 |

FY 2004

| | | | | |
|-----------------------------------|--------------|---------------|-------------|---------------|
| Total revenues | \$ 7,029,453 | \$ 15,196,410 | \$ | \$ 22,225,863 |
| Intersegment revenues | | (1,093,035) | | (1,093,035) |
| Revenue from external customers | 7,029,453 | 14,103,375 | | 21,132,828 |
| Segment profit (loss) | 2,270,890 | 3,846,198 | (2,388,717) | 3,728,371 |
| Total assets | 2,636,145 | 8,061,324 | 7,269,776 | 17,967,245 |
| Capital expenditures | 213,072 | 170,192 | 86,629 | 469,893 |
| Total depreciation & amortization | 219,742 | 390,714 | 185,815 | 796,271 |

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NOTE 10 SUPPLEMENTAL CASH FLOW INFORMATION

For the three years ended February 28 or 29:

| | 2006 | 2005 | 2004 |
|-------------------|-----------|------------|------------|
| Interest paid | \$ 19,872 | \$ 100,067 | \$ 144,936 |
| Income taxes paid | 560,485 | 1,834,536 | 212,393 |

Non-Cash Investing Activities:

| | | | |
|---|-----------|------------|---------|
| Dividend payable | \$ 87,060 | \$ 180,982 | 236,108 |
| Issue stock for rights and services | 37,500 | | |
| Fair value of assets received upon settlement of notes and accounts receivable: | | | |
| Store to be operated | 200,000 | | |
| Inventory | 3,815 | | |
| Note receivable | 153,780 | | |

NOTE 11 EMPLOYEE BENEFIT PLAN

The Company has a 401(k) plan called the Rocky Mountain Chocolate Factory, Inc. 401(k) Plan. Eligible participants are permitted to make contributions up to statutory limits. The Company makes a matching contribution, which vests ratably over a 3-year period, and is 25% of the employee's contribution up to a maximum of 1.5% of the employee's compensation. For fiscal 2005 and 2004, the Company made an additional discretionary contribution by doubling the normal matching. During the years ended February 28 or 29, 2006, 2005 and 2004, the Company's contribution was approximately \$46,000, \$74,000 and \$63,000, respectively, to the plan.

NOTE 12 SUMMARIZED QUARTERLY DATA (UNAUDITED)

Following is a summary of the quarterly results of operations for the fiscal years ended February 28, 2006 and 2005:

| | Fiscal Quarter | | | | |
|----------------------------|----------------|--------------|--------------|--------------|---------------|
| | First | Second | Third | Fourth | Total |
| 2006 | | | | | |
| Total revenue | \$ 5,366,801 | \$ 6,583,160 | \$ 7,997,547 | \$ 8,126,104 | \$ 28,073,612 |
| Gross margin | 1,633,931 | 2,091,825 | 2,444,166 | 2,216,737 | 8,386,659 |
| Net income | 752,585 | 1,123,538 | 1,115,740 | 1,072,709 | 4,064,572 |
| Basic earnings per share | .12 | .18 | .18 | .17 | .65 |
| Diluted earnings per share | .11 | .17 | .17 | .16 | .61 |

| | Fiscal Quarter | | | | |
|---------------------------|----------------|--------------|--------------|--------------|---------------|
| | First | Second | Third | Fourth | Total |
| 2005 | | | | | |
| Total revenue | \$ 4,725,284 | \$ 5,867,937 | \$ 7,097,878 | \$ 6,832,520 | \$ 24,523,619 |
| Gross margin | 1,438,450 | 1,980,886 | 2,169,222 | 2,051,098 | 7,639,656 |
| Net income | 591,912 | 1,003,446 | 871,162 | 850,120 | 3,316,640 |
| Basic earnings per share | .10 | .17 | .15 | .14 | .55 |
| Dilute earnings per share | .09 | .16 | .13 | .13 | .51 |

NOTE 13 GOODWILL AND INTANGIBLE ASSETS

Intangible assets consist of the following at February 28:

| | 2006 | | 2005 | |
|--|--------------|----------------|----------------|-------------|
| | Amortization | Gross Carrying | Gross Carrying | Accumulated |
| | | Accumulated | | |

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| | Period | Value | Amortization | Value | Amortization |
|---|-----------------|--------------|--------------|--------------|--------------|
| Intangible assets subject to amortization | | | | | |
| Store design | 10 Years 3-5 | \$ 205,777 | \$ 85,093 | \$ 205,777 | \$ 63,983 |
| Packaging licenses | Years | 120,830 | 99,164 | 95,831 | 84,848 |
| Packaging design | 10 Years | 430,973 | 170,854 | 403,238 | 129,188 |
| Total | | 757,580 | 355,111 | 704,846 | 278,019 |
| Intangible assets not subject to amortization | | | | | |
| Franchising segment- | | | | | |
| Company stores goodwill | | 1,275,962 | 336,847 | 1,275,962 | 336,847 |
| Franchising goodwill | | 295,000 | 197,682 | 295,000 | 197,682 |
| Manufacturing segment-Goodwill | | 295,000 | 197,682 | 295,000 | 197,682 |
| Total Goodwill | | 1,865,962 | 732,211 | 1,865,962 | 732,211 |
| Total intangible assets | | \$ 2,623,542 | \$ 1,087,322 | \$ 2,570,808 | \$ 1,010,230 |

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NOTE 13 GOODWILL AND INTANGIBLE ASSETS CONTINUED

Amortization expense related to intangible assets totaled \$77,092 and \$72,058 during the fiscal year ended February 28, 2006 and 2005. The aggregate estimated amortization expense for intangible assets remaining as of February 28, 2006 is as follows:

| | |
|------------|------------|
| 2007 | 73,100 |
| 2008 | 73,100 |
| 2009 | 73,100 |
| 2010 | 73,100 |
| 2011 | 64,400 |
| Thereafter | 45,669 |
| Total | \$ 402,469 |

NOTE 14 RECENT ACCOUNTING PRONOUNCEMENTS

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an interpretation of FASB Statement No. 143 (FIN 47), which clarifies the impact that uncertainty surrounding the timing or method of settling an obligation should have on accounting for that obligation under SFAS No. 143, Accounting for Asset Retirement Obligations (SFAS 143). FIN 47 is effective no later than the end of the fiscal year ending after December 15, 2005, or December 31, 2005 for calendar year companies. The Company adopted this standard as of February 28, 2006. The adoption of this statement had no impact on the Company's financial statements.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 replaces Accounting Principles Board Opinion No. 20 (APB 20), Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, APB 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 requires retrospective application to prior periods financial statements of direct effects of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 carries forward without change the guidance for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted this standard as of March 1, 2006. The adoption of this statement had no impact on the Company's financial statements.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS No. 123R) which replaces SFAS No. 123, supersedes Accounting Principles Board (APB) No. 25 and related interpretations and amends SFAS No. 95, Statement of Cash Flows. The provisions of SFAS No. 123R are similar to those of SFAS No. 123; however, SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statement as compensation cost based on their fair value on the date of the grant. The fair value of the share-based awards will be determined using an option-pricing model on the grant date. SFAS No. 123R is effective at the beginning of the first fiscal year beginning after June 15, 2005. The Company adopted SFAS No. 123R effective March 1, 2006.

Through fiscal 2006, the Company accounted for stock-based employee compensation under the recognition and measurement principles of APB Opinion No. 25. In accordance with that standard, no stock-based employee compensation cost for stock options has been reflected in the statements of income except in fiscal 2006 upon acceleration of options (Note 1). In accordance with the provisions of the original SFAS No. 123, the Company has disclosed, on a pro forma basis, the effect on net income had the Company applied the provisions of that statement to Stock-based employee compensation.

SFAS No. 123R requires the Company to recognize stock option expense in the statements of income beginning in the first quarter of fiscal 2007 and to estimate the effect of stock option forfeitures. Through fiscal 2006, as permitted by the original SFAS No. 123, the Company has accounted for forfeitures as they occur. In addition, SFAS 123(R)

amends FASB Statement No. 95, Statements of Cash Flows, to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid.

NOTE 14 RECENT ACCOUNTING PRONOUNCEMENTS CONTINUED

As of the beginning of the first quarter in fiscal 2007 (the required effective date), the Company will apply the provisions of SFAS 123R to new stock awards and to awards modified, repurchased or canceled after the required effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered that are outstanding as of the required effective date shall be recognized as the service is rendered on or after that date. The compensation cost for that portion of awards will be based on the fair value of those awards as calculated for pro forma disclosure purposes under the original SFAS No. 123.

The Company estimates that stock option expense in fiscal 2007 will be approximately \$30,000 to \$60,000 post-tax. The actual amount of stock option expense may vary materially from this estimate, due to certain factors, including number of options that will actually be issued, the timing of option grants, and the market price of our stock on the date of grant.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH
ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Changes in Internal Control Over Financial Reporting

Limitations on Controls and Procedures Because of their inherent limitations, disclosure controls and procedures and internal control over financial reporting (collectively, Control Systems) may not prevent or detect all failures or misstatements of the type sought to be avoided by Control Systems. Also, projections of any evaluation of the effectiveness of the Company's Control Systems to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management, including the Company's Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), does not expect that the Company's Control Systems will prevent all error or all fraud. A Control System, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the Control System are met. Further, the design of a Control System must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all Control Systems, no evaluation can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These reports by management, including the CEO and CFO, on the effectiveness of the Company's Control Systems express only reasonable assurance of the conclusions reached.

Disclosure Controls and Procedures The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Exchange Act, is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

Management, with the participation of the CEO and CFO, has evaluated the effectiveness, as of February 28, 2006, of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act). Based on that evaluation, the CEO and CFO have concluded that the Company's disclosure controls and procedures were effective as of February 28, 2006.

Management's Annual Report on Internal Control over Financial Reporting Management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act). Management, with the participation of the CEO and CFO, has evaluated the effectiveness, as of February 28, 2006, of the Company's internal control over financial reporting. In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in its publication Internal Control-Integrated Framework. Based on that evaluation, the CEO and CFO have concluded that the Company's internal control over financial reporting was effective as of February 28, 2006.

Changes in Internal Control over Financial Reporting There were no changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Section 240.13a-15 of the Exchange Act that occurred during the Company's last fiscal quarter (the Company's fourth quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Attestation Report of the Registered Public Accounting Firm The Company's independent registered public accounting firm, Ehrhardt Keefe Steiner & Hottman PC has issued the following attestation report on the Company's assessment and opinion on the effectiveness of the Company's internal control over financial reporting:

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Rocky Mountain Chocolate Factory, Inc.:

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting, that Rocky Mountain Chocolate Factory, Inc. (the Company) maintained effective internal control over financial reporting as of February 28, 2006 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of the effectiveness to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of February 28, 2006, is fairly stated, in all material respects, based upon the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 28, 2006, based upon the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended February 28, 2006, of the Company and our report dated April 28, 2006 expressed an unqualified opinion on those financial statements.

Ehrhardt Keefe Steiner & Hottman PC

Denver, CO

April 28, 2006

ITEM 9B. OTHER INFORMATION

None

PART III.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Certain information with respect to the executive officers of the Company is set forth in the section entitled "Executive Officers" in Part I of this report.

The information required by this item with respect to directors is incorporated by reference from the information under the caption "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance" contained in the Company's Proxy Statement for the Company's Annual Meeting of Shareholders expected to be held on July 21, 2006 (the "Proxy Statement").

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated by reference to the information appearing under the caption "Executive Compensation" in the Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated by reference to the information appearing under the caption "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" in the Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference to the information appearing under the caption "Certain Transactions" in the Proxy Statement.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated by reference to the information appearing under the caption "Principal Accountant Fees and Services" in the Proxy Statement.

PART IV.**ITEM 15. EXHIBITS and FINANCIAL STATEMENT SCHEDULES**

(a) The following documents are filed as part of this report:

1. Financial Statements

| | |
|--|------------|
| Report of Independent Registered Public Accounting Firms | Page 27 |
| Statements of Income | 28 |
| Balance Sheets | 29 |
| Statements of Changes in Stockholders' Equity | 30 |
| Statements of Cash Flows | 31 |
| Notes to Financial Statements | 32 |

2. Financial Statement Schedules

| | |
|---|------------|
| Report of Independent Registered Public Accounting Firm | Page 45 |
| SCHEDULE II Valuation and Qualifying Accounts | 45 |

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON SCHEDULES

Board of Directors and Stockholders

Rocky Mountain Chocolate Factory, Inc.

Durango, Colorado

In connection with our audit of the financial statements of Rocky Mountain Chocolate Factory, Inc. referred to in our report dated April 28, 2006, which is included in Part II of this Form 10-K, we have also audited Schedule II for the year ended February 28, 2006. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth therein.

Ehrhardt Keefe Steiner & Hottman PC

April 28, 2006

Denver, Colorado

SCHEDULE II Valuation and Qualifying Accounts

| | Balance at Beginning of Period | Additions Charged to Costs & Exp. | Deductions | Balance at End of Period |
|--|---|--|------------|--------------------------------|
| Year Ended February 28, 2006 Valuation Allowance for Accounts and Notes Receivable | 132,646 | -0- | 33,721 | 98,925 |
| Year Ended February 28, 2005 Valuation Allowance for Accounts and Notes Receivable | 120,635 | 25,000 | 12,989 | 132,646 |
| Year Ended February 29, 2004 Valuation Allowance for Accounts and Notes Receivable | 114,563 | 50,000 | 43,928 | 120,635 |

3. Exhibits

| Exhibit Number | Description | Incorporated by Reference to |
|----------------|--|---|
| 3.1 | Articles of Incorporation of the Registrant, as amended | Exhibit 3.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988. |
| 3.2 | By-laws of the Registrant, as amended on November 25, 1997 | Exhibit 3.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998. |
| 4.1 | Specimen Common Stock Certificate | Exhibit 4.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988. |
| 4.2 | Business Loan Agreement dated July 31, 2005 between Wells Fargo Bank and the Registrant | Exhibit 4.2 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2005. |
| 4.3 | Promissory Note dated July 31, 2005 in the amount of \$5,000,000 between Wells Fargo Bank and the Registrant | Exhibit 4.4 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2005. |
| 10.1 | Form of Stock Option Agreement for the Registrant | Exhibit 10.3 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1986. |
| 10.2 | Incentive Stock Option Plan of the Registrant as amended July 27, 1990 | Exhibit 10.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991. |
| 10.3 | Form of Employment Agreement between the Registrant and its officers | Exhibit 99.2 to Schedule on Form 14D9 of the Registrant filed on May 21, 1999. |
| 10.4 | Current form of franchise agreement used by the Registrant | Exhibit 10.4 to the Quarterly Report on form 10-Q of the Registrant for the quarter ended May 31, 2005. |
| 10.5 | Form of Real Estate Lease between the Registrant as Lessee and franchisee as Sublessee | Exhibit 10.7 to Registration Statement on Form S-18 (Registration No. 33-2016-D). |
| 10.6 | Form of Nonqualified Stock Option Agreement for Nonemployee Directors for the Registrant | Exhibit 10.8 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991. |
| 10.7 | Nonqualified Stock Option Plan for Nonemployee Directors dated March 20, 1990 | Exhibit 10.9 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991. |
| 10.8 | 1995 Stock Option Plan of the Registrant | Exhibit 10.9 to Registration Statement on Form S-1 (Registration No. 33-62149) filed August 25, 1995. |
| 10.9 | | |

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| | | |
|-------|--|--|
| | Forms of Incentive Stock Option Agreement for 1995 Stock Option Plan | Exhibit 10.10 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995. |
| 10.10 | Forms of Nonqualified Stock Option Agreement for 1995 Stock Option Plan | Exhibit 10.11 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995. |
| 10.11 | Form of Indemnification Agreement between the Registrant and its directors | Exhibit 10.12 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998. |
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3. Exhibits (continued)

| Exhibit Number | Description | Incorporated by Reference to |
|----------------|--|--|
| 10.13 | 2000 Nonqualified Stock Option Plan for Nonemployee Directors Of the Registrant | Exhibit 99.1 to Registration Statement on Form S-8 (Registration No. 333-109936 filed on October 23, 2003. |
| 10.14 | 2004 Stock Option Plan of the Registrant | Exhibit 99.1 to Registration Statement on Form S-8 (Registration No. 333-119107) filed September 17, 2004. |
| 10.15 | Commodity Contract with Guittard Chocolate Company* | Filed herewith. |
| 23.1 | Consent of Independent Registered Public Accounting Firm | Filed herewith. |
| 31.1 | Certification Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, Chief Executive Officer | Filed herewith. |
| 31.2 | Certification Pursuant TO Section 302 of the Sarbanes-Oxley Act of 2002, Chief Financial Officer | Filed herewith. |
| 32.1 | Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer | Filed herewith. |
| 32.2 | Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer | Filed herewith |

* Contains material that has been omitted pursuant to a request for confidential treatment and such material has been filed separately with the Commission.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: May 5, 2006

/S/ Bryan J. Merryman

BRYAN J. MERRYMAN
Chief Operating Officer, Chief
Financial Officer, Treasurer and
Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: May 5, 2006

/S/ Franklin E. Crail

FRANKLIN E. CRAIL
Chairman of the Board of
Directors, President, and
Director
(principal executive officer)

Date: May 5, 2006

/S/ Bryan J. Merryman

BRYAN J. MERRYMAN
Chief Operating Officer, Chief
Financial Officer, Treasurer and
Director
(principal financial and
accounting officer)

Date: May 5, 2006

/S/ Gerald A. Kien

GERALD A. KIEN, Director

Date: May 5, 2006

/S/ Lee N. Mortenson

LEE N. MORTENSON, Director

Date: May 5, 2006

/S/ Fred M. Trainor

FRED M. TRAINOR, Director

Date: May 5, 2006

/S/ Clyde Wm. Engle

CLYDE Wm. ENGLE, Director

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EXHIBIT INDEX

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