

ROCKY MOUNTAIN CHOCOLATE FACTORY INC

Form 10-Q

September 27, 2007

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

(Mark One)

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

For the quarterly period ended August 31, 2007

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

For the transition period from _____ to _____

Commission file number 0-14749

Rocky Mountain Chocolate Factory, Inc.

(Exact name of registrant as specified in its charter)

Colorado

(State of incorporation)

84-0910696

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

265 Turner Drive, Durango, CO 81303

(Address of principal executive offices)

(970) 259-0554

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

On September 24, 2007 the registrant had outstanding 6,366,345 shares of its common stock, \$.03 par value.

The exhibit index is located on page 20.

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FORM 10-Q
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Item 1. Financial Statements

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

	Three Months Ended August 31, 2007	2006	Six Months Ended August 31, 2007	2006
Revenues				
Sales	\$5,930,183	\$5,238,115	\$11,842,904	\$10,587,272
Franchise and royalty fees	1,617,896	1,541,454	2,984,060	2,960,709
Total revenues	7,548,079	6,779,569	14,826,964	13,547,981
Costs and Expenses				
Cost of sales, exclusive of depreciation and amortization expense of \$96,957, \$105,575, \$192,077 and \$214,662, respectively	3,605,384	3,166,734	7,394,593	6,503,129
Franchise costs	356,669	384,082	779,268	716,615
Sales and marketing	337,214	353,538	696,084	704,752
General and administrative	649,683	586,429	1,293,742	1,219,314
Retail operating	266,389	403,393	513,193	812,204
Depreciation and amortization	195,702	225,764	387,992	461,445
Total costs and expenses	5,411,041	5,119,940	11,064,872	10,417,459
Income from Operations	2,137,038	1,659,629	3,762,092	3,130,522
Other Income (Expense)				
Interest expense				
Interest income	25,050	12,061	58,543	37,214
Total other, net	25,050	12,061	58,543	37,214
Income Before Income Taxes	2,162,088	1,671,690	3,820,635	3,167,736
Provision for Income Taxes	828,735	631,900	1,455,665	1,197,405
Net Income	\$1,333,353	\$1,039,790	\$ 2,364,970	\$ 1,970,331
Basic Earnings per Common Share	\$.21	\$.16	\$.37	\$.30
Diluted Earnings per Common Share	\$.20	\$.16	\$.36	\$.29
Weighted Average Common Shares				
Outstanding	6,376,445	6,383,031	6,378,587	6,461,292
Dilutive Effect of Stock Options	167,250	228,584	160,778	247,831
Weighted Average Common Shares Outstanding, Assuming Dilution	6,543,695	6,611,615	6,539,365	6,709,123

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

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ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.
BALANCE SHEETS

	August 31, 2007 (unaudited)	February 28, 2007
Assets		
Current Assets		
Cash and cash equivalents	\$ 1,724,168	\$ 2,830,175
Accounts receivable, less allowance for doubtful accounts of \$174,265 and \$187,519 respectively	4,096,082	3,756,212
Notes receivable	39,892	50,600
Inventories, less reserve for slow moving inventory of \$95,856 and \$146,456, respectively	4,696,201	3,482,139
Deferred income taxes	272,871	272,871
Other	495,263	367,420
Total current assets	11,324,477	10,759,417
Property and Equipment, Net	5,734,910	5,754,122
Other Assets		
Notes receivable	295,619	310,453
Goodwill, net	939,074	939,074
Intangible assets, net	312,801	349,358
Other	273,716	343,745
Total other assets	1,821,210	1,942,630
Total assets	\$ 18,880,597	\$ 18,456,169
Liabilities and Stockholders Equity		
Current Liabilities		
Accounts payable	\$ 1,349,822	\$ 898,794
Accrued salaries and wages	426,393	931,614
Other accrued expenses	629,817	585,402
Dividend payable	606,194	551,733
Deferred Income	449,500	288,500
Total current liabilities	\$ 3,461,726	\$ 3,256,043
Deferred Income Taxes	685,613	685,613
Commitments and Contingencies		
Stockholders Equity		
Common stock, \$.03 par value, 100,000,000 shares authorized, 6,366,345 and 6,418,905 issued and outstanding	190,990	192,567
Additional paid-in capital	11,472,410	6,987,558
Retained earnings	3,069,858	7,334,388
Total stockholders equity	14,733,258	14,514,513

Total liabilities and stockholders' equity	\$18,880,597	\$18,456,169
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The accompanying notes are an integral part of these financial statements.

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

	Six Months Ended August 31,	
	2007	2006
Cash Flows From Operating activities		
Net income	\$ 2,364,970	\$ 1,970,331
Adjustments to reconcile net income to net cash Provided by operating activities:		
Depreciation and amortization	387,992	461,445
Provision for obsolete inventory	30,000	30,000
Loss on sale of property and equipment	27,010	76,273
Expense recorded for stock options	58,355	201,269
Changes in operating assets and liabilities:		
Accounts receivable	(339,870)	77,626
Inventories	(1,244,062)	(1,233,100)
Other current assets	(138,951)	(3,596)
Accounts payable	451,028	101,807
Accrued liabilities	(459,580)	61,593
Deferred income	161,000	
Net cash provided by operating activities	1,297,892	1,743,648
Cash Flows From Investing Activities		
Proceeds received on notes receivable	25,542	61,508
Proceeds from sale of assets	29,000	(16,012)
Purchases of property and equipment	(314,967)	(119,640)
Decrease in other assets	6,645	4,667
Net cash used in investing activities	(253,780)	(69,477)
Cash Flows From Financing Activities		
Repurchase and redemption of common stock	(1,256,513)	(3,764,914)
Dividends paid	(1,159,891)	(992,217)
Costs of stock dividend or stock split	(9,647)	
Proceeds from exercise of stock options	275,932	336,257
Net cash used in financing activities	(2,150,119)	(4,420,874)
Net Decrease in Cash and Cash Equivalents	(1,106,007)	(2,746,703)
Cash and Cash Equivalents, Beginning of Period	2,830,175	3,489,750
Cash and Cash Equivalents, End of Period	\$ 1,724,168	\$ 743,047

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

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

NOTE 1 NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of Operations

Rocky Mountain Chocolate Factory, Inc. is an international franchiser, confectionery manufacturer and retail operator in the United States, 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 RMCF stores at August 31, 2007:

	Sold, Not Yet		
	Open	Open	Total
Company owned stores		5	5
Company owned kiosks			
Franchise stores Domestic stores	21	258	279
Franchise stores Domestic kiosks		19	19
Franchise units International		39	39
	21	321	342

Basis of Presentation

The accompanying financial statements have been prepared by the Company, without audit, and reflect all adjustments which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and Securities and Exchange Commission regulations. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect all adjustments (of a normal and recurring nature) which are necessary for a fair presentation of the financial position, results of operations and cash flows for the interim periods presented. The results of operations for the six months ended August 31, 2007 are not necessarily indicative of the results to be expected for the entire fiscal year. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2007.

Stock-Based Compensation

At August 31, 2007, the Company had stock-based compensation plans for employees and nonemployee directors which authorized the granting of stock awards.

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 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

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

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 \$0 and \$33,198 related equity-based compensation expense during the three and six month periods ended August 31, 2007. 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 three months ended August 31, 2007 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. No excess tax benefit was included in net cash provided by financing activities for the second quarter ended August 31, 2007.

The weighted-average fair value of stock options granted during the six-month periods ended August 31, 2007 was \$2.69 and there were no options granted during the six-month period ended August 31, 2006. As of August 31, 2007, there was \$0 of unrecognized compensation cost related to non-vested share-based compensation that is expected to be recognized over the remainder of fiscal 2008.

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:

	Six Months Ended August 31,	
	2007	2006
Expected dividend yield	2.60%	n/a
Expected stock price volatility	20%	n/a
Risk-free interest rate	4.7%	n/a
Expected life of options	5 years	n/a

NOTE 2 EARNINGS PER SHARE

Basic earnings per share is calculated using the weighted average number of common shares outstanding. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through stock options. For the three months ended August 31, 2007 and 2006, 92,010 and 153,888 stock options, respectively, were excluded from the computation of earnings per share because their effect would have been anti-dilutive. For the six months ended August 31, 2007 and 2006, 115,336 and 149,037 stock options, respectively, were excluded from the computation of earnings per share because their effect would have been anti-dilutive.

NOTE 3 INVENTORIES

Inventories consist of the following:

	August 31, 2007	February 28, 2007
Ingredients and supplies	\$1,796,655	\$ 1,730,850
Finished candy	2,899,546	1,751,289
Total inventories	\$4,696,201	\$ 3,482,139

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Property and equipment consists of the following:

	August 31, 2007	February 28, 2007
Land	\$ 513,618	\$ 513,618
Building	4,717,230	4,717,230
Machinery and equipment	6,603,739	6,284,433
Furniture and fixtures	674,804	673,194
Leasehold improvements	422,164	418,764
Transportation equipment	350,714	350,714
	13,282,269	12,957,953
Less accumulated depreciation	7,547,359	7,203,831
Property and equipment, net	5,734,910	\$ 5,754,122

NOTE 5 STOCKHOLDERS EQUITY**Stock Dividend**

On July 9, 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.

All share and per share data have been restated in all periods presented to give effect to the stock dividend.

Stock Repurchases

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 June 30, 2006 and February 28, 2007 the Company repurchased 87,587 shares at an average price of \$13.03 per share. Between March 24, 2006 and May 18, 2006 the Company repurchased 235,424 shares at an average price of \$13.52 per share.

Cash Dividend

The Company paid a quarterly cash dividend of \$0.095 per common share on June 15, 2007 to shareholders of record on June 1, 2007. The Company paid a quarterly cash dividend of \$0.086 per common share on March 16, 2007 to shareholders of record on March 2, 2007. On August 23, 2007 the Company declared a quarterly cash dividend of \$0.095 per common share payable on September 14, 2007 to shareholders of record on September 4, 2007.

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

NOTE 6 SUPPLEMENTAL CASH FLOW INFORMATION

	Six Months Ended August 31,	
	2007	2006
Cash paid (received) for:		
Interest	\$	\$
Income taxes	1,439,875	1,060,033
Non-Cash Financing Activities	\$ 54,461	(\$16,321)
Dividend Payable		

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The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. The Company's retail stores provide an environment for testing consumer behavior, various pricing strategies, new products and promotions, operating and training methods and merchandising techniques. All Company-owned retail stores are evaluated by management in relation to their contribution to franchising efforts and are included in the Franchising segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 to the Company's financial statements included in the Company's annual report on Form 10-K for the year ended February 28, 2007. The Company evaluates performance and allocates resources based on operating contribution, which excludes unallocated corporate general and administrative costs and income tax expense or benefit. The Company's reportable segments are strategic businesses that utilize common merchandising, distribution, and marketing functions, as well as common information systems and corporate administration. All inter-segment sales prices are market based. Each segment is managed separately because of the differences in required infrastructure and the difference in products and services:

	Franchising	Manufacturing	Other	Total
Three Months Ended August 31, 2007				
Total revenues	\$2,124,971	\$ 5,857,010	\$	\$ 7,981,981
Intersegment revenues		(433,902)		(433,902)
Revenue from external customers	2,124,971	5,423,108		7,548,079
Segment profit (loss)	975,062	1,857,466	(670,440)	2,162,088
Total assets	2,355,278	12,475,028	4,050,291	18,880,597
Capital expenditures	5,993	171,928	7,163	185,084
Total depreciation & amortization	48,046	102,299	45,357	195,702
Three Months Ended August 31, 2006				
Total revenues	\$2,272,393	\$ 4,979,486	\$	\$ 7,251,879
Intersegment revenues		(472,310)		(472,310)
Revenue from external customers	2,272,393	4,507,176		6,779,569
Segment profit (loss)	791,766	1,468,867	(588,943)	1,671,690
Total assets	2,735,143	10,979,924	3,270,161	16,985,228
Capital expenditures	9,739	48,098	6,805	64,642
Total depreciation & amortization	61,185	110,954	53,625	225,764
Six Months Ended August 31, 2007				
Total revenues	\$3,895,434	\$11,845,196	\$	\$15,740,630
Intersegment revenues		(913,666)		(913,666)
Revenue from external customers	3,895,434	10,931,530		14,826,964
Segment profit (loss)	1,509,493	3,637,712	(1,326,570)	3,820,635
Total assets	2,355,278	12,475,028	4,050,291	18,880,597
Capital expenditures	5,993	208,990	99,984	314,967
Total depreciation & amortization	95,051	202,796	90,145	387,992
Six Months Ended August 31, 2006				
Total revenues	\$4,335,243	\$10,133,365	\$	\$14,468,608
Intersegment revenues		(920,627)		(920,627)
Revenue from external customers	4,335,243	9,212,738		13,547,981
Segment profit (loss)	1,468,125	2,917,685	(1,218,074)	3,167,736
Total assets	2,735,143	10,979,924	3,270,161	16,985,228

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Capital expenditures	22,803	71,811	25,026	119,640
Total depreciation & amortization	123,687	225,451	112,307	461,445

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Intangible assets consist of the following:

	Amortization Period	August 31, 2007		February 28, 2007	
		Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Intangible assets subject to amortization					
Store design	10 Years	205,777	116,760	205,777	106,204
Packaging licenses	3-5 Years	120,830	106,664	120,830	104,164
Packaging design	10 Years	430,973	241,355	430,973	217,854
Trademark		20,000		20,000	
Total		777,580	464,779	777,580	428,222
Intangible assets not subject to amortization					
Franchising segment- Company stores goodwill		1,011,458	267,020	1,011,458	267,020
Franchising goodwill		295,000	197,682	295,000	197,682
Manufacturing segment-Goodwill		295,000	197,682	295,000	197,682
Total Goodwill		1,601,458	662,384	1,601,458	662,384
Total intangible assets		\$2,379,038	\$1,127,163	\$2,379,038	\$1,090,606

Amortization expense related to intangible assets totaled \$36,556 and \$36,555 during the six months ended August 31, 2007 and 2006, respectively. The aggregate estimated amortization expense for intangible assets remaining as of August 31, 2007 is as follows:

Remainder of fiscal 2008	\$ 36,500
2009	73,100
2010	73,100
2011	64,400
2012	37,700
Thereafter	8,003
Total	\$292,803

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

A Note About Forward-Looking Statements

The following discussion and analysis of the financial condition and results of operations of the Company should be read in conjunction with the unaudited financial statements and related Notes of the Company included elsewhere in this report. The nature of the Company's operations and the environment in which it operates subject it to changing economic, competitive, regulatory and technological conditions, risks and uncertainties. The statements, other than statements of historical fact, included in this report are forward-looking statements. Many of the forward-looking statements contained in this document may be identified by the use of forward-looking words such as will, intend, believe, expect, anticipate, should, plan, estimate and potential, or similar expressions. Factors which could 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 the Company's 10-K for the fiscal year ended February 28, 2007 which can be viewed at the SEC's website at www.sec.gov or through our website at www.rmcf.com. These forward-looking statements apply only as of the date of this report. As such they should not be unduly relied upon for more current circumstances. Except as required by law, the Company is not obligated to release publicly any revisions to these forward-looking statements that might reflect events or circumstances occurring after the date of this report or those that might reflect the occurrence of unanticipated events.

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The Company is a product-based international franchiser. The Company's revenues and profitability are derived principally from its franchised system of retail stores that feature chocolate and other confectionery products. The Company also sells its candy in selected locations outside its system of retail stores to build brand awareness. The Company operates 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 are located in street fronts, tourist locations, factory outlets and regional malls. Seasonal fluctuation in sales cause fluctuations in quarterly results of operations. Historically, the strongest sales of the Company's products have occurred during the Christmas holiday and summer vacation seasons. Additionally, quarterly results have been, and in the future are likely to be, affected by the timing of new store openings and sales of franchises. Because of the seasonality of the Company's business and the impact of new store openings and sales of franchises, results for any quarter are not necessarily indicative of results that may be achieved in other quarters or for a full fiscal year.

The most important factors in continued growth in the Company's earnings are ongoing unit growth, increased same store sales and increased same store pounds purchased from the factory. Historically, unit growth has more than offset decreases in same store sales and same store pounds purchased.

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

Efforts to reverse the decline in same store pounds purchased from the factory by franchised stores and to increase total factory sales depends on many factors not within the Company's control including the receptivity of its franchise system of its product introductions and promotional programs. Same store pounds purchased from the factory by franchised stores declined approximately 9% in the first quarter, declined approximately 9% in the second quarter and declined approximately 9% in the first six months of fiscal 2008.

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

Results of Operations**Three Months Ended August 31, 2007 Compared to the Three Months Ended August 31, 2006**

Basic earnings per share increased 31.3% from \$.16 for the three months ended August 31, 2006 to \$.21 for the three months ended August 31, 2007. Revenues increased 11.3% from the second quarter of fiscal 2007 to the second quarter of fiscal 2008. Operating income increased 28.8% from \$1.7 million in the second quarter of fiscal 2007 to \$2.1 million in the second quarter of fiscal 2008. Net income increased 28.2% from \$1.0 million in the second quarter of fiscal 2007 to \$1.3 million in the second quarter of fiscal 2008. The increase in earnings per share, operating income, and net income for the second quarter of fiscal 2008 versus the same period in fiscal 2007 was due primarily to an increase in sales to specialty markets and an increase in the average number of franchise stores in operation.

(\$ s in thousands)	Three Months Ended		Change	% Change
	2007	2006		
Factory sales	\$5,423.1	\$4,507.2	\$915.9	