ROCKY MOUNTAIN CHOCOLATE FACTORY INC
Form 10-K
May 14, 2008

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

(Mark One)

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

**For the fiscal year ended February 29, 2008**

**OR**

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

**For the transition period from __________ to __________**

**Commission file number 0-14749**

**Rocky Mountain Chocolate Factory, Inc.**

(Exact name of registrant as specified in its charter)

| Colorado | 84-0910696 |
|---|---|
| (State of Incorporation) | (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:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock $.03 Par Value per Share | The NASDAQ Stock Market LLC |

Securities Registered Pursuant To Section 12(g) Of The Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

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 o No þ

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

Indicate by check mark 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. o

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

| Large accelerated filer o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |
|---|---|---|---|

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

On April 30, 2008, there were 5,980,919 shares of Common Stock outstanding. The aggregate market value of the Common Stock (based on the closing price as quoted on the Nasdaq Global Market on August 31, 2007) held by non-affiliates was $67,078,231. As of September 30, 2007 Hodges Capital Management, Inc. and affiliates held 1,024,123 shares of outstanding Common Stock. These shares have been excluded from the dollar value of Common Stock held by non-affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement furnished to stockholders in connection with the 2008 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.

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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 franchisor 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, 2008 there were 5 Company-owned and 329 franchised Rocky Mountain Chocolate Factory stores operating in 38 states, Canada, and the United Arab Emirates. The Company believes approximately 50% 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 (75-72-69%); (ii) sales at Company-owned stores of chocolates and other confectionery products (including products manufactured by the Company) (5-8-11%) and (iii) the collection of initial franchise fees and royalties from franchisees (20-20-20%). The Company s revenues are derived from domestic (97-98-98%) and international (3-2-2%) sources. The figures in parentheses show the percentage of total revenues attributable to each source for fiscal years ended February 28 (29), 2008, 2007 and 2006, respectively.

According to the National Confectioners Association, the total U.S. candy market approximated $29.1 billion of retail sales in 2007 with chocolate generating sales of approximately $16.3 billion. According to the Department of Commerce, per capita consumption of chocolate in 2006 was approximately 14 pounds per year nationally and decreased 1% when compared to 2005.

## Business Strategy

The Company s objective is to build on its position as a leading international franchisor 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 the Company s master candy makers. 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.

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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, 2008, 197 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 bi-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:

| | |
|---|---|
| 2004 | (0.6%) |
| 2005 | 4.8% |
| 2006 | 2.4% |
| 2007 | 0.3% |
| 2008 | (0.9%) |

The Company believes that the negative trend in fiscal 2008 was due to the overall weakening of the economy and retail environment. The Company experienced positive same store sales of 1.0% and 1.6% in its fiscal first and second quarters of 2008 followed by decreases in same store sales of (2.5%) and (4.7%) in its fiscal third and fourth quarters of fiscal 2008 compared with the same periods in fiscal 2007.

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 2008, same store pounds purchased by franchisees decreased 9.1% compared to 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. The Company believes the decrease in same store pounds purchased was due to a product mix shift from factory-made products to products made in the store such as caramel apples and fudge.

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 Advanced Planning and Scheduling (APS) system, implementation of alternative manufacturing strategies and installation of enhanced Point-of-Sale (POS) systems in all of its Company-owned and 182 of its franchised stores through March 31, 2008. 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.

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## 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 centers) 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: outlet centers, tourist environments, regional centers, street fronts, airports and other entertainment oriented environments. The Company, over the last several years, has had a particular focus on regional center locations. The Company is optimistic that its exciting new store design will allow it to continue targeting the over 1,400 regional centers 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 many 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 specialty markets 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 granite or marble tables, and are often invited to sample the store s products. The Company believes that an average of approximately 50% 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 centers. 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. The Company is requiring that all new Rocky Mountain Chocolate Factory stores incorporate the revised store design concept. The Company also requires that key elements of the revised store design concept be incorporated into existing store design upon renewal of the Franchise Agreement, or transfer in store ownership.

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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, 2008 there were 18 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 makers. 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 40% of the revenues of Rocky Mountain Chocolate Factory stores are generated by products manufactured at the Company s factory, 50% 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 $14.90 to $24.00 per pound, with an average price of $18.30 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 centers, tourist areas, outlet centers, street fronts, airports and other entertainment oriented shopping centers. Each of these environments has a number of attractive features, including high levels of foot traffic.

Outlet Centers

There are approximately 110 factory outlet centers in the United States, and as of February 29, 2008, there were Rocky Mountain Chocolate Factory stores in approximately 67 of these centers in over 25 states. The Company has established business relationships with most of the major outlet center developers in the United States. Although not all factory outlet centers 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 centers.

Tourist Areas, Street Fronts and Other Entertainment Oriented Shopping Centers

As of February 29, 2008, there were approximately 40 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

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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 Centers

There are approximately 1,400 regional centers in the United States, and as of February 29, 2008, there were Rocky Mountain Chocolate Factory stores in approximately 95 of these centers, including locations in the Mall of America in Bloomington, Minnesota; and Fort Collins, Colorado. Although often providing favorable levels of foot traffic, regional centers 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 center 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. Twelve franchised Rocky Mountain Chocolate Factory stores exist at airport locations: two at Atlanta International (Hartsfield-Jackson), two at Denver International Airport, one at Charlotte International Airport, one at Minneapolis International Airport, one at Phoenix Sky Harbor Airport, one at Salt Lake City International Airport, one at Dallas Fort Worth International Airport and three in Canada; one at Edmonton International Airport, one at Toronto Pearson International Airport and one at Vancouver International Airport.

On July 20, 2007 the Company entered into an exclusive airport development agreement (the Agreement ) with The Grove, Inc. Pursuant to this Agreement, The Grove will have the exclusive right to open Rocky Mountain Chocolate Factory stores in all airports in the United States where there are no Rocky Mountain Chocolate Factory stores currently operating or under development. Additionally, the Agreement sets forth a commission on the initial franchise fee and future royalty revenue to be paid by the Company to The Grove, Inc. for any third-party, qualified, franchisees who develop an airport location under the Agreement. The Agreement expires on July 20, 2009 or upon 30 days written notice of default by the Franchisee.

**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 January 2008, Rocky Mountain Chocolate Factory was rated the number one franchise opportunity in the candy category by Entrepreneur Magazine. As of March 31, 2008, there were 329 franchised stores in the Rocky Mountain Chocolate Factory system. See the audited financial statements and the related notes thereto included elsewhere in the report for a discussion of the revenues, profits or losses and total assets related to the franchising segment of the Company s business.

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, 2008, operated 38 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, 2008, operated 3 stores under this agreement.

In fiscal 2008, the Company entered into an airport development agreement with The Grove, Inc. Pursuant to this Agreement, The Grove will have the exclusive right to open Rocky Mountain Chocolate Factory stores in all airports

in the United States where there are no Rocky Mountain

Chocolate Factory stores currently operating or under development. The Grove, Inc., as of March 31, 2008, 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.

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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, 2008 there were 5 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, which may then be incorporated into the franchise store operations.

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 to achieve its marketing motto of *the Peak of Perfection in Handmade Chocolates®*.

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. See the audited financial statements and the related notes thereto included elsewhere in this report for a discussion of the revenues, profits or losses and total assets related to the manufacturing segment of the Company s business.

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 FactoryÒ*, the phrases, *The Peak of Perfection in Handmade ChocolatesÒ* , *America s ChocolatierÒ* , *The World s Chocolatierâ* 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.

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**Employees**

At February 29, 2008, the Company employed approximately 190 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 30, 2008 are as follows:

| Name | Age | Position |
|---|---|---|
| Franklin E. Crail | 66 | Chairman of the Board, President and Director |
| Bryan J. Merryman | 47 | Chief Operating Officer, Chief Financial Officer, Treasurer and Director |
| Gregory L. Pope | 41 | Sr. Vice President Franchise Development and Operations |
| Edward L. Dudley | 44 | Sr. Vice President Sales and Marketing |
| William K. Jobson | 52 | Chief Information Officer |
| Jay B. Haws | 58 | Vice President Creative Services |
| Virginia M. Perez | 70 | 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.

**Available Information**

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 ).

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## 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. 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 center 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.

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**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.

**Adverse Changes in National or Regional U.S. Economic Conditions**

Adverse economic changes could have a significant negative impact on U.S. consumer spending, particularly discretionary spending, which, in turn, could directly affect the Company s overall revenues. Consumer confidence, recessionary and inflationary trends, equity market levels, consumer credit availability, interest rates, consumers disposable income and spending levels, energy prices, job growth and unemployment rates may impact the volume of customer traffic and level of sales in our locations. Negative trends in any of these economic conditions, whether national or regional in nature, could adversely affect our financial results, including our net sales and profitability.

**Company Manufactured Products**

We believe that approximately 40% of franchised stores revenues are generated by sales of products manufactured by and purchased from us, 50% 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 2008, the Company s factory produced approximately 2.84 million pounds of chocolate candies, an increase of 4% from the approximately 2.73 million pounds produced in fiscal 2007. During fiscal 2008 the Company conducted a study of factory capacity. As a result of this study, the Company believes the factory has the capacity to produce approximately 5.3 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, 2008, all of the 5 Company-owned stores were occupied pursuant to non-cancelable leases of five to ten years having varying expiration dates from April 2008 to August 2017, 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, 2008, the Company was the primary lessee at 3 of its 329 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 material legal proceedings other than ordinary routine litigation incidental to its business.

## 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 Global Market which is part of The Nasdaq Stock Market under the trading symbol RMCF . On July 10, 2007 the Board of Directors declared a 5% stock dividend payable on July 31, 2007 to shareholders of record as of July 20, 2007. On February 19, 2008, the Board of Directors declared a fourth quarter cash dividend of $0.10 cents per common share outstanding. The cash dividend was paid March 14, 2008 to shareholders of record as of February 29, 2008.

The Company declared these stock and cash dividends 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 this Item 5. have been adjusted, where necessary, for the effects of the stock dividend.

Between January 9, 2008 and February 8, 2008, the Company repurchased 391,600 shares at an average price of $11.94. Between August 15, 2007 and August 28, 2007, the Company repurchased 16,000 shares at an average price of $15.96 per share. Between March 1, 2007 and May 15, 2007 the Company repurchased 76,335 shares at an average price of $13.12 per share. Between May 1, 2006 and February 28, 2007 the Company repurchased 253,141 shares at an average price of $12.94 per share. Between March 24, 2006 and April 28, 2006 the Company repurchased 74,249 shares at an average price of $14.90 per share. Between October 7, 2005 and February 3, 2006 the Company repurchased 185,429 Company shares at an average price of $14.63 per share. Between April 18 and April 20, 2005, the Company repurchased 18,529 Company shares at an average price of $13.28 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.

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The table below sets forth high and low price information for the Common Stock for each quarter of fiscal years 2008 and 2007, and dividend information.

| **Fiscal Year Ended February 29, 2008** | HIGH | LOW | Dividends declared |
|---|---|---|---|
| Fourth Quarter | $17.69 | $10.45 | .1000 |
| Third Quarter | $18.04 | $15.40 | .1000 |
| Second Quarter | $18.00 | $14.20 | .0950 |
| First Quarter | $15.18 | $12.62 | .0952 |

| **Fiscal Year Ended February 28, 2007** | HIGH | LOW | Dividends declared |
|---|---|---|---|
| Fourth Quarter | $14.75 | $12.65 | .0857 |
| Third Quarter | $14.26 | $11.86 | .0857 |
| Second Quarter | $13.81 | $11.11 | .0762 |
| First Quarter | $15.24 | $12.14 | .0762 |

On April 30, 2008 the closing price for the Common Stock was $12.30.

**Holders**

On April 30, 2008 there were approximately 400 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 2007 | | | | 4,649,960 |
| January 2008 | 141,600 | 12.63 | 141,600 | 2,861,373 |
| February 2008 | 250,000 | 11.55 | 250,000 | 3,003,867 |
| Total | 391,600 | 11.94 | 391,600 | 3,003,867 |

(1) During the fourth quarter of Fiscal 2008 ending February 29, 2008, the Company purchased 391,600 shares in the open market.

(2) On January 5, 2006, May 4, 2006 and May 25, 2006 the Company announced plans to repurchase up to $2,000,000 of the Company s common stock, on May 10, 2007 the Company announced plans to repurchase up to $5,000,000 of the Company s common stock and on February 19, 2008 the Company announced plans to repurchase up to $3,000,000 of the Company s common stock in the open market or in private transactions, whenever deemed appropriate by management. The plans were only to expire once the designated amounts were reached. The January 5, 2006 plan was completed in May 2006. The May 4, 2006 plan was completed in July 2006. The May 25, 2006 plan was

completed in May 2007. The May 10, 2007 plan was completed in February 2008. The Company plans to continue the February 19, 2008 plan until it has been completed.

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**Comparison of Return on Equity**

The following graph reflects the total return, which assumes reinvestment of dividends, of a $100 investment in the Company s Common Stock, in the Nasdaq Index, in the Russell 2000 Index and in a Peer Group Index of companies in the confectionery industry, on February 28, 2003.

| Company/Index Name | Base Period 2/2003 | Return 2/2004 | Return 2/2005 | Return 2/2006 | Return 2/2007 | Return 2/2008 |
|---|---|---|---|---|---|---|
| Rocky Mountain Chocolate Factory, Inc. | 100.00 | 215.97 | 540.76 | 551.24 | 502.19 | 503.38 |
| Nasdaq Index US | 100.00 | 152.22 | 154.10 | 172.40 | 183.46 | 172.24 |
| Russell 2000 Index | 100.00 | 164.41 | 180.08 | 209.95 | 230.67 | 201.98 |
| Peer Group(l) | 100.00 | 117.82 | 151.42 | 141.44 | 148.50 | 164.43 |

(1) Comprised of the following companies: The Hershey Company, Imperial Sugar Company, Monterey Gourmet Foods, Inc., Paradise, Inc., Tootsie Roll Industries, Inc., Valhi, Inc. and Wrigley (Wm.), Jr. Company.

**ITEM 6. SELECTED FINANCIAL DATA**

The selected financial data presented below for the fiscal years ended February 28 or 29, 2004 through 2008, are derived from the Financial Statements of the Company, which have been audited by Ehrhardt Keefe Steiner & Hottman PC, independent registered public accounting firm. 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.

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(Amounts in thousands, except per share data)

| | YEARS ENDED FEBRUARY 28 or 29, | | | | |
|---|---|---|---|---|---|
| | 2008 | 2007 | 2006 | 2005 | 2004 |
| **Selected Statement of Operations Data** | | | | | |
| Total revenues | $ 31,878 | $ 31,573 | $ 28,074 | $ 24,524 | $ 21,133 |
| Operating income | 7,914 | 7,561 | 6,459 | 5,339 | 3,779 |
| Net income | $ 4,961 | $ 4,745 | $ 4,065 | $ 3,317 | $ 2,319 |
| **Basic Earnings per Common Share** | $ .78 | $ .74 | $ .62 | $ .53 | $ .38 |
| **Diluted Earnings per Common Share** | $ .76 | $ .71 | $ .58 | $ .49 | $ .35 |
| Weighted average common shares outstanding | 6,341 | 6,432 | 6,582 | 6,307 | 6,147 |
| Weighted average common shares outstanding, assuming dilution | 6,501 | 6,659 | 7,009 | 6,806 | 6,619 |
| **Selected Balance Sheet Data** | | | | | |
| Working capital | $ 5,152 | $ 7,503 | $ 7,533 | $ 8,008 | $ 6,394 |
| Total assets | 16,147 | 18,456 | 19,057 | 19,248 | 17,967 |
| Long-term debt | | | | 1,539 | 1,986 |
| Stockholders equity | 11,655 | 14,515 | 15,486 | 13,894 | 11,590 |
| **Cash Dividend Declared per Common Share** | $ .390 | $ .324 | $ .271 | $ .200 | $ .102 |

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

**A Note About Forward Looking Statements**

*The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the 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 nature of the Company s operations and the environment in which it operates subject it to changing economic, competitive, regulatory and technological conditions, risks and uncertainties. The statements, other than statements of historical fact, included in this report are forward-looking statements. Many of the forward-looking statements contained in this document may be identified by the use of forward-looking words such as will, intend, believe, expect, anticipate, should, plan, estimate and potential, or similar expressions. Factors which could cause results to differ include, but are not limited to: changes in the confectionery business environment, seasonality, consumer interest in the Company s products, general economic conditions, consumer trends, costs and availability of raw materials, competition and the effect of government regulation. Government regulation which the Company and its franchisees either are or may be subject to and which could cause results to differ from forward-looking statements include, but are not limited to: local, state and federal laws regarding health, sanitation, safety, building and fire codes, franchising, employment, manufacturing, packaging and distribution of food products and motor carriers. For a detailed discussion of the risks and uncertainties that may cause the Company s actual results to differ from the forward-looking statements contained herein, please see the Risk Factors contained in this document at 1A. These forward-looking statements apply only as of the date of this report. As such they should not be unduly relied upon for more current circumstances. Except as required by law, the Company is not obligated to*

*release publicly any revisions to these forward-looking statements that might reflect events or circumstances occurring after the date of this report or those that might reflect the occurrence of unanticipated events.*

The Company is a product-based international 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 five 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 centers, 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 new store openings, competition, the receptivity of the Company s franchise system to the Company s product introductions and promotional programs. Same store pounds purchased from the factory by franchised stores declined approximately 9% in the first quarter, second quarter and third quarter; 12% in the fourth quarter and 9% overall in fiscal 2008.

**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 collectability 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 collectability 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 collectability of accounts receivable are reasonably likely to change in the future.

The Company recorded expense of approximately $48,000 per year for potential uncollectible accounts over the three-year period ended February 29, 2008. Write-offs of uncollectible accounts net of recoveries averaged approximately $54,000 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 4.4% of gross receivables.

Revenue Recognition The Company recognizes revenue on sales of products to franchisees and other customers at the time of delivery. Through fiscal 2006, franchise fee revenue was 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 was recognized upon signing of the franchise agreement. The balance of the fee

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was recognized upon the franchisee s commitment to a property lease. Beginning in fiscal 2007, franchise fee revenue is recognized upon the opening of the store. The Company also recognizes a marketing and promotion fee of one percent (1%) of the Rocky Mountain Chocolate Factory franchised stores gross retail sales and a royalty fee based on gross retail sales. Beginning with franchise store openings in the third quarter of fiscal year 2004, the Company modified its royalty structure. Under the current structure, the Company recognizes no royalty on franchised stores retail sales of products purchased from the Company and recognizes a ten percent (10%) royalty on all other sales of product sold at franchise locations. For franchise stores opened prior to the third quarter of fiscal 2004 the Company recognizes a royalty fee of five percent (5%) of franchised stores gross retail sales.

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 29, 2008, the Company recorded expense averaging approximately $68,000 per year for potential inventory losses, or approximately 0.4% 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 2008 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 2008 Compared To Fiscal 2007**

Results Summary

Basic earnings per share increased 5.4% from $.74 in fiscal 2007 to $.78 in fiscal 2008. Revenues increased 1.0% from fiscal 2007 to fiscal 2008. Operating income increased 4.7% from $7.6 million in fiscal 2007 to $7.9 million in fiscal 2008. Net income increased 4.6% from $4.7 million in fiscal 2007 to $5.0 million in fiscal 2008. The increase in revenue, earnings per share, operating income, and net income in fiscal 2008 compared to fiscal 2007 was due primarily to increased sales to specialty markets, increased number of franchised stores in operation and the corresponding increases in revenue.

Revenues

| ($ s in thousands) | 2008 | 2007 | Change | % Change |
|---|---|---|---|---|
| Factory sales | $23,758.2 | $22,709.0 | $1,049.2 | 4.6% |
| Retail sales | 1,800.0 | 2,626.7 | (826.7) | (31.5%) |
| Royalty and marketing fees | 5,696.9 | 5,603.8 | 93.1 | 1.7% |

| | | | | |
|---|---|---|---|---|
| Franchise fees | 623.1 | 633.8 | (10.7) | (1.7%) |
| Total | $31,878.2 | $31,573.3 | $ 304.9 | 1.0% |

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Factory Sales

Factory sales increased in fiscal 2008 compared to fiscal 2007 due to an increase of 28.8% in product shipments to specialty markets and growth in the average number of stores in operation to 324 in fiscal 2008 from 310 in fiscal 2007. Same store pounds purchased in fiscal 2008 were down approximately 9% from fiscal 2007, more than offsetting the increase in the average number of franchised stores in operation and mostly offsetting the increase in specialty market sales. The Company believes the decrease in same store pounds purchased is due primarily to a product mix shift from factory products to products made in the stores and softening in the retail sector of the economy.

Retail Sales

The decrease in retail sales resulted primarily from a decrease in the average number of Company-owned stores in operation from 8 in fiscal 2007 to 5 in fiscal 2008. Same store sales at Company-owned stores increased 1.1% from fiscal 2007 to fiscal 2008.

Royalties, Marketing Fees and Franchise Fees

The increase in royalties and marketing fees resulted from growth in the average number of domestic units in operation from 266 in fiscal 2007 to 281 in fiscal 2008 partially offset by a decrease in same store sales of 0.9%. Franchise fee revenues decreased due to a decrease in the number of franchises sold during the same period last year.

Costs and Expenses

| ($ s in thousands) | 2008 | 2007 | Change | % Change |
|---|---|---|---|---|
| Cost of sales factory adjusted | $15,948.7 | $14,942.9 | $1,005.8 | 6.7% |
| Cost of sales retail | 729.8 | 1,045.7 | (315.9) | (30.2%) |
| Franchise costs | 1,498.7 | 1,570.0 | (71.3) | (4.5%) |
| Sales and marketing | 1,503.2 | 1,538.5 | (35.3) | (2.3%) |
| General and administrative | 2,505.7 | 2,538.7 | (33.0) | (1.3%) |
| Retail operating | 994.8 | 1,502.1 | (507.3) | (33.8%) |
| Total | $23,180.9 | $23,137.9 | $ 43.0 | 0.2% |

Adjusted Gross margin

| ($ s in thousands) | 2008 | 2007 | Change | % Change |
|---|---|---|---|---|
| Factory adjusted gross margin | $7,809.5 | $7,766.1 | $ 43.4 | 0.6% |
| Retail | 1,070.2 | 1,581.0 | (510.8) | (32.3%) |
| Total | $8,879.7 | $9,347.1 | $(467.4) | (5.0%) |
| | | | | |
| (Percent) | | | | |
| Factory adjusted gross margin | 32.9% | 34.2% | (1.3%) | (3.8%) |
| Retail | 59.5% | 60.2% | (0.7%) | (1.2%) |
| Total | 34.7% | 36.9% | (2.2%) | (6.0%) |

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

such as gross margin. The following table provides a reconciliation of adjusted gross margin to gross margin, the most comparable performance measure under GAAP:

| ($ s in thousands) | 2008 | 2007 |
| --- | --- | --- |
| Factory adjusted gross margin | $7,809.5 | $7,766.1 |
| Less: Depreciated and Amortization | 389.3 | 412.6 |
| Factory GAAP gross margin | $7,420.2 | $7,353.5 |

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Cost of Sales

Factory adjusted gross margin declined 130 basis points from fiscal 2007 to fiscal 2008 due primarily to increased costs and mix of product sold during fiscal 2008 versus fiscal 2007. Company-owned store margin declined 70 basis points from fiscal 2007 to fiscal 2008 due primarily to a change in mix of product sold associated with a decrease in the average number of company stores in operation.

Franchise Costs

The decrease in franchise costs is due to lower incentive compensation costs. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 23.7% in fiscal 2008 from 25.2% in fiscal 2007.

Sales and Marketing

The decrease in sales and marketing was due primarily to lower incentive compensation costs.

General and Administrative

The decrease in general and administrative costs is due primarily to lower incentive compensation costs related to Company performance. As a percentage of total revenues, general and administrative expenses decreased to 7.9% in fiscal 2008 compared to 8.0% in fiscal 2007.

Retail Operating Expenses

The decrease in retail operating expenses was due primarily to a decrease in the average number of Company-owned stores during fiscal 2008 versus fiscal 2007. Retail operating expenses, as a percentage of retail sales, decreased from 57.2% in fiscal 2007 to 55.3% in fiscal 2008 due to a larger decrease in costs relative to the decrease in revenues associated with a decrease in the average number of Company stores in operation.

Depreciation and Amortization

Depreciation and amortization of $783,000 in fiscal 2008 decreased 10.4% from $874,000 incurred in fiscal 2007 due to the sale or closure of four Company-owned stores and certain assets becoming fully depreciated.

Other, Net

Other, net of $101,000 realized in fiscal 2008 represents an increase of $34,000 from the $67,000 realized in fiscal 2007, due primarily to higher average outstanding balances of invested cash during fiscal 2008. Notes receivable balances and related interest income declined in fiscal 2008 because of two notes maturing or being paid in full compared with fiscal 2007. The Company also incurred interest expense related to use of an operating line of credit.

Income Tax Expense

The Company s effective income tax rate in fiscal 2008 was 38.1% which is an increase of 0.3% compared to fiscal 2007. The increase in the effective tax rate is primarily due to increased income in states with higher income tax rates. In July 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company adopted FIN 48 effective March 1, 2007 with no impact on the Company s financial statements.

**Fiscal 2007 Compared To Fiscal 2006**

Results Summary

Basic earnings per share increased 18.5% from $.62 in fiscal 2006 to $.74 in fiscal 2007. Revenues increased 12.5% from fiscal 2006 to fiscal 2007. Operating income increased 17.1% from $6.5 million in fiscal 2006 to $7.6 million in fiscal 2007. Net income increased 16.7% from $4.1 million in fiscal 2006 to $4.7 million in fiscal 2007. The increase in revenue, earnings per share, operating income, and net income in fiscal 2007 compared to fiscal 2006 was due primarily to increased number of franchised stores in operation, increased sales to speciality

markets and the corresponding increases in revenue.

Revenues

| ($ s in thousands) | 2007 | 2006 | Change | % Change |
|---|---|---|---|---|
| Factory sales | $22,709.0 | $19,297.2 | $3,411.8 | 17.7% |
| Retail sales | 2,626.7 | 3,046.0 | (419.3) | (13.8%) |
| Royalty and marketing fees | 5,603.8 | 5,047.9 | 555.9 | 11.0% |
| Franchise fees | 633.8 | 682.5 | (48.7) | (7.1%) |
| Total | $31,573.3 | $28,073.6 | $3,499.7 | 12.5% |

Factory Sales

The increase in factory sales was due to the growth in the average number of franchised stores in operation to 302 in fiscal 2007 from 285 in fiscal 2006 and an increase of 53.3% in sales to specialty markets. Partially offsetting this increase was a 2.6% decrease in same store pounds purchased from the factory by franchised stores when compared to the same period in the prior year. The Company believes that this same store pounds decrease reflects an unseasonably hot summer in many regions of the country. Historically, retail sales of chocolate products suffer when weather conditions are unusually hot in particular markets.

Retail Sales

The decrease in retail sales resulted primarily from a decrease in the average number of Company-owned stores in operation from 9 in fiscal 2006 to 7 in fiscal 2007. Same store sales at Company-owned stores increased 6.9% from fiscal 2006 to fiscal 2007.

Royalties, Marketing Fees and Franchise Fees

The increase in royalties and marketing fees resulted from growth in the average number of domestic units in operation from 251 in fiscal 2006 to 266 in fiscal 2007 plus an increase in same store sales of 0.3%. Franchise fee revenues decreased due to a decrease in the number of franchises sold during the same period last year.

Costs and Expenses

| ($ s in thousands) | 2007 | 2006 | Change | % Change |
|---|---|---|---|---|
| Cost of sales factory adjusted | $14,942.9 | $12,732.3 | $2,210.6 | 17.4% |
| Cost of sales retail | 1,045.7 | 1,224.3 | (178.6) | (14.6%) |
| Franchise costs | 1,570.0 | 1,466.3 | 103.7 | 7.1% |
| Sales and marketing | 1,538.5 | 1,321.0 | 217.5 | 16.5% |
| General and administrative | 2,538.7 | 2,239.1 | 299.6 | 13.4% |
| Retail operating | 1,502.1 | 1,755.7 | (253.6) | (14.4%) |
| Total | $23,137.9 | $20,738.7 | $2,399.2 | 11.6% |

Adjusted Gross margin

| ($ s in thousands) | 2007 | 2006 | Change | % Change |
|---|---|---|---|---|
| Factory adjusted gross margin | $7,766.1 | $6,564.9 | $1,201.2 | 18.3% |
| Retail | 1,581.0 | 1,821.7 | (240.7) | (13.2%) |
| Total | $9,347.1 | $8,386.6 | $ 960.5 | 11.5% |
| | | | | |
| (Percent) | | | | |
| Factory adjusted gross margin | 34.2% | 34.0% | 0.2% | 0.6% |
| Retail | 60.2% | 59.8% | 0.4% | 0.7% |
| Total | 36.9% | 37.5% | (0.6%) | (1.6%) |

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

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

Due to these limitations, we use adjusted gross margin as a measure of performance only in conjunction with GAAP measures of performance such as gross margin. The following table provides a reconciliation of adjusted gross margin to gross margin, the most comparable performance measure under GAAP:

| ($ s in thousands) | 2007 | 2006 |
|---|---|---|
| Factory adjusted gross margin | $7,766.1 | $6,564.9 |
| Less: Depreciated and Amortization | 412.6 | 381.1 |
| Factory GAAP gross margin | $7,353.5 | $6,183.8 |

Cost of Sales

Factory margins were consistent from fiscal 2006 to fiscal 2007. Higher commodity and labor costs were offset by increased production volume, which lowered fixed costs per unit of production. Increases in Company-owned store margin is due to changes in mix of product sold.

Franchise Costs

The increase in franchise costs is due to increased professional fees and incentive compensation costs. As a percentage of total royalty and marketing fees and franchise fee revenue, franchise costs decreased to 25.2% in fiscal 2007 from 25.6% in fiscal 2006. 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 incentive compensation costs and expenses related to a 53.3% increase in sales to specialty markets.

General and Administrative

The increase in general and administrative costs is due primarily to increased incentive compensation costs related to Company performance. As a percentage of total revenues, general and administrative expenses were unchanged at 8.0% in fiscal 2007 compared to 8.0% in fiscal 2006.

Retail Operating Expenses

The decrease in retail operating expenses was due primarily to a decrease in the average number of Company-owned stores during fiscal 2007 versus fiscal 2006. Retail operating expenses, as a percentage of retail sales, decreased from 57.6% in fiscal 2006 to 57.2% in fiscal 2007 due to a larger decrease in costs relative to the increase in revenues.

Depreciation and Amortization

Depreciation and amortization of $874,000 in fiscal 2007 was essentially unchanged from the $876,000 incurred in fiscal 2006.

Other, Net

Other, net of $67,000 realized in fiscal 2007 represents a decrease of $9,000 from the $76,000 realized in fiscal 2006, due primarily to lower interest income on lower average outstanding balances of notes receivable and invested cash. Notes receivable balances are declining due to payments and the Company has been using its excess cash to repurchase stock. The Company also incurred less interest expense on lower average balances of long-term debt. The Company paid its long-term debt in full during the first quarter of fiscal 2006.

Income Tax Expense

The Company s effective income tax rate in fiscal 2007 was 37.8%, which is the same as the effective rate in fiscal 2006.

**Liquidity and Capital Resources**

As of February 29, 2008, working capital was $5.2 million compared with $7.5 million as of February 28, 2007. The change in working capital was due primarily to operating results less the payment of $2.4 million in cash dividends and the repurchase and retirement of $5.9 million of the Company s common stock.

Cash and cash equivalent balances decreased from $2.8 million as of February 28, 2007 to $676,000

as of February 29, 2008 as a result of cash flows generated by operating and investing activities being less than cash flows used in financing activities. The Company s current ratio was 2.35 to 1 at February 29, 2008 in comparison with 3.30 to 1 at February 28, 2007. 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 $4.7 million was available (subject to certain borrowing base limitations) as of February 29, 2008, secured by substantially all of the Company s assets except retail store assets. The credit line is subject to renewal in July, 2008.

The table below presents significant contractual obligations of the Company at February 29, 2008.

| (Amounts in thousands)<br>Contractual Obligations | Less than 1 year | 1-3 Years | 4-5 years | After 5 years | Total |
|---|---|---|---|---|---|
| Line of credit | 300 | | | | 300 |
| Notes payable | | | | | |
| Operating leases | 418 | 621 | 203 | 52 | 1,294 |
| Other long-term obligations | 87 | 141 | 150 | 386 | 764 |
| Total Contractual cash obligations | 805 | 762 | 353 | 438 | 2,358 |

For fiscal 2009, the Company anticipates making capital expenditures of approximately $500,000, 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 2009. 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 September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS 157 establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurement. SFAS 157 also creates consistency and comparability in fair value measurements among the many accounting pronouncements that require fair value measurements but does not require any new fair value measurements. SFAS 157 is effective for fiscal years (including interim periods) beginning after November 15, 2007. The Company will adopt SFAS No. 157 in fiscal 2009 and does not expect it to have a significant impact on the Company s financial statements.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. This standard amends SFAS 115, Accounting for Certain

Investment in Debt and Equity Securities, with respect to accounting for a transfer to the trading category for all entities with available-for-sale and trading securities electing the fair value option. This standard allows companies to elect fair value accounting for many financial instruments and other items that currently are not required



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to be accounted as such, allows different applications for electing the option for a single item or groups of items, and requires disclosures to facilitate comparisons of similar assets and liabilities that are accounted for differently in relation to the fair value option. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt SFAS No. 159 in fiscal 2009 and does not expect it to have a significant impact on the Company s financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, which replaces FASB Statement No. 141. SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non controlling interest in the acquiree and the goodwill acquired. The Statement also establishes disclosure requirements which will enable users to evaluate the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity s fiscal year that begins after December 15, 2008 (Fiscal 2010). The Company is in the process of evaluating the potential impact, if any, of the adoption of SFAS No. 141R.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51, which establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. The Statement also establishes reporting requirements that provide sufficient disclosures that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No.160 is effective as of the beginning of an entity s fiscal year that begins after December 15, 2008 (Fiscal 2010). The Company is in the process of evaluating the potential impact, if any, of the adoption of SFAS No. 160.

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## 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 29, 2008, $300,000 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
To the Board of Directors and Stockholders of
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 29, 2008 and February 28, 2007, and the related statements of income, changes in stockholders equity and cash flows for each of the three years in the period ended February 29, 2008. Our audits also included the financial statement schedule II for each of the three years in the period ended February 29, 2008. We also have audited the Company s internal control over financial reporting as of February 29, 2008, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying *Management s Annual Report on Internal Control Over Financial Reporting*, included in item 9A. Our responsibility is to express an opinion on these financial statements and an opinion on the effectiveness of the Company s internal control over financial reporting 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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 accounting principles generally accepted in the United States. 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of February 29, 2008 and February 28, 2007, and the results of its operations and its cash flows for each of the three years in the period ended February 29, 2008 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule II for each of the three years in the period ended February 29, 2008, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein. Also in our opinion, the Company maintained in all material respects, effective internal control over financial reporting as of February 29, 2008 based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ).

Ehrhardt Keefe Steiner & Hottman PC
May 14, 2008
Denver, Colorado



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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
STATEMENTS OF INCOME

| | FOR THE YEARS ENDED FEBRUARY 28 OR 29 | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| **Revenues** | | | |
| Sales | $25,558,198 | $25,335,739 | $22,343,209 |
| Franchise and royalty fees | 6,319,985 | 6,237,594 | 5,730,403 |
| Total revenues | 31,878,183 | 31,573,333 | 28,073,612 |
| **Costs and Expenses** | | | |
| Cost of sales, exclusive of depreciation and amortization expense of $389,273, $412,546 and $381,141, respectively | 16,678,472 | 15,988,620 | 13,956,550 |
| Franchise costs | 1,498,709 | 1,570,026 | 1,466,322 |
| Sales & marketing | 1,503,224 | 1,538,476 | 1,320,979 |
| General and administrative | 2,505,676 | 2,538,667 | 2,239,109 |
| Retail operating | 994,789 | 1,502,134 | 1,755,738 |
| Depreciation and amortization | 782,951 | 873,988 | 875,940 |
| Total costs and expenses | 23,963,821 | 24,011,911 | 21,614,638 |
| **Operating Income** | 7,914,362 | 7,561,422 | 6,458,974 |
| **Other Income (Expense)** | | | |
| Interest expense | (1,566) | | (19,652) |
| Interest income | 102,360 | 67,071 | 95,360 |
| Other, net | 100,794 | 67,071 | 75,708 |
| **Income Before Income Taxes** | 8,015,156 | 7,628,493 | 6,534,682 |
| **Income Tax Expense** | 3,053,780 | 2,883,575 | 2,470,110 |
| **Net Income** | $ 4,961,376 | $ 4,744,918 | $ 4,064,572 |
| **Basic Earnings per Common Share** | $ .78 | $ .74 | $ .62 |
| **Diluted Earnings per Common Share** | $ .76 | $ .71 | $ .58 |
| **Weighted Average Common Shares Outstanding** | 6,341,286 | 6,432,123 | 6,581,612 |
| **Dilutive Effect of Employee Stock Options** | 159,386 | 227,350 | 427,780 |
| **Weighted Average Common Shares Outstanding, Assuming Dilution** | 6,500,672 | 6,659,473 | 7,009,392 |

The accompanying notes are an integral part of these statements.

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
BALANCE SHEETS

| | AS OF FEBRUARY 28 or 29 | |
|---|---|---|
| | 2008 | 2007 |
| **Assets** | | |
| **Current Assets** | | |
| Cash and cash equivalents | $ 675,642 | $ 2,830,175 |
| Accounts receivable, less allowance for doubtful accounts of $114,271 and $187,519, respectively | 3,801,172 | 3,756,212 |
| Notes receivable | 22,435 | 50,600 |
| Refundable income taxes | 63,357 | |
| Inventories, less reserve for slow moving inventory of $194,719 and $147,700, respectively | 4,015,459 | 3,482,139 |
| Deferred income taxes | 117,846 | 272,871 |
| Other | 267,184 | 367,420 |
| Total current assets | 8,963,095 | 10,759,417 |
| | | |
| **Property and Equipment, Net** | 5,665,108 | 5,754,122 |
| | | |
| **Other Assets** | | |
| Notes receivable | 205,916 | 310,453 |
| Goodwill, net | 939,074 | 939,074 |
| Intangible assets, net | 276,247 | 349,358 |
| Other | 98,020 | 343,745 |
| Total other assets | 1,519,257 | 1,942,630 |
| | | |
| Total assets | $16,147,460 | $18,456,169 |
| **Liabilities and Stockholders Equity** | | |
| **Current Liabilities** | | |
| Line of Credit | $ 300,000 | $ |
| Accounts payable | 1,710,380 | 898,794 |
| Accrued salaries and wages | 430,498 | 931,614 |
| Other accrued expenses | 467,543 | 585,402 |
| Dividend payable | 599,473 | 551,733 |
| Deferred income | 303,000 | 288,500 |
| Total current liabilities | 3,810,894 | 3,256,043 |
| | | |
| **Deferred Income Taxes** | 681,529 | 685,613 |
| | | |
| **Commitments and Contingencies** | | |
| **Stockholders Equity** | | |
| Common stock, $.03 par value; 100,000,000 shares authorized; 100,000,000 and 5,980,919, 6,418,905 shares issued and outstanding, respectively | 179,428 | 192,567 |
| Additional paid-in capital | 7,047,142 | 6,987,558 |
| Retained earnings | 4,428,467 | 7,334,388 |
| Total stockholders equity | 11,655,037 | 14,514,513 |

| | | |
|---|---|---|
| Total liabilities and stockholders equity | $16,147,460 | $18,456,169 |

The accompanying notes are an integral part of these statements.

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

| | FOR THE YEARS ENDED FEBRUARY 28 or 29 | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| **Common Stock** | | | |
| Balance at beginning of year | $ 192,567 | $ 197,881 | $ 193,301 |
| Repurchase and retirement of common stock | (14,518) | (9,822) | (6,119) |
| Issuance of common stock | | 26 | 55 |
| Exercise of stock options and other | 1,379 | 4,482 | 10,644 |
| Balance at end of year | 179,428 | 192,567 | 197,881 |
| | | | |
| **Additional Paid-In Capital** | | | |
| Balance at beginning of year | 6,987,558 | 10,363,107 | 11,041,971 |
| Repurchase and retirement of common stock | (5,918,087) | (4,371,268) | (2,952,323) |
| Stock dividends declared | 5,415,148 | | |
| Costs related to stock splits and dividends | (9,647) | | (8,902) |
| Issuance of common stock | | 15,797 | 37,444 |
| Exercise of stock options and other | 388,290 | 819,992 | 1,062,085 |
| Tax benefit from employee stock transactions | 183,880 | 159,930 | 1,182,830 |
| Balance at end of year | 7,047,142 | 6,987,558 | 10,363,107 |
| | | | |
| **Retained Earnings** | | | |
| Balance at beginning of year | 7,334,388 | 4,924,830 | 2,658,298 |
| Net income | 4,961,376 | 4,744,918 | 4,064,572 |
| Stock dividends declared | (5,415,148) | | |
| Cash dividends declared | (2,452,149) | (2,078,208) | (1,798,040) |
| Adoption of SAB 108 | | (257,152) | |
| Balance at end of year | 4,428,467 | 7,334,388 | 4,924,830 |
| | | | |
| **Total Stockholders Equity** | $11,655,037 | $14,514,513 | $15,485,818 |
| | | | |
| **Common Shares** | | | |
| Balance at beginning of year | 6,418,905 | 6,596,016 | 6,443,354 |
| Repurchase and retirement of common stock | (483,935) | (327,390) | (203,958) |
| Issuance of common stock | | 876 | 1,840 |
| Exercise of stock options and other | 45,949 | 149,403 | 354,780 |
| Balance at end of year | 5,980,919 | 6,418,905 | 6,596,016 |

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 | | |
|---|---|---|---|
| | 2008 | 2007 | 2006 |
| **Cash Flows From Operating Activities:** | | | |
| Net income | $ 4,961,376 | $ 4,744,918 | $ 4,064,572 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 782,951 | 873,988 | 875,940 |
| Provision for loss on accounts receivable | 75,000 | 70,000 | |
| Provision for inventory loss | 90,000 | 70,000 | 45,000 |
| Loss on sale of assets | 34,744 | 101 | 37,411 |
| Expense recorded for stock options | 58,355 | 201,269 | |
| Deferred income taxes | 150,941 | (133,432) | 4,195 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (117,460) | (711,456) | (445,921) |
| Refundable income taxes | (63,357) | | 364,630 |
| Inventories | (623,320) | (613,905) | (461,207) |
| Other assets | 76,891 | 104,843 | (236,640) |
| Accounts payable | 811,586 | (246,616) | 56,934 |
| Income taxes payable | (167,965) | (33,729) | (824,860) |
| Accrued liabilities | (449,784) | 452,255 | 602,187 |
| Deferred income | 14,500 | 5,000 | |
| Net cash provided by operating activities | 5,634,458 | 4,783,236 | 4,082,241 |
| **Cash Flows From Investing Activities:** | | | |
| Additions to notes receivable | | (124,452) | |
| Proceeds received on notes receivable | 132,702 | 211,143 | 345,442 |
| Proceeds (expense) from sale or distribution of assets | 29,382 | 434,335 | (4,395) |
| Decrease in other assets | 158,826 | (134,221) | 15,748 |
| Purchase of property and equipment | (578,433) | (201,037) | (1,300,314) |
| Net cash provided by (used in) investing activities | (257,523) | 185,768 | (943,519) |
| **Cash Flows From Financing Activities:** | | | |
| Net change in line of credit | 300,000 | | |
| Payments on long-term debt | | | (1,665,084) |
| Costs of stock split or dividend | (9,647) | | (8,902) |
| Issuance of common stock | 331,313 | 623,206 | 1,072,729 |
| Tax benefit of stock option exercise | 183,880 | 159,930 | 1,182,830 |
| Repurchase and redemption of common stock | (5,932,605) | (4,381,090) | (2,958,441) |
| Dividends paid | (2,404,409) | (2,030,625) | (1,710,980) |
| Net cash used in financing activities | (7,531,468) | (5,628,579) | (4,087,848) |
| **Net Decrease In Cash And Cash Equivalents** | (2,154,533) | (659,575) | (949,126) |
| **Cash And Cash Equivalents At Beginning Of Year** | 2,830,175 | 3,489,750 | 4,438,876 |
| **Cash And Cash Equivalents At End Of Year** | $ 675,642 | $ 2,830,175 | $ 3,489,750 |

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, 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 29, 2008:

| | Sold, Not Yet Open | Open | Total |
|---|---|---|---|
| Company owned stores | | 5 | 5 |
| Franchise stores Domestic stores | 14 | 266 | 280 |
| Franchise stores Domestic kiosks | | 18 | 18 |
| Franchise stores International | | 41 | 41 |

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 $257,000 at February 29, 2008.

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 29, 2008, the Company has $228,000 of notes receivable outstanding. The notes require monthly payments and bear interest at rates ranging from 8.0% to 8.5%. The notes mature through February 2012 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

NOTE 1 NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

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.

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.

Sales

Sales of products to franchisees and other customers are recognized at the time of delivery. 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 for inventory are reported as cost of sales or inventory.

Franchise and Royalty Fees

Franchise fee revenue is recognized upon opening of the franchise store. Also see Note 14 to these financial statements. In addition to the initial franchise fee, The Company also recognizes a marketing and promotion fee of one percent (1%) of the Rocky Mountain Chocolate Factory franchised stores gross retail sales and a royalty fee based on gross retail sales. Beginning with franchise store openings in the third quarter of fiscal year 2004, the Company modified its royalty structure. Under the current structure, the Company recognizes no royalty on franchised stores retail sales of products purchased from the Company and recognizes a ten percent (10%) royalty on all other sales of product sold at franchise locations. For franchise stores opened prior to the third quarter of fiscal 2004 the Company recognizes a royalty fee of five percent (5%) of franchised stores gross retail 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 29, 2008, the Company had notes receivable of approximately $228,000 due from two 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

At February 29, 2008, the Company had stock-based compensation plans for employees and nonemployee directors which authorized the granting of stock options.

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

Effective March 1, 2006, the Company adopted the recognition provisions of Statement of Financial Accounting Standard No. 123R, Share-Based Payment ( SFAS No. 123R ), using the

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NOTE 1 NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES CONTINUED

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

The Company recognized $33,198 related equity-based compensation expense during the year ended February 29, 2008. Compensation costs related to share-based compensation are generally amortized over the vesting period in selling, general and administrative expenses in the statement of operations.

On February 21, 2006, the Company accelerated the vesting of all outstanding stock options and recognized a share-based compensation charge related to this acceleration. The Company recognized an additional share-based compensation charge of $25,158 for the year ended February 29, 2008 related to this acceleration due to changes in certain estimates and assumptions related to employee turnover since the acceleration date. Adjustments in future periods may be necessary as actual results could differ from these estimates and assumptions.

Prior to adopting SFAS No. 123R, the Company presented all benefits from tax deductions arising from equity-based compensation as a non-cash transaction in the Statement of Cash Flows. SFAS No. 123R requires that the tax benefits in excess of the compensation cost recognized for those exercised options be classified as cash provided by financing activities. The excess tax benefit included in net cash provided by financing activities for the years ended February 28 or 29, 2008, 2007 and 2006 was $183,880, $159,930 and $1,182,830 respectively.

The weighted-average fair value of stock options granted during the years ended February 28, 29, 2008 and 2007 was $2.69 and $0 per share, respectively. As of February 29, 2008, there was $0 of unrecognized compensation cost related to non-vested share-based compensation.

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Net Income as reported | $4,961 | $4,745 | $4,065 |
| 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) |
| Net Income pro forma | 4,961 | 4,745 | 3,432 |
| Basic Earnings per Share-as reported | .78 | .74 | .62 |
| Diluted Earnings per Share-as reported | .76 | .71 | .58 |
| Basic Earnings per Share-pro forma | .78 | .74 | .52 |
| Diluted Earnings per Share-pro forma | .76 | .71 | .49 |

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 2008, 2007 and 2006, 136,119, 140,389, and 144,186 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 $261,663, $308,052, and $354,367 for the fiscal years ended February 28 or 29, 2008, 2007 and 2006, 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.

Reclassifications

Certain reclassifications have been made to the prior years financial statements in order to conform to the current year presentation.

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NOTE 2 INVENTORIES

Inventories consist of the following at February 28 or 29:

| | 2008 | 2007 |
|---|---|---|
| Ingredients and supplies | $1,985,929 | $1,730,850 |
| Finished candy | 2,029,530 | 1,751,289 |
| | $4,015,459 | $3,482,139 |

NOTE 3 PROPERTY AND EQUIPMENT, NET

Property and equipment consists of the following at February 28 or 29:

| | 2008 | 2007 |
|---|---|---|
| Land | $ 513,618 | $ 513,618 |
| Building | 4,717,230 | 4,717,230 |
| Machinery and equipment | 6,855,408 | 6,284,433 |
| Furniture and fixtures | 699,473 | 673,194 |
| Leasehold improvements | 428,937 | 418,764 |
| Transportation equipment | 350,714 | 350,714 |
| | 13,565,380 | 12,957,953 |
| Less accumulated depreciation | 7,900,272 | 7,203,831 |
| Property and equipment, net | $ 5,665,108 | $ 5,754,122 |

NOTE 4 LINE OF CREDIT AND LONG-TERM DEBT

Line of Credit

At February 29, 2008 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 (5.50% at February 29, 2008). At February 29, 2008, $4.7 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 29, 2008 the Company was in compliance with all such covenants. The credit line is subject to renewal in July, 2008.

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 five 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:

| | |
|---|---|
| 2009 | $159,000 |
| 2010 | 207,000 |
| 2011 | 171,000 |
| 2012 | 100,000 |
| 2013 | 103,000 |
| Thereafter | 52,000 |
| Total | $792,000 |

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

| | |
|---|---|
| 2009 | $ 87,300 |
| 2010 | 69,700 |
| 2011 | 71,800 |
| 2012 | 73,900 |
| 2013 | 76,100 |
| Thereafter | 386,300 |
| | $765,100 |

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Minimum rentals | $ 336,859 | $ 438,797 | $ 611,535 |
| Less sublease rentals | (100,900) | (108,200) | (239,300) |
| Contingent rentals | 22,476 | 26,640 | 23,921 |
| | $ 258,435 | $ 357,237 | $ 396,156 |

In fiscal year 2008 the Company entered into an operating lease for warehouse space in the immediate vicinity of its manufacturing operation. The following is a schedule, by year, of future minimum rental payments required under such lease for the years ending February 28 or 29:

| | |
|---|---|
| 2009 | $102,000 |
| 2010 | 102,000 |
| 2011 | 34,000 |
| | $238,000 |

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:

| | |
|---|---|
| 2009 | $157,000 |
| 2010 | 58,200 |
| 2011 | 48,500 |
| | $263,700 |

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

| 2008 | 2007 | 2006 |
|---|---|---|
| 222,682 | 187,599 | 308,719 |

Purchase contracts

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 $1,825,517 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.

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NOTE 6 INCOME TAXES

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

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Current | | | |
| Federal | $2,435,496 | $2,533,401 | $2,147,826 |
| State | 467,342 | 483,605 | 318,089 |
| Total Current | 2,902,838 | 3,017,007 | 2,465,915 |
| | | | |
| Deferred | | | |
| Federal | 131,776 | (120,018) | 3,774 |
| State | 19,166 | (13,414) | 421 |
| Total Deferred | 150,942 | (133,432) | 4,195 |
| Total | $3,053,780 | $2,883,575 | $2,470,110 |

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:

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Statutory rate | 34.0% | 34.0% | 34.0% |
| State income taxes, net of federal benefit | 4.0% | 4.1% | 3.2% |
| Other | 0.1% | (0.3%) | .6% |
| Effective Rate | 38.1% | 37.8% | 37.8% |

The components of deferred income taxes at February 28 or 29 are as follows:

| | 2008 | 2007 |
|---|---|---|
| Deferred Tax Assets | | |
| Allowance for doubtful accounts and notes | $ 43,538 | $ 70,882 |
| Inventories | 74,188 | 55,831 |
| Accrued compensation | 34,512 | 42,701 |
| Loss provisions and deferred income | | 143,925 |
| Self insurance accrual | 20,214 | 15,368 |
| Amortization, design costs | 74,649 | 67,208 |
| | 247,101 | 395,915 |
| Deferred Tax Liabilities | | |
| Depreciation and amortization | (803,066) | (808,657) |
| Loss provisions and deferred income | (7,718) | |
| Net deferred tax liability | $ (563,683) | $ (412,742) |
| | | |
| Current deferred tax assets | $ 117,846 | $ 272,871 |
| Non-current deferred tax liabilities | (681,529) | (685,613) |
| Net deferred tax liability | $ (563,683) | $ (412,742) |

The Company files income tax returns in the U.S. federal and various state taxing jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal and state tax examinations in its major tax jurisdictions for periods before fiscal year 2004.

Realization of the Company s deferred tax assets is dependent upon the Company generating sufficient taxable income, in the appropriate tax jurisdictions, in future years to obtain benefit from the reversal of net deductible temporary differences. The amount of deferred tax assets considered realizable is subject to adjustment in future periods if estimates of future taxable income are changed. Management believes that it is more likely than not that the Company will realize the benefits of its deferred tax assets as of February 29, 2008.

In July 2006, the FASB issued Interpretation 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. The interpretation applies to all tax positions accounted for in accordance with Statement 109 and requires a more-likely-than-not recognition threshold. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. Subsequent recognition, derecognition, and measurement is based on management s best judgment given the facts, circumstances and information available at the reporting date. FIN 48 is effective for fiscal years beginning after December 15, 2006. Early adoption is permitted as of the beginning of an enterprise s fiscal year, provided the enterprise has not yet issued financial statements, including financial statements for any interim period, for that fiscal year. The Company adopted FIN No. 48 as of March 1, 2007. The adoption of FIN 48 did not have a material impact on the Company s balance sheet or statement of income.

The Company does not have any significant unrecognized tax benefits and does not anticipate a significant increase or decrease in unrecognized tax benefits within the next twelve months. Amounts are recognized for income tax related interest and penalties as a component of general and administrative expense in the statement of income and are immaterial for years ended February 29, 2008 and February 28, 2007.

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NOTE 7 STOCKHOLDERS EQUITY

Stock Issuance

In March 2006, the Company issued 584 shares of stock, valued at $12,500, for partial payment of certain sales services for one year. In June 2006 the Company issued 250 shares of stock valued at $3,322 for franchise recognition at the Company s National Convention.

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 July 10, 2007 the Board of Directors declared a 5 percent stock dividend payable on July 31, 2007 to shareholders of record as of July 20, 2007. Shareholders received one additional share of Common Stock for every twenty shares owned prior to the record date. Subsequent to the dividend there were 6,380,945 shares outstanding.

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.

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.

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 January 9, 2008 and February 8, 2008, the Company repurchased 391,600 shares at an average price of $11.94. Between August 15, 2007 and August 28, 2007, the Company repurchased 16,000 shares at an average price of $15.96 per share. Between March 1, 2007 and May 15, 2007 the Company repurchased 76,335 shares at an average price of $13.12 per share. Between May 1, 2006 and February 28, 2007 the Company repurchased 253,141 shares at an average price of $12.94 per share. Between March 24, 2006 and April 28, 2006 the Company repurchased 74,249 shares at an average price of $14.90 per share. Between October 7, 2005 and February 3, 2006 the Company repurchased 185,429 Company shares at an average price of $14.63 per share. Between April 18 and April 20, 2005, the Company repurchased 18,529 Company shares at an average price of $13.28 per share.

Cash Dividend

The Company paid a quarterly cash dividend of $0.0643 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 $0.0667 per common share on December 16, 2005 to shareholders of record on December 1, 2005. The Company paid a quarterly cash dividend of $0.0762 per common share on March 16, 2006, June 16, 2006 and September 16, 2006 to shareholders of record on March 8, 2006, June 2, 2006 and September 1, 2006, respectively. The Company paid a quarterly cash dividend of $0.0857 per common share on December 15, 2006 and March 16, 2007 to shareholders of record on December 1, 2006 and March 2, 2007. The Company paid a quarterly cash dividend of $0.0952 per common share on June 15, 2007 to shareholders of record on June 1, 2007. The Company paid a quarterly cash dividend of $0.0950 per common share on September 14, 2007 to shareholders of record on September 4, 2007. The Company paid a quarterly cash dividend of $0.10 per common share on December 14, 2007 and March 14, 2008 to shareholders of record on December 3, 2007 and February 29, 2008.

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

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NOTE 8 STOCK OPTION PLANS

In fiscal 2008 shareholders approved the 2007 Equity Incentive Plan (the 2007 Plan ). The 2007 Plan allows awards of stock options; stock appreciation rights; stock awards, restricted stock, and stock units; performance shares and performance units; other stock or cash based awards. As of February 29, 2008, no awards had been made under the 2007 Plan and 391,325 shares of common stock is available for award under the plan consisting of 300,000 shares originally authorized, 85,340 previously reserved for issuance under earlier plans and 5,985 shares forfeited under suspended 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 970,200, 441,000, 279,720 and 299,060 shares, respectively, of the Company s common stock were previously authorized to 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 68,875, 292,446, 0 and 38,808 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 29, 2008. 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:

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Expected dividend yield | 2.60% | n/a | 2.18% |
| Expected stock price volatility | 20% | n/a | 30% |
| Risk-free interest rate | 4.69% | n/a | 4.5% |
| Expected life of options | 5 years | n/a | 5 years |

Information with respect to options outstanding under the Plans at February 29, 2008, and changes for the three years then ended was as follows:

| | 2008 | |
|---|---|---|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 440,041 | $ 9.80 |
| Granted | 12,936 | 13.16 |
| Exercised | (45,813) | 7.23 |
| Forfeited | (7,035) | 18.69 |
| Outstanding at end of year | 400,129 | $ 10.05 |
| | | |
| Options exercisable at February 29, 2008 | 400,129 | $ 10.05 |

| | 2007 | |
|---|---|---|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 604,670 | $ 8.61 |
| Granted | | |
| Exercised | (149,404) | 4.17 |
| Forfeited | (15,225) | 17.83 |

| | | |
|---|---|---|
| Outstanding at end of year | 440,041 | $ 9.80 |
| Options exercisable at February 28, 2007 | 440,041 | $ 9.80 |

| | 2006 | |
|---|---|---|
| | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 808,500 | $ 4.47 |
| Granted | 157,122 | 17.28 |
| Exercised | (354,778) | 3.02 |
| Forfeited | (6,174) | 7.41 |
| Outstanding at end of year | 604,670 | 8.61 |
| Options exercisable at February 28, 2006 | 604,670 | $ 8.61 |

Weighted average fair value per share of options granted during 2008, 2007 and 2006 were $2.69, $0 and $3.03, respectively.

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NOTE 8 STOCK OPTION PLANS CONTINUED

Additional information about stock options outstanding at February 29, 2008 is summarized as follows:

| | Options Outstanding | | |
|---|---|---|---|
| Range of exercise prices | Number exercisable | Weighted average remaining contractual life | Weighted average exercise price |
| $1.527 to 3.748 | 68,875 | 4.17 | 3.35 |
| $5.857 to 7.415 | 189,630 | 6.22 | 7.38 |
| $13.162 to 20.571 | 141,624 | 6.76 | 16.87 |

NOTE 9 OPERATING SEGMENTS

The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. The Company has five Company-owned stores. Company-owned stores provide an environment for testing new products and promotions, operating and training methods and merchandising techniques. Company management eval