

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

October 10, 2003

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

(Mark One)

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

For the quarterly period ended August 31, 2003

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-14749

**Rocky Mountain Chocolate Factory, Inc.**

(Exact name of registrant as specified in its charter)

Colorado

(State of incorporation)

84-0910696

(I.R.S. Employer Identification No.)

265 Turner Drive, Durango, CO 81303

(Address of principal executive offices)

(970) 259-0554

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

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

On September 30, 2003 the registrant had outstanding 2,536,922 shares of its common stock, \$.03 par value.

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## Item 1. Financial Statements

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

|  | Three Months Ended August 31, |             | Six Months Ended August 31, |              |
|--|-------------------------------|-------------|-----------------------------|--------------|
|  | 2003                          | 2002        | 2003                        | 2002         |
| <b>Revenues</b>  |                               |             |                             |              |
| Sales  | \$4,310,622                   | \$3,976,609 | \$7,278,005                 | \$6,927,411  |
| Franchise and royalty fees   | 1,160,631                     | 1,089,751   | 2,120,047                   | 2,111,288    |
| Total revenues   | 5,471,253                     | 5,066,360   | 9,398,052                   | 9,038,699    |
| <b>Costs and Expenses</b>  |                               |             |                             |              |
| Cost of sales  | 2,657,541                     | 2,499,463   | 4,583,373                   | 4,236,405    |
| Franchise costs  | 251,629                       | 306,852     | 498,545                     | 598,883      |
| Sales and marketing  | 252,085                       | 323,159     | 505,969                     | 636,972      |
| General and administrative   | 510,966                       | 498,127     | 941,439                     | 966,099      |
| Retail operating   | 463,495                       | 213,997     | 699,470                     | 412,597      |
| Depreciation and amortization  | 227,069                       | 205,939     | 428,041                     | 411,985      |
| Total costs and expenses   | 4,362,785                     | 4,047,537   | 7,656,837                   | 7,262,941    |
| <b>Income from Operations</b>  | 1,108,468                     | 1,018,823   | 1,741,215                   | 1,775,758    |
| <b>Other Income (Expense)</b>  |                               |             |                             |              |
| Interest expense   | (38,503)                      | (88,140)    | (81,832)                    | (173,688)    |
| Interest income  | 22,915                        | 59,412      | 46,254                      | 126,657      |
| Other, net   | (15,588)                      | (28,728)    | (35,578)                    | (47,031)     |
| <b>Income Before Income Taxes</b>                                    | 1,092,880                     | 990,095     | 1,705,637                   | 1,728,727    |
| <b>Provision for Income Taxes</b>                                    | 413,110                       | 374,255     | 644,730                     | 653,460      |
| <b>Net Income</b>  | \$ 679,770                    | \$ 615,840  | \$ 1,060,907                | \$ 1,075,267 |
| <b>Basic Earnings per Common Share</b>                               | \$ .27                        | \$ .25      | \$ .42                      | \$ .43       |
| <b>Diluted Earnings per Common Share</b>                             | \$ .25                        | \$ .23      | \$ .39                      | \$ .39       |
| <b>Weighted Average Common Shares Outstanding</b>                    | 2,529,833                     | 2,498,699   | 2,521,674                   | 2,491,693    |
| <b>Dilutive Effect of Employee Stock Options</b>                     | 184,291                       | 207,378     | 168,302                     | 245,601      |
| <b>Weighted Average Common Shares Outstanding, Assuming Dilution</b> | 2,714,124                     | 2,706,077   | 2,689,976                   | 2,737,294    |

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

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BALANCE SHEETS

|  | August 31,<br>2003 | February 28,<br>2003 |
|--|--------------------|----------------------|
| <b>Assets</b>  | (unaudited)        |                      |
| <b>Current Assets</b>  |                    |                      |
| Cash and cash equivalents  | \$ 2,774,411       | \$ 1,282,972         |
| Accounts receivable, less allowance for doubtful accounts of \$81,082 and \$65,117, respectively           | 2,478,721          | 2,021,391            |
| Notes receivable   | 328,000            | 288,100              |
| Refundable income taxes  | 46,071             | 548,490              |
| Inventories  | 2,497,742          | 3,062,135            |
| Deferred income taxes  | 174,616            | 174,616              |
| Other  | 360,165            | 276,002              |
| Total current assets   | 8,659,726          | 7,653,706            |
| <b>Property and Equipment, Net</b>   | 5,485,112          | 5,618,239            |
| <b>Other Assets</b>  |                    |                      |
| Notes receivable, less valuation allowance of \$49,446   | 708,729            | 801,309              |
| Goodwill, net  | 1,133,751          | 1,039,872            |
| Intangible assets, net   | 529,766            | 557,167              |
| Assets held for sale   | 44,898             | 373,525              |
| Other  | 31,540             | 40,428               |
| Total other assets   | 2,448,684          | 2,812,301            |
| Total assets   | \$ 16,593,522      | \$ 16,084,246        |
| <b>Liabilities and Stockholders Equity</b>   |                    |                      |
| <b>Current Liabilities</b>   |                    |                      |
| Current maturities of long-term debt   | \$ 1,229,000       | \$ 1,218,400         |
| Accounts payable   | 627,199            | 612,770              |
| Accrued salaries and wages   | 256,531            | 678,223              |
| Other accrued expenses   | 687,240            | 363,192              |
| Dividend payable   | 189,969            |                      |
| Total current liabilities  | 2,989,939          | 2,872,585            |
| <b>Long-Term Debt, Less Current Maturities</b>   | 2,457,093          | 3,072,798            |
| <b>Deferred Gain on Sale of Assets</b>   | 14,066             | 15,657               |
| <b>Deferred Income Taxes</b>   | 232,215            | 232,215              |
| <b>Commitments and Contingencies</b>   |                    |                      |
| <b>Stockholders Equity</b>   |                    |                      |
| Common stock, \$.03 par value, 7,250,000 shares authorized, 2,532,922 and 2,500,123 issued and outstanding | 75,988             | 75,004               |
| Additional paid-in capital   | 2,858,729          | 2,721,433            |
| Retained earnings  | 7,965,492          | 7,094,554            |
| Total stockholders equity  | 10,900,209         | 9,890,991            |
| Total liabilities and stockholders equity  | \$ 16,593,522      | \$ 16,084,246        |

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

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

|   | Six Months Ended<br>August 31, |                   |
|---|--------------------------------|-------------------|
|   | 2003                           | 2002              |
| <b>Cash Flows From Operating activities</b>                                       |                                |                   |
| Net income  | \$ 1,060,907                   | \$ 1,075,267      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                |                   |
| Depreciation and amortization   | 428,041                        | 411,985           |
| Provision for doubtful accounts   | 50,000                         | 50,000            |
| Gain on sale of property and equipment  | (1,252)                        | (87)              |
| Changes in operating assets and liabilities:                                      |                                |                   |
| Accounts receivable   | (507,330)                      | (209,392)         |
| Refundable income taxes   | 502,419                        |                   |
| Inventories   | 564,393                        | (764,890)         |
| Other current assets  | (84,163)                       | (169,052)         |
| Accounts payable  | 14,429                         | 251,273           |
| Accrued liabilities   | (97,644)                       | (368,837)         |
| Net cash provided by operating activities   | 1,929,800                      | 276,267           |
| <b>Cash Flows From Investing Activities</b>                                       |                                |                   |
| Proceeds received on notes receivable   | 105,042                        |                   |
| Addition to notes receivable  | (52,362)                       | (210,504)         |
| Proceeds from sale of assets  | 75,327                         | 960               |
| Purchases of property and equipment   | (90,238)                       | (154,326)         |
| Increase in other assets  | (9,305)                        | (71,422)          |
| Net cash provided by (used in) investing activities                               | 28,464                         | (435,292)         |
| <b>Cash Flows From Financing Activities</b>                                       |                                |                   |
| Payments on long-term debt  | (605,105)                      | (601,870)         |
| Proceeds from line of credit  |                                | 1,900,000         |
| Payments on line of credit  |                                | (1,340,000)       |
| Costs of stock split  |                                | (14,010)          |
| Reduction of loan from officer  |                                | 39,999            |
| Proceeds from exercise of stock options   | 138,280                        | 117,516           |
| Net cash (used in) provided by financing activities                               | (466,825)                      | 101,635           |
| <b>Net Increase (Decrease) in Cash and Cash Equivalents</b>                       | <b>1,491,439</b>               | <b>(57,390)</b>   |
| <b>Cash and Cash Equivalents, Beginning of Period</b>                             | <b>1,282,972</b>               | <b>165,472</b>    |
| <b>Cash and Cash Equivalents, End of Period</b>                                   | <b>\$ 2,774,411</b>            | <b>\$ 108,082</b> |

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

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.  
NOTES TO INTERIM FINANCIAL STATEMENTS

NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Rocky Mountain Chocolate Factory, Inc. is an international franchiser, confectionery manufacturer and retail operator in the United States, Guam, Canada and the United Arab Emirates. The Company manufactures an extensive line of premium chocolate candies and other confectionery products. The Company's revenues are currently derived from three principal sources: sales to franchisees and others of chocolates and other confectionery products manufactured by the Company; the collection of initial franchise fees and royalties from franchisees' sales; and sales at Company-owned stores of chocolates and other confectionery products.

Basis of Presentation

The accompanying financial statements have been prepared by the Company, without audit, and reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and Securities and Exchange Commission regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods. The results of operations for the six months ended August 31, 2003 are not necessarily indicative of the results to be expected for the entire fiscal year.

These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2003.

Stock-Based Compensation

Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* encourages, but does not require, companies to record compensation cost for stock-based employee compensation plans at fair value. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees* and provides the required pro forma disclosures prescribed by SFAS 123 and SFAS 148.

The Company has adopted the disclosure-only provisions of SFAS 123. In accordance with those provisions, the Company applies APB 25 and related interpretations in accounting for its stock option plans and, accordingly, does not recognize compensation cost if the exercise price is not less than market. No compensation expense was recognized during the quarters ended August 31, 2003 or 2002. If the Company had elected to recognize compensation cost based on the fair value of the options granted at grant dates as prescribed by SFAS 123, net income and earnings per share would have been reduced to the pro-forma amounts indicated in the table below for the six months ending August 31, (in 000's except per share amounts):

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

## Stock-Based Compensation Continued

|   | Three Months ended<br>August 31, |        | Six Months Ended August<br>31, |          |
|---|----------------------------------|--------|--------------------------------|----------|
|   | 2003                             | 2002   | 2003                           | 2002     |
| Net Income as reported  | \$ 680                           | \$ 616 | \$ 1,061                       | \$ 1,075 |
| Total stock-based compensation expense<br>determined under fair value based method, net of<br>tax | 18                               | 24     | 37                             | 48       |
| Net Income pro forma  | 662                              | 592    | 1,024                          | 1,027    |
| Basic Earnings per Share as reported  | .27                              | .25    | .42                            | .43      |
| Diluted Earnings per Share as reported  | .25                              | .23    | .39                            | .39      |
| Basic Earnings per Share pro forma  | .26                              | .24    | .41                            | .41      |
| Diluted Earnings per Share pro forma  | .24                              | .22    | .38                            | .38      |

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:

|                                 | 2004    | 2003    |
|---------------------------------|---------|---------|
| Expected dividend yield         | 3.75%   | 0%      |
| Expected stock price volatility | 30%     | 40%     |
| Risk-free interest rate         | 2.4%    | 4.3%    |
| Expected life of options        | 5 years | 5 years |

## NOTE 2 EARNINGS PER SHARE

Basic earnings per share is calculated using the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through stock options. For the three months ended August 31, 2003 and 2002, 86,998 and 35,666 stock options were excluded from the computation of earnings per share because their effect would have been anti-dilutive. For the six months ended August 31, 2003 and 2002, 114,498 and 24,500 stock options were excluded from the computation of earnings per share because their effect would have been anti-dilutive.

## NOTE 3 INVENTORIES

Inventories consist of the following:

|                          | August 31, 2003 | February 28, 2003 |
|--------------------------|-----------------|-------------------|
| Ingredients and supplies | \$ 1,415,500    | \$ 1,583,631      |
| Finished candy           | 1,082,242       | 1,478,504         |
|                          | \$2,497,742     | \$3,062,135       |

## NOTE 4 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following:

|                         | August 31, 2003 | February 28, 2003 |
|-------------------------|-----------------|-------------------|
| Land                    | \$ 513,618      | \$ 513,618        |
| Building                | 3,846,394       | 3,838,936         |
| Machinery and equipment | 6,962,138       | 6,746,190         |
| Furniture and fixtures  | 826,774         | 658,145           |
| Leasehold improvements  | 644,527         | 489,405           |

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|                               |              |              |
|-------------------------------|--------------|--------------|
| Transportation equipment      | 180,723      | 180,723      |
|                               | 12,974,174   | 12,427,017   |
| Less accumulated depreciation | 7,489,062    | 6,808,778    |
| Property and equipment, net   | \$ 5,485,112 | \$ 5,618,239 |

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## NOTE 5 STOCKHOLDERS EQUITY

## Cash Dividend

The Company paid an initial quarterly cash dividend of \$0.075 per common share on September 16, 2003 to shareholders of record on September 2, 2003. The Board of Directors also announced, on September 26, 2003, their intent to declare dividends per common share of \$0.08125 in October and \$0.0875 in January and ensuing quarters.

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

## NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION

|   | Six Months Ended<br>August 31, |            |
|---|--------------------------------|------------|
|   | 2003                           | 2002       |
| Cash paid (received) for:                     |                                |            |
| Interest                                      | \$ 81,563                      | \$ 173,191 |
| Income taxes                                  | (208,635)                      | 671,730    |
| Non-Cash Financing Activities                 |                                |            |
| Company financed sales of retail store Assets | \$                             | \$ 230,317 |

## NOTE 7 OPERATING SEGMENTS

The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. The Company's retail stores provide an environment for testing consumer behavior, various pricing strategies, new products and promotions, operating and training methods and merchandising techniques. Three operational stores previously classified as held for sale were reclassified as assets held and used when management's intentions changed. All Company-owned retail stores are evaluated by management in relation to their contribution to franchising efforts and are included in the Franchising segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 to the Company's financial statements included in the Company's annual report on Form 10-K for the year ended February 28, 2003. The Company evaluates performance and allocates resources based on operating contribution, which excludes unallocated corporate general and administrative costs and income tax expense or benefit. The Company's reportable segments are strategic businesses that utilize common merchandising, distribution, and marketing functions, as well as common information systems and corporate administration. All inter-segment sales prices are market based. Each segment is managed separately because of the differences in required infrastructure and the difference in products and services:

| Three Months Ended<br>August 31, 2003 | Franchising  | Manufacturing | Other     | Total        |
|---------------------------------------|--------------|---------------|-----------|--------------|
| Total revenues                        | \$ 2,066,048 | \$ 3,693,068  | \$        | \$ 5,759,116 |
| Intersegment revenues                 |              | (287,863)     |           | (287,863)    |
| Revenue from external customers       | 2,066,048    | 3,405,205     |           | 5,471,253    |
| Segment profit (loss)                 | 763,317      | 905,443       | (575,880) | 1,092,880    |
| Total assets                          | 2,501,641    | 8,302,240     | 5,789,641 | 16,593,522   |
| Capital expenditures                  | 2,003        | 2,537         | 19,014    | 23,554       |
| Total depreciation & amortization     | 79,846       | 99,487        | 47,736    | 227,069      |

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## NOTE 7 OPERATING SEGMENTS CONTINUED

**Three Months Ended****August 31, 2003**

|                                 |              |              |           |              |
|---------------------------------|--------------|--------------|-----------|--------------|
| Total revenues                  | \$ 1,476,774 | \$ 3,805,268 | \$        | \$ 5,282,042 |
| Intersegment revenues           |              | (215,682)    |           | (215,682)    |
| Revenue from external customers | 1,476,774    | 3,589,586    |           | 5,066,360    |
| Segment profit (loss)           | 516,979      | 1,049,171    | (576,055) | 990,095      |
| Total assets                    | 2,018,023    | 10,500,869   | 5,335,837 | 17,854,729   |
| Capital expenditures            |              |              |           |              |