SAGA COMMUNICATIONS INC
Form 10-Q
August 08, 2008

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)

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

For the Quarterly Period ended June 30, 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 1-11588

Saga Communications, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**38-3042953**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
73 Kercheval Avenue Grosse Pointe Farms, Michigan	**48236**
(Address of principal executive offices)	*(Zip Code)*

(313) 886-7070

(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 þ No 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 definitions 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 (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

The number of shares of the registrant s Class A Common Stock, $.01 par value, and Class B Common Stock, $.01 par value, outstanding as of August 1, 2008 was 17,278,940 and 2,402,338, respectively.

INDEX

		Page
PART I.	FINANCIAL INFORMATION	3
Item 1.	Financial Statements (Unaudited)	3
	Condensed consolidated balance sheets June 30, 2008 and December 31, 2007	3
	Condensed consolidated statements of income Three and six months ended June 30, 2008 and 2007	4
	Condensed consolidated statements of cash flows Three and six months ended June 30, 2008 and 2007	5
	Notes to unaudited condensed consolidated financial statements	6
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	29
Item 4.	Controls and Procedures	29
PART II	OTHER INFORMATION	30
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	30
Item 4.	Submission of Matters to a Vote of Security Holders	30
Item 6.	Exhibits	31
Signatures		32

Ex-31.1 Section 302 Certification of Chief Executive Officer
Ex-31.2 Section 302 Certification of Chief Financial Officer
Ex-32 Section 906 Certification of C.E.O. and C.F.O.

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

SAGA COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2008 (Unaudited)	December 31, 2007 (Note)
	(In thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 10,179	$ 13,343
Accounts receivable, net	24,136	23,449
Prepaid expenses and other current assets	5,256	4,590
Total current assets	39,571	41,382
Property and equipment	156,836	153,504
Less accumulated depreciation	80,990	77,287
Net property and equipment	75,846	76,217
Other assets:		
Broadcast licenses, net	167,203	163,102
Goodwill, net	54,974	49,661
Other intangibles, deferred costs and investments, net	6,798	7,282
Total other assets	228,975	220,045
	$ 344,392	$ 337,644
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 1,280	$ 3,017
Payroll and payroll taxes	7,193	7,722
Other accrued expenses	4,513	4,848
Barter transactions	2,588	1,720
Current portion of long-term debt	1,061	
Total current liabilities	16,635	17,307
Deferred income taxes	38,755	36,829
Long-term debt	133,350	129,911
Other liabilities	4,271	4,521
Stockholders equity		
Common stock	215	213
Additional paid-in capital	51,343	50,600
Retained earnings	116,464	112,137
Treasury stock	(16,641)	(13,874)

Total stockholders equity	151,381	149,076
	$ 344,392	$ 337,644

Note: The balance sheet at December 31, 2007 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

See notes to unaudited condensed consolidated financial statements.

Table of Contents

SAGA COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(Unaudited) (In thousands, except per share data)			
Net operating revenue	**$ 37,342**	$ 38,421	**$ 68,874**	$ 70,304
Station operating expenses	**27,246**	27,016	**52,667**	53,011
Corporate general and administrative	**2,574**	2,606	**5,126**	4,922
Gain on asset exchange	**(224)**		**(224)**	
Operating income	**7,746**	8,799	**11,305**	12,371
Other expenses, net:				
Interest expense	**1,876**	2,281	**3,871**	4,578
Other expense, net	**7**	47	**27**	82
Income before income tax	**5,863**	6,471	**7,407**	7,711
Income tax provision	**2,403**	2,661	**3,037**	3,161
Net income	**$ 3,460**	$ 3,810	**$ 4,370**	$ 4,550
Earnings per share				
Basic	**$ .17**	$ .19	**$ .22**	$ .23
Diluted	**$ .17**	$ .19	**$ .22**	$ .23
Weighted average common shares	**19,800**	20,083	**19,931**	20,066
Weighted average common and common equivalent shares	**19,803**	20,113	**19,937**	20,101

See notes to unaudited condensed consolidated financial statements.

Table of Contents

SAGA COMMUNICATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(Unaudited) (In thousands)	
Cash flows from operating activities:		
Cash provided by operating activities	$ 9,839	$ 9,233
Cash flows from investing activities:		
Acquisition of property and equipment	(3,525)	(4,563)
Increase in intangibles and other assets	(170)	(282)
Acquisition of stations	(10,734)	(2,941)
Other investing activities	1	26
Net cash used in investing activities	(14,428)	(7,760)
Cash flows from financing activities:		
Proceeds from long-term debt	5,500	
Payments on long-term debt	(1,000)	(4,000)
Purchase of shares held in treasury	(3,033)	(126)
Other financing activities	(42)	190
Net cash provided by (used in) financing activities	1,425	(3,936)
Net decrease in cash and cash equivalents	(3,164)	(2,463)
Cash and cash equivalents, beginning of period	13,343	10,799
Cash and cash equivalents, end of period	$ 10,179	$ 8,336

See notes to unaudited condensed consolidated financial statements.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for annual financial statements.

In our opinion, the accompanying financial statements include all adjustments of a normal, recurring nature considered necessary for a fair presentation of our financial position as of June 30, 2008 and the results of operations for the three and six months ended June 30, 2008 and 2007. Results of operations for the six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Saga Communications, Inc. Annual Report on Form 10-K for the year ended December 31, 2007.

Change in Accounting Estimate

In the second quarter of 2008, the Company reviewed the estimated useful lives of its television analog equipment. This review was performed because of the Federal Communications Commission s (FCC) mandatory requirement that all television stations convert from analog to digital spectrum by February 2009. As a result of this review, the Company s depreciation rate of its analog equipment was increased to reflect the estimated period during which these assets will remain in service. In accordance with FASB 154, *Accounting Changes and Error Corrections,* this change of estimated useful lives is deemed as a change in accounting estimate and has been accounted for prospectively, effective April 1, 2008. The effect of this change in estimate was to decrease net income approximately $115,000 and decrease basic and diluted earnings per share by $.01 for the three and six months ended June 30, 2008.

Income Taxes

Our effective tax rate is higher than the federal statutory rate as a result of certain non-deductible depreciation and amortization expenses and the inclusion of state taxes in the income tax amount.

Revenue Recognition

Revenue from the sale of commercial broadcast time to advertisers is recognized when commercials are broadcast. Revenue is reported net of advertising agency commissions. Agency commissions, when applicable, are based on a stated percentage applied to gross billing. All revenue is recognized in accordance with the Securities and Exchange Commission s (SEC) Staff Accounting Bulletin (SAB) No. 104, Topic 13, *Revenue Recognition Revised and Updated.*

Time Brokerage Agreements

We have entered into Time Brokerage Agreements (TBAs) or Local Marketing Agreements (LMA s) in certain markets. In a typical TBA/LMA, the FCC licensee of a station makes available, for a fee, blocks of air time on its station to another party that supplies programming to be broadcast during that air time and sells their own commercial advertising announcements during the time periods specified. We account for TBA s/LMA s under Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases* and related interpretations. Revenue and expenses related to TBA s/LMA s are included in the accompanying unaudited Condensed Consolidated Statements of Income.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Nonmonetary Asset Exchanges

In 2006, the FCC granted to Sprint Nextel Corporation (Nextel) the right to reclaim from broadcasters in each market across the country the 1.9 GHz spectrum to use for an emergency communications system. In order to reclaim this signal, Nextel must replace all analog equipment currently using this spectrum with digital equipment. All broadcasters have agreed to use the digital substitute that Nextel will provide. The exchange of equipment will be completed on a market by market basis. As the equipment is exchanged and put into service in each of our markets we have and expect to continue to record gains to the extent that the fair market value of the equipment we receive exceeds the book value of the analog equipment we exchange. See Note 8, Gain on Asset Exchange.

2. Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* (SFAS 141R), which changes the principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effect of the business combination. SFAS 141R is effective prospectively for fiscal years beginning after December 15, 2008 (as of January 1, 2009 for the Company). SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 151* (SFAS 160), which establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. We do not currently expect the adoption of SFAS 160 to have a material impact on our consolidated financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which allows entities the option to measure eligible financial instruments at fair value as of specified dates. Such election, which may be applied on an instrument by instrument basis, is typically irrevocable once elected. An entity would report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The provisions of SFAS 159 were effective as of January 1, 2008. We did not elect the fair value option under this standard upon adoption.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157) which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Companies were required to apply the recognition and disclosure provision of SFAS 157 for financial assets and financial liabilities effective January 1, 2008. In February 2008, the FASB issued FSP FAS 157-2 that delayed by one year, the effective date of SFAS 157 for the majority of nonfinancial assets and nonfinancial liabilities. We adopted the provisions of SFAS 157 effective January 1, 2008 for certain assets which were not included in FSP FAS 157-2, which did not have a material impact or effect on our consolidated financial position, results of operations and cash flows. We do not expect the adoption of the deferred portion of SFAS 157 to have a material impact on our consolidated financial position, results of operations and cash flows.

In September 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* (EITF No. 06-4). EITF No. 06-4 requires that for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with SFAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. We adopted EITF No. 06-4 effective January 1, 2008, which did not have a material impact or effect on our consolidated financial position, results of operations and cash flows.

7

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. Intangible Assets and Goodwill

Under SFAS No. 142 *Accounting for Goodwill and Other Intangible Assets,* (SFAS 142) goodwill and intangible assets deemed to have indefinite lives are not amortized and are subject to impairment tests which are conducted annually, or more frequent if impairment indicators arise.

We consider FCC broadcast licenses to have indefinite lives. Factors that we considered in evaluating that the radio and television FCC licenses are indefinite-lived intangible assets under SFAS 142 include the following:

The radio and television broadcasting licenses may be renewed indefinitely at little cost.

The radio and television broadcasting licenses are essential to our business, and we intend to renew our licenses indefinitely.

We have never been denied the renewal of a FCC broadcast license.

We do not believe that there will be any compelling challenge to the renewal of our broadcast licenses.

We do not believe that the technology used in broadcasting will be replaced by another technology in the foreseeable future.

Based on the above, we believe cash flows from our radio and television licenses are expected to continue indefinitely.

Separate intangible assets that have finite lives are amortized over their useful lives using the straight-line method. Favorable lease agreements are amortized over the lives of the leases. Other intangibles are amortized over one to eleven years.

4. Common Stock and Treasury Stock

The following summarizes information relating to the number of shares of our common stock issued in connection with stock transactions through June 30, 2008:

	Common Stock Issued	
	Class A	**Class B**
	(Shares in thousands)	
Balance, January 1, 2007	18,892	2,396
Exercised options	43	
Conversion of shares	8	(8)
Issuance of restricted stock	36	5
Forfeiture of restricted stock	(2)	
Balance, December 31, 2007	18,977	2,393
Exercised options	19	
Conversion of shares	3	(3)
Issuance of restricted stock	93	12
Forfeiture of restricted stock	(1)	
Balance, June 30, 2008	19,091	2,402

We have a Stock Buy-Back Program (the Buy-Back Program) to allow us to purchase up to $60,000,000 of our Class A Common Stock. From its inception in 1998 through June 30, 2008, we have repurchased 2,443,572 shares of our Class A Common Stock for approximately $29,285,000.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Acquisitions

We actively seek and explore opportunities for expansion through the acquisition of additional broadcast properties. The unaudited condensed consolidated statements of income include the operating results of the acquired stations from their respective dates of acquisition. All acquisitions were accounted for as purchases and, accordingly, the total costs were allocated to the acquired assets and assumed liabilities based on their estimated fair values as of the acquisition dates. The excess of the consideration paid over the estimated fair value of net assets acquired have been recorded as goodwill, which is deductible for tax purposes.

2008 Acquisitions

On January 21, 2004, we entered into agreements to acquire an FM radio station (WOXL-FM) serving the Asheville, North Carolina market. On November 1, 2002 we began providing programming under a Sub-Time Brokerage Agreement to WOXL-FM, and on January 31, 2008 we closed on the acquisition for approximately $9,463,000 of which approximately $9,354,000 was paid in 2008 and $109,000 was paid in prior years.

On January 31, 2008, in connection with the 2006 acquisition of one FM radio station (WTMT-FM) serving the Tazewell, Tennessee market for approximately $4,186,000, we paid the seller $1,350,000, which had been recorded as a note payable at December 31, 2007. We relocated the tower to Weaverville, North Carolina (serving the Asheville, North Carolina market) and started broadcasting in Asheville on June 8, 2007.

2007 Acquisitions

On November 1, 2007, we acquired an FM radio station (WCLZ-FM) serving the Portland, Maine market for approximately $3,555,000.

On August 31, 2007, we acquired two radio stations (WKRT-AM and WIII-FM licensed to Cortland, New York, and an FM translator station that rebroadcasts WIII) serving the Ithaca, New York market for approximately $3,843,000. Due to FCC ownership rules we were not permitted to own WKRT-AM and as part of the transaction we donated WKRT-AM to a non-profit organization.

On January 2, 2007 we acquired one FM radio station (WCNR-FM) serving the Charlottesville, Virginia market for $3,330,000. On September 1, 2006 we began providing programming under an LMA to WCNR-FM. We funded this acquisition on December 31, 2006.

On January 16, 2007, we agreed to pay $50,000 to cancel a clause in our 2003 purchase agreement of WSNI-FM in the Winchendon, Massachusetts market that would have required us to pay the seller an additional $500,000 if within five years of closing we obtained approval from the FCC for a city of license change.

On January 2, 2007, in connection with the 2003 acquisition of one FM radio station (WJZA-FM) serving the Columbus, Ohio market, we paid an additional $850,000 to the seller upon obtaining approval from the FCC for a city of license change.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Condensed Consolidated Balance Sheet of 2008 and 2007 Acquisitions

The following unaudited condensed consolidated balance sheets represent the estimated fair value assigned to the related assets and liabilities of the 2008 and 2007 acquisitions at their respective acquisition dates. We paid approximately $10,734,000, $2,941,000 and $10,298,000 in connection with acquisitions during the six months ended June 30, 2008 and 2007 and the year ended December 31, 2007, respectively.

Saga Communications, Inc.
Condensed Consolidated Balance Sheet of 2008 and 2007 Acquisitions

	Acquisitions in	
	2008	2007
	(In thousands)	
Assets Acquired:		
Current assets	$	$ 130
Property and equipment	56	931
Other assets:		
Broadcast licenses-Radio segment	5,450	12,210
Goodwill-Radio segment	5,312	834
Other intangibles, deferred costs and investments		46
Total other assets	10,762	13,090
Total assets acquired	10,818	14,151
Liabilities Assumed:		
Current liabilities	84	3,853
Total liabilities assumed	84	3,853
Net assets acquired	$ 10,734	$ 10,298

Pro Forma Results of Operations for Acquisitions and Dispositions (Unaudited)

The following unaudited pro forma results of our operations for the six months ended June 30, 2008 and 2007 assume the 2008 and 2007 acquisitions occurred as of January 1, 2007. The pro forma results give effect to certain adjustments, including depreciation, amortization of intangible assets, increased interest expense on acquisition debt and related income tax effects. The pro forma results have been prepared for comparative purposes only and do not purport to indicate the results of operations which would actually have occurred had the combinations been in effect on the dates indicated or which may occur in the future.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(In thousands, except per share data)			
Consolidated Results of Operations				
Net operating revenue	**$ 37,342**	$ 38,752	**$ 68,874**	$ 70,945
Station operating expense	**27,246**	27,284	**52,667**	53,568

Corporate general and administrative	**2,574**	2,606	**5,126**	4,922
Gain on asset exchange	**(224)**		**(224)**	
Operating income	**7,746**	8,862	**11,305**	12,455
Interest expense	**1,876**	2,281	**3,871**	4,578
Other expense, net	**7**	47	**27**	82
Income taxes	**2,403**	2,686	**3,037**	3,195
Net income	**$ 3,460**	$ 3,848	**$ 4,370**	$ 4,600
Basic earnings per share	**$ .17**	$ .19	**$ .22**	$ .23
Diluted earnings per share	**$ .17**	$ .19	**$ .22**	$ .23

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In thousands)			
Radio Broadcasting Segment				
Net operating revenue	**$ 32,629**	$ 34,174	**$ 60,010**	$ 62,377
Station operating expense	**23,398**	23,723	**45,311**	46,525
Operating income	**$ 9,231**	$ 10,451	**$ 14,699**	$ 15,852

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
	(In thousands)			
Television Broadcasting Segment				
Net operating revenue	**$ 4,713**	$ 4,578	**$ 8,864**	$ 8,568
Station operating expense	**3,848**	3,561	**7,356**	7,043
Gain on asset exchange	**(224)**		**(224)**	
Operating income	**$ 1,089**	$ 1,017	**$ 1,732**	$ 1,525

Reconciliation of pro forma segment operating income to pro forma consolidated operating income:

	Radio	Television	Corporate and Other	Consolidated
	(In thousands)			
Three Months Ended June 30, 2008:				
Net operating revenue	$ 32,629	$ 4,713	$	$ 37,342
Station operating expense	23,398	3,848		27,246
Corporate general and administrative			2,574	2,574
Gain on asset exchange		(224)		(224)
Operating income (loss)	$ 9,231	$ 1,089	$ (2,574)	$ 7,746

	Radio	Television	Corporate and Other	Consolidated
	(In thousands)			
Three Months Ended June 30, 2007:				
Net operating revenue	$ 34,174	$ 4,578	$	$ 38,752
Station operating expense	23,723	3,561		27,284

Corporate general and administrative			2,606	2,606
Operating income (loss)	$ 10,451	$ 1,017	$ (2,606)	$ 8,862

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Six Months Ended June 30, 2008:				
Net operating revenue	$ 60,010	$ 8,864	$	$ 68,874
Station operating expense	45,311	7,356		52,667
Corporate general and administrative			5,126	5,126
Gain on asset exchange		(224)		(224)
Operating income (loss)	$ 14,699	$ 1,732	$ (5,126)	$ 11,305

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Six Months Ended June 30, 2007:				
Net operating revenue	$ 62,377	$ 8,568	$	$ 70,945
Station operating expense	46,525	7,043		53,568
Corporate general and administrative			4,922	4,922
Operating income (loss)	$ 15,852	$ 1,525	$ (4,922)	$ 12,455

6. Stock Based Compensation

The Company accounts for stock-based awards under the provisions of SFAS No. 123R, *Share-Based Payment* (SFAS 123R). Compensation expense of approximately $242,000 and $495,000, respectively, and related tax benefits of $99,000 and $203,000, respectively, was recognized for the three and six months ended June 30, 2008. For the three and six months ended June 30, 2007, the Company recognized compensation expense of approximately $227,000 and $424,000, respectively, and related tax benefits of $93,000 and $174,000, respectively. Compensation expense is reported in corporate general and administrative expenses in our results of operations.

Employee Stock Purchase Plan

We have an employee stock purchase plan (ESPP) for all eligible employees. Each quarter, an eligible employee may elect to withhold up to 10 percent of his or her compensation, up to a maximum of $5,000, to purchase shares of our stock at a price equal to 85% of the fair value of the stock as of the last day of such quarter. The ESPP will terminate on December 31, 2008. Approximately 14,919 and 10,791 shares were purchased under the ESPP during the six months ended June 30, 2008 and 2007, respectively. Our ESPP is deemed compensatory under the provisions of FAS 123R.

2005 Incentive Compensation Plan

The 2005 Incentive Compensation Plan (the 2005 Plan) replaced our 2003 Stock Option Plan (the 2003 Plan) as to future grants. The 2005 Plan extends through March 2015 and allows for the granting of restricted stock, restricted stock units, incentive stock options, nonqualified stock options, and performance awards to officers and a selected number of employees.

2003 Stock Option Plan

We adopted the 2003 Plan, upon expiration of our 1992 Stock Option Plan (the 1992 Plan) in December 2002, pursuant to which our key employees, including directors who are employees, were eligible to receive grants of options to purchase our Class A Common Stock or Class B Common Stock. With the approval of the 2005 Plan, the 2003 Plan was terminated as to future grants, therefore the shares available for future grants under the 2003 Plan are no longer available.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following summarizes the stock option transactions for the 2005, 2003 and 1992 Plans for the six months ended June 30, 2008:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2007	2,682,752	$ 12.81	4.4	$
Granted				
Exercised				
Forfeited	(4,817)	10.00		
Outstanding at June 30, 2008	2,677,935	$ 12.81	3.8	$
Exercisable at June 30, 2008	2,132,834	$ 13.50	2.8	$

The following summarizes the non-vested stock option transactions for the 2005, 2003 and 1992 Plans for the six months ended June 30, 2008:

	Number of Options	Weighted Average Grant Date Fair Value
Non-vested at December 31, 2007	738,263	$ 5.09
Granted		
Vested	(188,345)	5.23
Forfeited/canceled	(4,817)	4.96
Non-vested at June 30, 2008	545,101	$ 5.04

We calculated the fair value of the each option award on the date of grant using the Black-Scholes option pricing model. The following assumptions were used for each respective period:

	2007 Grants	2006 Grants
Weighted average grant date fair value per share	$ 4.82	$ 4.49
Expected volatility	36.50%	37.19%
Expected term of options (years)	7.9	7.8
Risk-free interest rate	4.76%	4.27%
Dividend yield	0%	0%

The estimated expected volatility, expected term of options and estimated annual forfeiture rate was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant.

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following summarizes the restricted stock transactions for the six months ended June 30, 2008:

	Shares	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2007	164,072	$ 10.24
Granted	105,300	5.99
Vested	(41,843)	10.55
Forfeited	(1,071)	10.00
Non-vested and outstanding at June 30, 2008	226,458	$ 8.21

For the three and six months ended June 30, 2008 and the three and six months ended June 30, 2007, we had approximately $112,000, $225,000, $102,000 and $191,000, respectively, of total compensation expense related to restricted stock-based compensation arrangements.

1997 Non-Employee Director Stock Option Plan

In 1997, we adopted the 1997 Non-Employee Director Stock Option Plan (the Directors Plan) pursuant to which our directors who are not our employees were eligible to receive options. Options granted under the Directors Plan were non-qualified stock options, were immediately vested and become exercisable at the written election of the director. The options expire on the earlier of (i) 10 years from the date of grant or (ii) the March 16th following the calendar year in which they first become exercisable. This plan expired on May 12, 2007.

Effective January 1, 2007, each director who is not an employee shall receive cash for his or her services as a director.

The following summarizes the stock option transactions for the Directors Plan for the six months ended June 30, 2008:

	Number of Options	Weighted Average Price per Share	Aggregate Intrinsic Value
Outstanding at December 31, 2007	23,080	$ 0.009	$ 135,726
Granted			
Exercised	(18,945)	0.009	
Outstanding and exercisable at June 30, 2008	4,135	$ 0.009	$ 20,681

7. Long-Term Debt

Long term debt consisted of the following:

	June 30, 2008	December 31, 2007
	(In thousands)	
Credit Agreement:		
Reducing revolver facility	$ 133,350	$ 128,850

Secured debt of affiliate	1,061	1,061
	134,411	129,911
Amounts payable within one year	1,061	
	$ 133,350	$ 129,911

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Our Credit Agreement is a $187,500,000 reducing revolving line of credit maturing on July 29, 2012. On each of March 31, 2008 and June 30, 2008, the Revolving Commitments (as defined in the Credit Agreement) were permanently reduced by $6,250,000 and will continue to be permanently reduced at the end of each calendar quarter in amounts ranging from 3.125% to 12.5% of the total Revolving Commitments that were in effect on March 31, 2008. In addition, the Revolving Commitments shall be further reduced by specified percentages of Excess Cash Flow (as defined in the Credit Agreement) based on leverage ratios. Any outstanding balance under the Credit Agreement will be due on the maturity date of July 29, 2012.

Our indebtedness under the Credit Agreement is secured by a first priority lien on substantially all of our assets and of our subsidiaries, by a pledge of our subsidiaries stock and by a guarantee of our subsidiaries. We have approximately $54,150,000 of unused borrowing capacity under the Credit Agreement at June 30, 2008.

The Credit Agreement contains a number of financial covenants (all of which we were in compliance with at June 30, 2008) that, among other things, requires us to maintain specified financial ratios and impose certain limitations on us with respect to (i) the incurrence of additional indebtedness; (ii) acquisitions, except under specified conditions; (iii) the incurrence of additional liens, except those relating to capital leases and purchase money indebtedness; (iv) the disposition of assets; (v) the payment of cash dividends; and (vi) mergers, changes in business and management, investments and transactions with affiliates. The financial covenants become more restrictive over the life of the Credit Agreement. The Credit Agreement allows for the payment of dividends provided certain requirements are met.

8. Gain on Asset Exchange

In 2006, the FCC granted to Nextel the right to reclaim from broadcasters in each market across the country the 1.9 GHz spectrum to use for an emergency communications system. In order to reclaim this signal, Nextel must replace all analog equipment currently using this spectrum with digital equipment. We have agreed to accept the substitute equipment that Nextel will provide and in turn we must relinquish our existing equipment to Nextel. This arrangement is accounted for as an exchange of assets in accordance with Accounting Principles Board No. 29, *Accounting for Nonmonetary Transactions,* as amended by SFAS No. 153, *Exchanges of Nonmonetary Assets.*

The equipment we receive under this arrangement is recorded at its estimated fair market value and depreciated over estimated useful lives ranging from 5 to 15 years. Fair market value is derived from quoted prices obtained from manufacturers and vendors for the specific equipment acquired. As the equipment is exchanged and put into service in each of our markets we have and expect to continue to record gains to the extent that the fair market value of the equipment we receive exceeds the book value of the analog equipment we exchange. For the three and six months ended June 30, 2008, we recognized a gain of approximately $224,000 from the exchange of this equipment.

Table of Contents

SAGA COMMUNICATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Segment Information

We evaluate the operating performance of our markets individually. For purposes of business segment reporting, we have aligned operations with similar characteristics into two business segments: Radio and Television.

The Radio segment includes twenty-three markets, which includes all ninety-one of our radio stations and five radio information networks. The Television segment includes three markets and consists of five television stations and four low power television (LPTV) stations. The Radio and Television segments derive their revenue from the sale of commercial broadcast inventory. The category Corporate general and administrative represents the income and expense not allocated to reportable segments.

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Three Months Ended June 30, 2008:				
Net operating revenue	$ 32,629	$ 4,713	$	$ 37,342
Station operating expense	23,398	3,848		27,246
Corporate general and administrative			2,574	2,574
Gain on asset exchange		(224)		(224)
Operating income (loss)	$ 9,231	$ 1,089	$ (2,574)	$ 7,746
Depreciation and amortization	$ 1,591	$ 605	$ 53	$ 2,249

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Three Months Ended June 30, 2007:				
Net operating revenue	$ 33,843	$ 4,578	$	$ 38,421
Station operating expense	23,455	3,561		27,016
Corporate general and administrative			2,606	2,606
Operating income (loss)	$ 10,388	$ 1,017	$ (2,606)	$ 8,799
Depreciation and amortization	$ 1,539	$ 400	$ 51	$ 1,990

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Six Months Ended June 30, 2008:				
Net operating revenue	$ 60,010	$ 8,864	$	$ 68,874
Station operating expense	45,311	7,356		52,667
Corporate general and administrative			5,126	5,126

Gain on asset exchange		(224)		(224)
Operating income (loss)	$ 14,699	$ 1,732	$ (5,126)	$ 11,305
Depreciation and amortization	$ 3,153	$ 1,000	$ 106	$ 4,259
Total assets	$ 298,472	$ 32,136	$ 13,784	$ 344,392

	Radio	Television	Corporate and Other	Consolidated
		(In thousands)		
Six Months Ended June 30, 2007:				
Net operating revenue	$ 61,736	$ 8,568	$	$ 70,304
Station operating expense	45,968	7,043		53,011
Corporate general and administrative			4,922	4,922
Operating income (loss)	$ 15,768	$ 1,525	$ (4,922)	$ 12,371
Depreciation and amortization	$ 3,045	$ 789	$ 98	$ 3,932
Total assets	$ 280,308	$ 31,612	$ 13,748	$ 325,668

Table of Contents

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

Results of Operations

The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto of Saga Communications, Inc. and its subsidiaries contained elsewhere herein and the audited financial statements and Management Discussion and Analysis contained in our Annual Report on Form 10-K for the year ended December 31, 2007. The following discussion is presented on both a consolidated and segment basis. Corporate general and administrative expenses, interest expense, other (income) expense, and income tax expense are managed on a consolidated basis and are therefore, reflected only in our discussion of consolidated results.

Our discussion of the results of operations of our operating segments focuses on their operating income because we manage our operating segments primarily on their operating income. We evaluate the operating performance of our markets individually. For purposes of business segment reporting, we have aligned operations with similar characteristics into two business segments: Radio and Television. The Radio segment includes twenty-three markets, which includes all ninety-one of our radio stations and five radio information networks. The Television segment includes three markets and consists of five television stations and four LPTV stations.

General

We are a broadcast company primarily engaged in acquiring, developing and operating radio and television stations. We actively seek and explore opportunities for expansion through the acquisition of additional broadcast properties. We review acquisition opportunities on an ongoing basis.

For additional information with respect to acquisitions, see Liquidity and Capital Resources below.

Radio Segment

Our radio segment s primary source of revenue is from the sale of advertising for broadcast on our stations. Depending on the format of a particular radio station, there are a predetermined number of advertisements available to be broadcast each hour.

Most advertising contracts are short-term, and generally run only for a few weeks. The majority of our revenue is generated from local advertising, which is sold primarily by each radio markets sales staff. For the six months ended June 30, 2008 and 2007, approximately 86% of our radio segment s gross revenue was from local advertising. To generate national advertising sales, we engage an independent advertising sales representative firm that specializes in national sales for each of our broadcast markets.

Our revenue varies throughout the year. Advertising expenditures, our primary source of revenue, generally have been lowest during the winter months, which include the first quarter of each year.

Our net operating revenue, station operating expense and operating income varies from market to market based upon the market s rank or size which is based upon population and the available radio advertising revenue in that particular market.

Our financial results are dependent on a number of factors, the most significant of which is our ability to generate advertising revenue through rates charged to advertisers. The rates a station is able to charge are, in large part, based on a station s ability to attract audiences in the demographic groups targeted by its advertisers. In a number of our markets this is measured by periodic reports generated by independent national rating services. In the remainder of our markets it is measured by the results advertisers obtain through the actual running of an advertising schedule. Advertisers measure these results based on increased demand for their goods or services and/or actual revenues generated from such demand. Various factors affect the rate a station can charge, including the general strength of the local and national economies, population growth, ability to provide popular programming, local market competition, target marketing capability of radio compared to other advertising media and signal strength. Because reaching a large and demographically attractive audience is crucial to a station s financial success, we endeavor to develop strong listener loyalty.

Table of Contents

When we acquire and/or begin to operate a station or group of stations we generally increase programming and advertising and promotion expenses to increase our share of our target demographic audience. Our strategy sometimes requires levels of spending commensurate with the revenue levels we plan on achieving in two to five years. During periods of economic downturns, or when the level of advertising spending is flat or down across the industry, this strategy may result in the appearance that our cost of operations are increasing at a faster rate than our growth in revenues, until such time as we achieve our targeted levels of revenue for the acquired station or group of stations.

The number of advertisements that can be broadcast without jeopardizing listening levels (and the resulting ratings) is limited in part by the format of a particular radio station. Our stations strive to maximize revenue by constantly managing the number of commercials available for sale and adjusting prices based upon local market conditions and ratings. While there may be shifts from time to time in the number of advertisements broadcast during a particular time of the day, the total number of advertisements broadcast on a particular station generally does not vary significantly from year to year. Any change in our revenue, with the exception of those instances where stations are acquired or sold, is generally the result of inventory sell out ratios and pricing adjustments, which are made to ensure that the station efficiently utilizes available inventory.

Our radio stations employ a variety of programming formats. We periodically perform market research, including music evaluations, focus groups and strategic vulnerability studies. Our stations also employ audience promotions to further develop and secure a loyal following. We believe that the diversification of formats on our radio stations helps to insulate us from the effects of changes in musical tastes of the public on any particular format.

The primary operating expenses involved in owning and operating radio stations are employee salaries including commissions, depreciation, programming expenses, and advertising and promotion expenses.

Similar to the fluctuations in the current general economic climate, radio revenue growth has been declining or stagnant over the last several years primarily in major markets that are dependent on national advertising. We believe that this decline in major market radio advertising revenue is the result of a lack of pricing discipline by radio operators and new technologies and media (such as the Internet, satellite radio, and MP3 players). These new technologies and media are gaining advertising share against radio and other traditional media. Conversely, radio revenue in the small to mid markets has been trending upward in recent months.

We have begun several initiatives to offset the declines. We are continuing to expand our interactive initiative to provide a seamless audio experience across numerous platforms to connect with our listeners where and when they want, and are adding online components including streaming our stations over the Internet and on-demand options. We are seeing development potential in this area and believe that revenues from our interactive initiatives will continue to increase.

We also continue the rollout of HD Radio™. HD Radio utilizes digital technology that provides improved sound quality over standard analog broadcasts and also allows for the delivery of additional channels of diversified programming or data streams in each radio market. It is unclear what impact HD Radio will have on the industry and our revenue as the availability of HD receivers, particularly in automobiles, is not widely available.

During the six months ended June 30, 2008 and 2007 and the years ended December 31, 2007 and 2006, our Columbus, Ohio; Manchester, New Hampshire; Milwaukee, Wisconsin; and Norfolk, Virginia markets, when combined, represented approximately 62%, 65%, 60% and 64%, respectively, of our consolidated operating income. An adverse change in any of these radio markets or our relative market position in those markets could have a significant impact on our operating results as a whole.

A significant decline in the total available radio advertising dollars in the Columbus, Ohio and Norfolk, Virginia markets has resulted in a significant decline in our net operating revenue of 19% and 18%, respectively, for the six months ended June 30, 2008 as compared to the corresponding period of 2007. This decline in net operating revenue has directly affected the operating income of our radio stations at these markets. Additionally, we have experienced historical ratings softness in these markets which has also affected revenue. While we have seen recent increases in ratings, we do not expect any significant improvements in revenue in the Columbus and Norfolk markets in the foreseeable future.

Table of Contents

The following tables describe the percentage of our consolidated operating income represented by each of these markets:

	Percentage of Consolidated Operating Income for the Six Months Ended June 30,		Percentage of Consolidated Operating Income for the Years Ended December 31,	
	2008	2007	2007	2006
Market:				
Columbus, Ohio	4%	11%	7%	10%
Manchester, New Hampshire	18%	14%	15%	14%
Milwaukee, Wisconsin	37%	34%	31%	30%
Norfolk, Virginia	3%	6%	7%	10%

We use certain financial measures that are not calculated in accordance with generally accepted accounting principles in the United States of America (GAAP) to assess our financial performance. For example, we evaluate the performance of our markets based on station operating income (operating income plus corporate general and administrative expenses, depreciation and amortization). Station operating income is generally recognized by the broadcasting industry as a measure of performance, is used by analysts who report on the performance of the broadcasting industry and it serves as an indicator of the market value of a group of stations. In addition, we use it to evaluate individual stations, market-level performance, overall operations and as a primary measure for incentive based compensation of executives and other members of management. Station operating income is not necessarily indicative of amounts that may be available to us for debt service requirements, other commitments, reinvestment or other discretionary uses. Station operating income is not a measure of liquidity or of performance in accordance with GAAP, and should be viewed as a supplement to, and not a substitute for our results of operations presented on a GAAP basis.

During the six months ended June 30, 2008 and 2007 and the years ended December 31, 2007 and 2006, the radio stations in our four largest markets when combined, represented approximately 37%, 41%, 40% and 45%, respectively, of our consolidated station operating income. The following tables describe the percentage of our consolidated station operating income represented by each of these markets:

	Percentage of Consolidated Station Operating Income (*) for the Six Months Ended June 30,		Percentage of Consolidated Station Operating Income (*) for the Years Ended December 31,	
	2008	2007	2007	2006
Market:				
Columbus, Ohio	4%	7%	6%	8%
Manchester, New Hampshire	10%	9%	10%	9%
Milwaukee, Wisconsin	21%	21%	20%	21%
Norfolk, Virginia	2%	4%	4%	7%

* Operating income plus corporate general and administrative, depreciation and amortization.

Television Segment

Our television segment s primary source of revenue is from the sale of advertising for broadcast on our stations. The number of advertisements available for broadcast on our television stations is limited by network affiliation and syndicated programming agreements and, with respect to children s programs, federal regulation. Our television stations local market managers determine only the number of advertisements to be broadcast in locally produced programs, which are primarily news programming and occasionally local sports or information shows.

Table of Contents

Our net operating revenue, station operating expense and operating income vary from market to market based upon the market s rank or size which is based upon population, available television advertising revenue in that particular market, and the popularity of programming being broadcast.

Our financial results are dependent on a number of factors, the most significant of which is our ability to generate advertising revenue through rates charged to advertisers. The rates a station is able to charge are, in large part, based on a station s ability to attract audiences in the demographic groups targeted by its advertisers, as measured principally by periodic reports by independent national rating services. Various factors affect the rates a station can charge, including the general strength of the local and national economies, population growth, ability to provide popular programming through locally produced news, sports and weather and as a result of syndication and network affiliation agreements, local market competition, the ability of television broadcasting to reach a mass appeal market compared to other advertising media, and signal strength including cable/satellite coverage, and government regulation and policies.

When we acquire and/or begin operating a station or group of stations we generally increase programming expenses including local news, sports and weather programming, new syndicated programming, and advertising and promotion expenses to increase our viewership. Our strategy sometimes requires levels of spending commensurate with the revenue levels we plan on achieving in two to five years. During periods of economic downturns, or when the level of advertising spending is flat or down across the industry, this strategy may result in the appearance that our cost of operations are increasing at a faster rate than our growth in revenues, until such time as we achieve our targeted levels of revenue for the acquired/operated station or group of stations.

Our stations strive to maximize revenue by constantly adjusting prices for our commercial spots based upon local market conditions, demand for advertising and ratings. While there may be shifts from time to time in the number of advertisements broadcast during a particular time of the day, the total number of advertisements broadcast on a particular station generally does not vary significantly from year to year. Any change in our revenue, with the exception of those instances where stations are acquired or sold, is generally the result of pricing adjustments, which are made to ensure that the station efficiently utilizes available inventory.

Because audience ratings in the local market are crucial to a station s financial success, we endeavor to develop strong viewer loyalty by providing locally produced news, weather and sports programming. We believe that this emphasis on the local market provides us with the viewer loyalty we are trying to achieve.

Most of our revenue is generated from local advertising, which is sold primarily by each television markets sales staff. For the six months ended June 30, 2008 and 2007, approximately 80% and 81%, respectively, of our gross television revenue was from local advertising. To generate national advertising sales, we engage independent advertising sales representatives that specialize in national sales for each of our television markets.

Our revenue varies throughout the year. Advertising expenditures, our primary source of revenue, generally have been lowest during the winter months, which include the first quarter of each year.

The primary operating expenses involved in owning and operating television stations are employee salaries including commissions, depreciation, programming expenses, including news production and the cost of acquiring certain syndicated programming, and advertising and promotion expenses.

Our television market in Joplin, Missouri represented approximately 13%, 10%, 9% and 9%, respectively, of our consolidated operating income for the six months ended June 30, 2008 and 2007 and the years ended December 31, 2007 and 2006.

Table of Contents

Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007

Results of Operations

The following tables summarize our results of operations for the three months ended June 30, 2008 and 2007.

Consolidated Results of Operations

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	$ Increase (Decrease)	% Increase (Decrease)
	(In thousands, except percentages and per share information)			
Net operating revenue	$ 37,342	$ 38,421	$ (1,079)	(2.8)%
Station operating expense	27,246	27,016	230	0.9%
Corporate G&A	2,574	2,606	(32)	(1.2)%
Gain on asset exchange	(224)		224	N/M
Operating income	7,746	8,799	(1,053)	(12.0)%
Interest expense	1,876	2,281	(405)	(17.8)%
Other expense, net	7	47	(40)	N/M
Income taxes	2,403	2,661	(258)	(9.7)%
Net income	$ 3,460	$ 3,810	$ (350)	(9.2)%
			489,405	
Transportation equipment	180,723	180,723		
	12,797,000	12,427,017		
Less accumulated depreciation	7,340,305	6,808,778		
Property and equipment, net	$ 5,456,695	$ 5,618,239		
	32			

Table of Contents

NOTE 4 LINE OF CREDIT AND LONG-TERM DEBT

Line of Credit

At February 29, 2004 the Company had a $2.5 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 (3.5% at February 29, 2004). At February 29, 2004, $2.5 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. The credit line is subject to renewal in July, 2004.

Long-term debt

Long-term debt consists of the following at February 28 or 29:

	2004	2003
Mortgage note payable in monthly installments of $17,600 through August, 2016 including interest at 6.0% per annum, collateralized by land and factory building. Interest was subject to adjustment every 60 months until maturity in August, 2016 but was adjusted to a floating rate of prime less fifty basis points (currently 3.50%) effective November 15, 2002.	$1,804,917	$1,947,500
Chattel mortgage note payable in monthly installments of $65,500 through August, 2005 including interest at 6.00% per annum, collateralized by substantially all business assets. Interest rate was adjusted to a floating rate of prime less fifty basis points (currently 3.50%) effective November 15, 2002.	1,090,371	1,822,042
Chattel mortgage note payable in monthly installments of $30,300 through August, 2004 including interest at 6.00% per annum, collateralized by inventory, accounts, equipment and general intangibles. Interest rate was adjusted to a floating rate of prime less fifty basis points (currently 3.50%) effective November 15, 2002.	171,286	521,656
	3,066,574	4,291,198
Less current maturities	1,080,400	1,218,400
	$1,986,174	$3,072,798

Maturities of long-term debt are as follows for the years ending February 28 or 29:

2005	$1,080,400
2006	473,500
2007	141,400
2008	144,800
2009	146,500
Thereafter	1,079,974
	$3,066,574

Additionally, the line of credit and certain term debt are subject to various financial ratio and leverage covenants as well as cross-default provisions. At February 29, 2004 the Company was in compliance with all such convenants and provisions.

NOTE 5 COMMITMENTS AND CONTINGENCIES

Operating leases

The Company conducts its retail operations in facilities leased under five to ten-year noncancelable operating leases. Certain leases contain renewal options for between two and ten additional years at increased monthly rentals. The majority of the leases provide for contingent rentals based on sales in excess of predetermined base levels.

Table of Contents

NOTE 5 COMMITMENTS AND CONTINGENCIES CONTINUED

Operating leases continued

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

2005	$267,900
2006	174,800
2007	46,800
2008	22,200
2009	5,800
	$517,500

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:

2005	$313,800
2006	239,300
2007	135,500
2008	52,400
2009	19,700
	$760,700

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

	2004	**2003**	**2002**
Minimum rentals	$ 753,314	$1,023,898	$1,206,337
Less sublease rentals	(427,600)	(785,219)	(971,938)
Contingent rentals	11,187	9,628	8,999
	$ 336,901	$ 248,307	$ 243,398

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:

2005	$250,600
2006	141,800
2007	41,400
	$433,800

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

2004	2003	2002
$301,600	$305,798	$260,988

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 $2,256,000 of raw materials under such agreements.

Contingencies

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

Table of Contents

NOTE 6 INCOME TAXES

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

	2004	2003	2002
Current			
Federal	$ 878,546	$424,236	$1,033,009
State	182,115	66,023	167,797
Total Current	1,060,661	490,259	1,200,806
Deferred			
Federal	313,613	24,939	10,608
State	35,051	2,787	1,186
Total Deferred	348,664	27,726	11,794
Total	$1,409,325	$517,985	$1,212,600

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:

	2004	2003	2002
Statutory rate	34.0%	34.0%	34.0%
Goodwill amortization			.3%
State income taxes, net of federal benefit	3.7%	3.3%	3.5%
Other	.1%	.5%	
Effective Rate	37.8%	37.8%	37.8%

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

	2004	2003
Deferred Tax Assets		
Allowance for doubtful accounts and notes	45,600	$ 43,305
Inventories	32,572	26,520
Accrued compensation	33,425	39,508
Loss provisions	125,664	150,359
Self insurance accrual	25,098	28,902
Amortization, design costs and goodwill	27,694	45,790
	290,053	334,384
Deferred Tax Liabilities		
Depreciation	(702,318)	(308,966)
Deferred gain on sale	6,002	(83,017)
	(696,316)	(391,983)
Net deferred tax liability	$(406,263)	$ (57,599)
Current deferred tax assets	$ 149,304	$ 174,616
Non-current deferred tax liabilities	(555,567)	(232,215)
Net deferred tax liability	$(406,263)	$ (57,599)

NOTE 7 STOCKHOLDERS EQUITY

Stock Dividend

On May 4, 2004 the Board of Directors declared a 10 percent stock dividend payable on May 27, 2004 to shareholders of record as of May 13, 2004. Shareholders will receive one additional share of Common Stock for every ten shares owned prior to the record date. Subsequent to the dividend there will be approximately 4.3 million shares outstanding.

Stock Split

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

On January 28, 2002 the Board of Directors approved a four-for-three stock split payable March 4, 2002 to shareholders of record at the close of business on February 11, 2002. 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 2,783,877 shares outstanding. Subsequent to the split there were 3,711,960 shares outstanding.

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

Table of Contents

NOTE 7 STOCKHOLDERS EQUITY CONTINUED

Stock Repurchases

Between October 3, 2003 and February 19, 2004 the Company repurchased 120,285 Company shares at an average price of $7.56 per share. In March 2004 the Company repurchased 31,440 Company shares at an average price of $8.68 per share.

Between March 6, 2001 and September 28, 2001, the Company repurchased 203,535 Company shares at an average price of $3.07 per share. Of the shares repurchased during this time period, 41,800 were repurchased from employees.

Cash Dividend

The Company paid an initial quarterly cash dividend of $0.0455 per common share on September 16, 2003 to shareholders of record on September 2, 2003. The Company paid a quarterly cash dividend of $0.0492 per common share on December 16, 2003 to shareholders of record on December 2, 2003. The Company paid a quarterly cash dividend of $0.0545 per common share on March 16, 2004 to shareholders of record on March 3, 2004.

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

NOTE 8 STOCK OPTION PLANS

Under the Company s 1985 Incentive Stock Option Plan (the 1985 Plan), options to purchase 473,000 shares of the Company s common stock were granted at prices not less than market value at the date of grant. The 1985 Plan expired in October 1995. Options granted under the 1985 Plan could not have a term exceeding ten years. No options representing the right to purchase shares of the Company s common stock remained outstanding under the 1985 Plan at February 28, 2004.

Under the 1995 Stock Option Plan (the 1995 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 660,000, 198,000 and 132,000 shares, respectively, of the Company s common stock may be granted at prices not less than market value at the date of grant. Options granted may not have a term exceeding ten years under the 1995 plan 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 448,580, 22,000 and 70,950 shares of the Company s common stock were outstanding under the 1995 Plan, the Director s Plan, and the 2000 Director s Plan, respectively, at February 29, 2004. Options become exercisable over a one to five year period from the date of the grant. The options outstanding under these plans will expire, if not exercised through March 2012.

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

	2004	2003	2002
Expected dividend yield	3.09%	0%	0%
Expected stock price volatility	30%	40%	40%
Risk-free interest rate	2.4%	4.3%	4.8%
Expected life of options	5 years	5 years	5 years

Information with respect to options outstanding under the Plans at February 29, 2004, and changes for the three years then ended was as follows:

	2004	
	Shares	**Weighted Average Exercise Price**
Outstanding at beginning of year	759,000	$ 3.21
Granted	50,050	4.72
Exercised	(267,520)	2.85
Outstanding at end of year	541,530	$ 3.53
Options exercisable at February 29, 2004	338,910	$ 3.20

Table of Contents

NOTE 8 STOCK OPTION PLANS CONTINUED

	2003	
	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	716,100	$ 2.92
Granted	84,700	5.51
Exercised	(41,800)	3.00
Outstanding at end of year	759,000	$ 3.21
Options exercisable at February 28, 2003	537,460	$ 3.00

	2002	
	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	631,400	$ 3.09
Granted	172,700	2.88
Exercised	(55,000)	4.30
Forfeited	(33,000)	3.60
Outstanding at end of year	716,100	$ 2.92
Options exercisable at February 28, 2002	510,400	$ 3.01

Weighted average fair value per share of options granted during 2004, 2003 and 2002 were $1.08, $2.31 and $1.20, respectively.

Additional information about stock options outstanding at February 29, 2004 is summarized as follows:

	Options Outstanding		
Range of exercise prices	Number outstanding	Weighted average remaining contractual life	Weighted average exercise price
$1.818 to 2.327	175,450	6.13	$ 2.23
$2.386 to 4.097	174,350	3.15	2.74
$4.445 to 8.182	191,730	7.13	5.43

	Options Exercisable	
Range of exercise prices	Number Exercisable	Weighted average exercise price
$1.818 to 2.327	107,690	$ 2.26

$2.386 to 4.097	171,600	2.74
$4.445 to 8.182	59,620	6.21

NOTE 9 OPERATING SEGMENTS

The Company classifies its business interests into two reportable segments: Franchising and Manufacturing. Previously the Company segregated Retail as a third reportable segment. The Company has phased out its Company-owned store program to eight remaining stores. The remaining stores provide an environment for testing new products and promotions, operating and training methods and merchandising techniques. Company management evaluates these stores in relation to their contribution to franchising efforts. The previously reported Retail segment is now included in the Franchising segment and all previously reported periods have been restated. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1. The Company evaluates performance and allocates resources based on operating contribution, which excludes unallocated corporate general and administrative costs, provision for loss on accounts and notes receivable and related foreclosure costs and income tax expense or benefit. The Company s reportable segments are strategic businesses that utilize common merchandising, distribution, and marketing functions, as well as common information systems and corporate administration. All inter-segment sales prices are market based. Each segment is managed separately because of the differences in required infrastructure and the difference in products and services:

	Franchising	**Manufacturing**	**Other**	**Total**
FY 2004				
Total revenues	$7,029,453	$15,196,410	$	$22,225,863
Intersegment revenues		(1,093,035)		(1,093,035)
Revenue from external customers	7,029,453	14,103,375		21,132,828
Segment profit (loss)	2,270,890	3,846,198	(2,388,717)	3,728,371
Total assets	2,636,145	8,061,324	7,269,776	17,967,245
Capital expenditures	213,072	170,193	86,629	469,894
Total depreciation & amortization	219,742	390,715	185,815	796,272

37

Table of Contents

NOTE 9 OPERATING SEGMENTS CONTINUED

	Franchising	Manufacturing	Other	Total
FY 2003				
Total revenues	$5,555,876	$14,794,847	$	$20,350,723
Intersegment revenues		(889,251)		(889,251)
Revenue from external customers	5,555,876	13,905,596		19,461,472
Segment profit (loss)	1,635,959	3,701,220	(3,966,846)	1,370,333
Total assets	2,352,483	8,514,487	5,217,276	16,084,246
Capital expenditures	139,948	216,822	367,360	724,130
Provision for loss on accounts and notes receivable and related foreclosure costs			1,666,524	1,666,524
Total depreciation & amortization	206,923	411,994	196,362	815,279
FY 2002				
Total revenues	$5,819,742	$14,692,696	$	$20,512,438
Intersegment revenues		(1,073,361)		(1,073,361)
Revenue from external customers	5,819,742	13,619,335		19,439,077
Segment profit (loss)	1,750,056	3,898,178	(2,440,292)	3,207,942
Total assets	2,009,009	9,310,982	5,475,400	16,795,391
Capital expenditures	139,948	216,822	367,360	724,130
Total depreciation & amortization	272,359	432,714	200,154	905,227

NOTE 10 SUPPLEMENTAL CASH FLOW INFORMATION

For the three years ended February 28 or 29:

	2004	2003	2002
Interest paid	$144,936	$ 298,141	$ 448,384
Income taxes paid	212,393	1,088,692	1,024,208
Non-Cash Investing Activities:			
Company financed sales of retail store asset	$	$	$1,429,317
Dividend payable	236,108		
Fair value of assets received upon foreclosure of notes:			
Tangible store assets			
Held for sale		430,260	
Store to be operated		82,917	
Goodwill		242,083	

NOTE 11 EMPLOYEE BENEFIT PLAN

The Company has a 401(k) plan called the Rocky Mountain Chocolate Factory, Inc. 401(k) Plan. Eligible participants are permitted to make contributions up to statutory limits. The Company makes a matching contribution, which vests ratably over a 3-year period, and is 25% of the employee s contribution up to a maximum of 1.5% of the employee s compensation. For fiscal 2004, the Company made an additional discretionary contribution by doubling the normal matching. During the years ended February 28 or 29, 2004, 2003 and 2002, the Company s contribution was approximately $63,000, $33,000 and $33,000, respectively, to the plan.

NOTE 12 STORE SALES AND FORECLOSURES

In connection with the Company s plans to phase out its Company-owned stores, the Company sold ten Company-owned stores in fiscal 2002 resulting in sales proceeds consisting of cash and notes receivable of approximately $1.2 million and recognized and deferred gains of approximately $124,000 and $386,000, respectively.

In connection with the Company s plans to phase out its Company-owned stores, the Company sold eighteen Company-owned stores in fiscal 2001 resulting in sales proceeds consisting of cash and notes receivable of approximately $2.3 million and recognized and deferred gains of approximately $542,000 and $193,000, respectively.

At February 29, 2004, the Company has $962,300 of notes receivable outstanding. The notes require monthly payments and bear interest at rates ranging from 7.5% to 12.5%. The notes mature through October 2006 and are secured by the assets financed.

Table of Contents

NOTE 12 STORE SALES AND FORECLOSURES CONTINUED

During fiscal 2002 the Company adjusted the repayment schedule of the notes from a single franchisee to correspond to the franchisee s store operating cycles. The Company also financed an additional $300,000 of inventory and wrote-off $243,750 of the notes receivable. During fiscal 2003 the Company financed $230,000 for an additional store for the franchisee. During the third quarter of fiscal 2003 the Company recorded an additional $1,667,000 provision for potential loss on accounts and notes receivable and foreclosure costs related to the insolvency of this franchisee. In December 2002, the Company foreclosed on four of the stores previously operated by the franchisee and planned to operate one such retail outlet as a Company-owned store and sell three stores to other franchisees (Note 15). At February 28, 2003 the Company has no balance recorded for notes receivable from this franchisee.

NOTE 13 SUMMARIZED QUARTERLY DATA (UNAUDITED)

Following is a summary of the quarterly results of operations for the fourth quarter ended February 28 (29), 2004 and 2003:

			Fiscal Quarter		
	First	**Second**	**Third**	**Fourth**	**Total**
2004					
Total revenue	$3,926,799	$5,471,253	$5,801,058	$5,933,718	$21,132,828
Gross margin	1,041,551	1,653,081	1,791,704	1,646,522	6,132,858
Net income	381,137	679,770	630,402	627,737	2,319,046
Basic earnings per share	.09	.16	.15	.15	.55
Diluted earnings per share	.09	.15	.14	.14	.52

			Fiscal Quarter		
	First	**Second**	**Third**	**Fourth**	**Total**
2003					
Total revenue	$3,972,339	$5,066,360	$5,632,577	$4,790,196	$19,461,472
Gross margin	1,213,860	1,477,146	1,505,766	1,111,001	5,307,773
Net income (loss)	459,427	615,840	(472,653)	249,734	852,348
Basic earnings (loss) per share	.11	.15	(.11)	.06	.21
Dilute earnings (loss) per share	.10	.14	(.11)	.06	.19

NOTE 14 GOODWILL AND INTANGIBLE ASSETS

Effective March 1, 2002 the Company adopted Statement of Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Intangible Assets. SFAS 142 revised the accounting for purchased goodwill and intangible assets. Under SFAS 142, goodwill and intangible assets with indefinite lives will no longer be amortized, will be tested for impairment annually and also in the event of an impairment indicator, and must be assigned to reporting units for purposes of impairment testing and segment reporting.

The Company has historically amortized goodwill on the straight-line method over ten to twenty-five years. Beginning March 1, 2002, quarterly and annual goodwill amortization is no longer recognized. The Company completed a transitional fair value based impairment test of goodwill as of March 1, 2002. There were no impairment losses resulting from the transitional testing. The Company has three reporting units with goodwill.

Intangible assets consist of the following at February 28 or 29:

		2004		2003	
	Amortization Period	**Gross Carrying Value**	**Accumulated Amortization**	**Gross Carrying Value**	**Accumulated Amortization**
Intangible assets subject to amortization					
Store design	10 Years	$ 205,777	$ 43,508	$ 189,640	$ 23,034
Packaging licenses	3-5 Years	95,831	73,865	95,831	61,670
Packaging design	10 Years	403,238	88,588	403,238	46,838
Total		704,846	205,961	688,709	131,542
Intangible assets not subject to amortization					
Franchising segment-					
Company stores goodwill		1,275,962	336,847	1,182,083	336,847
Franchising goodwill		295,000	197,682	295,000	197,682
Manufacturing segment-Goodwill		295,000	197,682	295,000	197,682
Total Goodwill		1,865,962	732,211	1,772,083	732,211
Total intangible assets		$2,570,808	$938,172	$2,460,792	$863,753

39

Table of Contents

NOTE 14 GOODWILL AND INTANGIBLE ASSETS CONTINUED

Amortization expense related to intangible assets totaled $74,419 and $87,498 during the fiscal year ended February 28 or 29, 2004 and 2003. The aggregate estimated amortization expense for intangible assets remaining as of February 29, 2004 is as follows:

2005	$ 77,800
2006	72,100
2007	61,100
2008	61,100
2009	61,100
Thereafter	165,685
Total	498,885

Net income and earnings per share for the year ended February 28 or 29, 2004, 2003 and 2002 adjusted to exclude goodwill amortization is as follows:

	2004	2003	2002
Reported net income	$2,319,046	$852,348	$1,995,342
Goodwill amortization, net of tax			73,152
Adjusted net income	$2,319,046	$852,348	$2,068,494
Basic earnings per share:			
Reported net income	$ .55	$ .21	$ .49
Goodwill amortization, net of tax			.02
Adjusted net income	$ .55	$ .21	$ .51
Diluted earnings per share:			
Reported net income	$ .52	$ .19	$ .46
Goodwill amortization, net of tax			.02
Adjusted net income	$ .52	$ .19	$ .48

NOTE 15 ASSETS HELD FOR SALE

Assets held for sale consist of individual items of equipment, furniture and fixtures that were acquired in partial satisfaction of certain notes receivable from a franchisee. The notes were originally extended as part of store sales and construction financing of additional stores for the franchisee (Note 12). Management expects to dispose of the acquired assets to either existing franchisees who plan to upgrade or expand their operations or to prospective franchisees. These assets are included in Other for segment reporting. Three operational stores in the amount of $255,000 previously classified as held for sale were reclassified to property and equipment, net when management s intentions changed in the second quarter of Fiscal 2004.

NOTE 16 RECENT ACCOUNTING PRONOUNCEMENTS

In December 2003, the Financial Accounting Standards Board (FASB) issued Interpretation 46(R) (FIN 46(R), *Consolidation of Variable Interest Entities*. FIN 46(R) replaces FIN 46 and addresses consolidation by business enterprises of variable interest entities. The provisions of FIN 46(R) are effective for the first reporting period that ends after December 15, 2003 for variable interests in those entities commonly referred to as special-purpose entities. Application of the provisions of FIN 46(R) for all other entities is effective for the first reporting period ending after March 15, 2004. The Company has no interest in any entity considered a special purpose entity. The Company does not anticipate FIN 46(R) to have a material effect on the Company s financial statements.

Table of Contents

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

On February 12, 2004 the Company dismissed Grant Thornton LLP as the Company s independent accountant and engaged Ehrhardt Keefe Steiner & Hottman PC as the Company s new independent accountant. The Company hereby incorporates by reference the information contained in its Current Report on Form 8-K filed with the Commission on February 17, 2004.

PART III.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

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

The information required by this item with respect to directors is incorporated by reference from the information under the caption Election of Directors and Section 16(a) Beneficial Ownership Reporting Compliance contained in the Company s Proxy Statement for the Company s Annual Meeting of Shareholders to be held on August 13, 2004 (the Proxy Statement).

ITEM 11. EXECUTIVE COMPENSATION

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

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

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

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

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

ITEM 14. CONTROLS AND PROCEDURES

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures within 90 days of the filing date of this annual report, and, based on their evaluation, our principal executive officer and principal financial officer have concluded that these controls and procedures are effective. There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. Disclosure controls and procedures are our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

ITEM 15. PRINCIPAL ACCOUNTANT FEES AND SERVICES

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

Table of Contents

PART IV.

ITEM 16. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

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

1. Financial Statements

	Page
Report of Independent Certified Public Accountants	24-25
Statements of Income	26
Balance Sheets	27
Statements of Changes in Stockholders Equity	28
Statements of Cash Flows	29
Notes to Financial Statements	30

2. Financial Statement Schedules

	Page
Report of Independent Certified Public Accountants on Schedules	42
SCHEDULE II Valuation and Qualifying Accounts	43

INDEPENDENT AUDITORS REPORT ON SCHEDULES

Board of Directors and Stockholders
Rocky Mountain Chocolate Factory, Inc.
Durango, Colorado

In connection with our audit of the financial statements of Rocky Mountain Chocolate Factory, Inc. referred to in our report dated April 23, 2004, which is included in Part II of this Form 10-K, we have also audited Schedule II for the year ended February 29, 2004. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth therein.

Ehrhardt Keefe Steiner & Hottman PC

April 23, 2004
Denver, Colorado

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS ON SCHEDULES

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

In connection with our audit of the financial statements of Rocky Mountain Chocolate Factory, Inc. referred to in our report dated April 18, 2003, which is included in Part II of this Form 10-K, we have also audited Schedule II for each of the three years in the period ended February 28, 2003. In our opinion, this schedule presents fairly, in all material respects, the information required to be set forth therein.

GRANT THORNTON LLP

Dallas, Texas
April 18, 2003

Table of Contents

SCHEDULE II Valuation and Qualifying Accounts

	Balance at Beginning of Period	Additions Charged to Costs & Exp.	Deductions	Balance at End of Period
Year Ended February 29, 2004				
Valuation Allowance for Accounts and Notes Receivable	$114,563	$ 50,000	$ 43,928	$120,635
Year Ended February 28, 2003				
Valuation Allowance for Accounts and Notes Receivable	298,959	1,754,524	1,938,920	114,563
Year Ended February 28, 2002				
Valuation Allowance for Accounts and Notes Receivable	202,544	162,046	65,631	298,959

3. Exhibits

Exhibit Number	Description	Incorporated by Reference to
3.1	Articles of Incorporation of the Registrant, as amended	Exhibit 3.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988.
3.2	By-laws of the Registrant, as amended on November 25, 1997	Exhibit 3.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
4.1	Specimen Common Stock Certificate	Exhibit 4.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988.
4.2	Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant	Exhibit 4.1 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.3	Change in Terms Agreement dated August 31, 2001 in the amount of $2,800,000 between Wells Fargo Bank and the Registrant	Exhibit 4.2 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.4	Change in Terms Agreement dated August 31, 2001 in the amount of $2,092,500 between Wells Fargo Bank and the Registrant	Exhibit 4.3 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.5		

	Promissory Note dated August 31, 2001 in the amount of $2,000,000 between Wells Fargo Bank and the Registrant	Exhibit 4.4 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.6	Fourth Amendment, dated October 31, 2003, to Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant	Exhibit 4.1 to the Quarterly Report on form 10.Q of the Registrant for the quarter ended November 30, 2003.
10.1	Form of Stock Option Agreement for the Registrant	Exhibit 10.3 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1986.

Table of Contents

3. Exhibits (continued)

Exhibit Number	Description	Incorporated by Reference to
10.2	Incentive Stock Option Plan of the Registrant as amended July 27, 1990	Exhibit 10.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.
10.3	Form of Employment Agreement between the Registrant and its officers	Exhibit 99.2 to Schedule on Form 14D9 of the Registrant filed on May 21, 1999.
10.4	Current form of franchise agreement used by the Registrant	Exhibit 10.1 to the Quarterly Report on form 10-Q of the Registrant for the quarter ended May 31, 2003.
10.5	Form of Real Estate Lease between the Registrant as Lessee and franchisee as Sublessee	Exhibit 10.7 to Registration Statement on Form S-18 (Registration No. 33-2016-D).
10.6	Form of Nonqualified Stock Option Agreement for Nonemployee Directors for the Registrant	Exhibit 10.8 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.
10.7	Nonqualified Stock Option Plan for Nonemployee Directors dated March 20, 1990	Exhibit 10.9 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.
10.8	1995 Stock Option Plan of the Registrant	Exhibit 10.9 to Registration Statement on Form S-1 (Registration No. 33-62149) filed August 25, 1995.
10.9	Forms of Incentive Stock Option Agreement for 1995 Stock Option Plan	Exhibit 10.10 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995.
10.10	Forms of Nonqualified Stock Option Agreement for 1995 Stock Option Plan	Exhibit 10.11 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995.
10.11	Form of Indemnification Agreement between the Registrant and its directors	Exhibit 10.12 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.12	Form of Indemnification Agreement between the Registrant and its officers	Exhibit 10.13 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.13	Form of Promissory Note and Stock Pledge Agreement between the Registrant and certain of its officers and directors	Exhibit 10.14 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.14	Commodity Contract with Guittard Chocolate Company *	Filed herewith.
23.1	Consent of Independent Certified Public Accountants	Filed herewith.

44

Table of Contents

3. Exhibits (continued)

Exhibit Number	Description	Incorporated by Reference to
31.1	Certification Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, Chief Executive Officer	Filed herewith.
31.2	Certification Pursuant TO Section 302 of the Sarbanes-Oxley Act of 2002, Chief Financial Officer	Filed herewith.
32.1	Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer	Filed herewith.
32.2	Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer	Filed herewith
99.1	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	Current Report on Form 8K of the Registrant filed on February 17, 2004 and exhibit 16.1 thereto.

Legend:

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

Table of Contents

(b) Reports on Form 8-K.

A report on Form 8-K was filed by the Registrant on January 8, 2004, disclosing Item 12 and Item 7 information. A report on Form 8-K were was filed by the Registrant on February 17, 2004, disclosing Item 4 and Item 7 information. No other reports on Form 8-K were filed during the fourth quarter of the year ended February 29, 2004. The Company filed a report on Form 8-K on May 6, 2004 disclosing Item 12 and Item 7 information.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

ROCKY MOUNTAIN CHOCOLATE FACTORY, INC.

/S/ Bryan J. Merryman

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

Date: November 5, 2004

Table of Contents

EXHIBIT INDEX

Exhibit Number	Description	Incorporated by Reference to
3.1	Articles of Incorporation of the Registrant, as amended	Exhibit 3.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988.
3.2	By-laws of the Registrant, as amended on November 25, 1997	Exhibit 3.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
4.1	Specimen Common Stock Certificate	Exhibit 4.1 to Current Report on Form 8-K of the Registrant filed on August 1, 1988.
4.2	Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant	Exhibit 4.1 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.3	Change in Terms Agreement dated August 31, 2001 in the amount of $2,800,000 between Wells Fargo Bank and the Registrant	Exhibit 4.2 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.4	Change in Terms Agreement dated August 31, 2001 in the amount of $2,092,500 between Wells Fargo Bank and the Registrant.	Exhibit 4.3 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.5	Promissory Note dated August 31, 2001 in the amount of $2,000,000 between Wells Fargo Bank and the Registrant.	Exhibit 4.4 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended August 31, 2001.
4.6	Fourth Amendment, dated October 31, 2003, to Credit Agreement dated August 31, 2001 between Wells Fargo Bank and the Registrant	Exhibit 4.1 to the Quarterly Report on Form 10-Q of the Registrant for the quarter ended November 30, 2003.
10.1	Form of Stock Option Agreement for the Registrant	Exhibit 10.3 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1986.
10.2	Incentive Stock Option Plan of the Registrant as amended July 27, 1990	Exhibit 10.2 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.
10.3	Form of Employment Agreement between the Registrant and its officers	Exhibit 99.2 to Schedule on Form 14D9 of the Registrant filed on May 21, 1999.
10.4	Current form of franchise agreement used by the Registrant	Exhibit 10.1 to the Quarterly Report on form 10-Q of the Registrant for the quarter ended May 31, 2003.
10.5	Form of Real Estate Lease between the Registrant as Lessee and franchisee as Sublessee	Exhibit 10.7 to Registration Statement on Form S-18 (Registration No. 33-2016-D).
10.6		

Form of Nonqualified Stock Option Agreement for Nonemployee Directors for the Registrant	Exhibit 10.8 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.

Table of Contents

Exhibit Number	Description	Incorporated by Reference to
10.7	Nonqualified Stock Option Plan for Nonemployee Directors dated March 20, 1990	Exhibit 10.9 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1991.
10.8	1995 Stock Option Plan of the Registrant	Exhibit 10.9 to Registration Statement on Form S-1 (Registration No. 33-62149) filed August 25, 1995.
10.9	Forms of Incentive Stock Option Agreement for 1995 Stock Option Plan	Exhibit 10.10 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995.
10.10	Forms of Nonqualified Stock Option Agreement for 1995 Stock Option Plan	Exhibit 10.11 to Registration Statement on Form S-1 (Registration No. 33-62149) filed on August 25, 1995.
10.11	Form of Indemnification Agreement between the Registrant and its directors	Exhibit 10.12 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.12	Form of Indemnification Agreement between the Registrant and its officers	Exhibit 10.13 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.13	Form of Promissory Note and Stock Pledge Agreement between the Registrant and certain of its officers and directors	Exhibit 10.14 to the Annual Report on Form 10-K of the Registrant for the fiscal year ended February 28, 1998.
10.14	Commodity Contract with Guittard Chocolate Company *	Filed herewith.
23.1	Consent of Independent Certified Public Accountants	Filed herewith.
31.1	Certification Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, Chief Executive Officer	Filed herewith.
31.2	Certification Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, Chief Financial Officer	Filed herewith.
32.1	Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Executive Officer	Filed herewith.
32.2	Certification Pursuant To Section 906 Of The Sarbanes-Oxley Act of 2002, Chief Financial Officer	Filed herewith
99.1	Changes in and Disagreements with Accountants on Accounting and Financial	Current Report on Form 8K of the Registrant filed on February 17, 2004 and exhibit 16.1 thereto.

Disclosure

Legend:

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