

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON D.C. 20549

QUARTERLY REPORT UNDER SECTION 13 OR 15 (d)  
OF THE SECURITIES AND EXCHANGE ACT OF 1934

For Quarter Ended  
**September 30, 2004**

Commission File Number:  
**0-21026**

**ROCKY SHOES & BOOTS, INC.**

(Exact name of registrant as specified in its charter)

**Ohio**  
(State of Incorporation)

**31-1364046**  
(IRS Employer Identification Number)

**39 E. Canal Street**  
**Nelsonville, Ohio 45764**  
(Address of principal executive offices)

**(740) 753-1951**  
(Registrant's telephone number, including area code)

(Former name, former address, and former Fiscal year if changed since last report.)

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 twelve (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 ninety (90) days.

Yes  No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

4,620,170 common shares, no par value, outstanding at October 29, 2004

Rocky Shoes & Boots, Inc. and Subsidiaries

Form 10-Q

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**PART 1 - FINANCIAL INFORMATION**  
**ITEM 1 - FINANCIAL STATEMENTS**

**Rocky Shoes & Boots, Inc. and Subsidiaries**  
**Condensed Consolidated Balance Sheets**

	September 30, 2004 Unaudited	December 31, 2003	September 30, 2003 Unaudited
<b>ASSETS:</b>			
<b>CURRENT ASSETS:</b>			
Cash and cash equivalents	\$ 780,739	\$ 2,159,050	\$ 1,374,062
Trade receivables – net	45,522,136	19,532,287	39,806,328
Other receivables	782,285	830,131	822,451
Inventories	38,738,153	38,068,187	42,216,415
Deferred income taxes	959,810	959,810	578,951
Prepaid expenses	809,482	1,045,238	1,633,904
Total current assets	<u>87,592,605</u>	<u>62,594,703</u>	<u>86,432,111</u>
FIXED ASSETS – net	20,091,910	17,610,238	17,953,270
DEFERRED PENSION ASSET	2,499,524	1,499,524	1,651,222
OTHER ASSETS	4,853,982	4,470,371	3,858,374
<b>TOTAL ASSETS</b>	<u><u>\$ 115,038,021</u></u>	<u><u>\$ 86,174,836</u></u>	<u><u>\$ 109,894,977</u></u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>			
<b>CURRENT LIABILITIES:</b>			
Accounts payable	\$ 6,704,676	\$ 2,810,161	\$ 7,775,924
Current maturities - long term debt	525,596	503,934	497,005
Accrued expenses:			
Income taxes	2,354,207	1,929,808	1,542,626
Taxes - other	382,846	372,432	377,883
Salaries and wages	2,270,769	1,885,896	1,992,671
Other	1,328,492	882,434	1,109,559
Total current liabilities	<u>13,566,586</u>	<u>8,384,665</u>	<u>13,295,668</u>
LONG TERM DEBT-less current maturities	32,388,913	17,514,994	40,780,812
DEFERRED LIABILITIES	2,495,578	1,890,500	1,954,277
<b>TOTAL LIABILITIES</b>	48,451,077	27,790,159	56,030,757
<b>SHAREHOLDERS' EQUITY:</b>			
Common stock, no par value;			
10,000,000 shares authorized; issued and outstanding			
September 30, 2004 - 4,620,170; December 31, 2003-			
4,360,400; September 30, 2003 - 4,126,930	36,674,834	34,880,199	32,819,489
Accumulated other comprehensive loss	(1,950,400)	(1,950,400)	(2,311,749)
Retained earnings	31,862,510	25,454,878	23,356,480
Total shareholders' equity	<u>66,586,944</u>	<u>58,384,677</u>	<u>53,864,220</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u><u>\$ 115,038,021</u></u>	<u><u>\$ 86,174,836</u></u>	<u><u>\$ 109,894,977</u></u>

See notes to the interim unaudited condensed consolidated financial statements.

**Rocky Shoes & Boots, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Income**  
**(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
NET SALES	\$ 50,052,894	\$ 41,349,824	\$ 99,368,970	\$ 76,967,913
COST OF GOODS SOLD	<u>34,056,404</u>	<u>28,264,032</u>	<u>69,977,667</u>	<u>53,681,609</u>
GROSS MARGIN	15,996,490	13,085,792	29,391,303	23,286,304
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	<u>8,323,464</u>	<u>7,628,958</u>	<u>19,047,531</u>	<u>16,823,883</u>
INCOME FROM OPERATIONS	7,673,026	5,456,834	10,343,772	6,462,421
OTHER INCOME AND (EXPENSES):				
Interest expense	(422,120)	(437,241)	(955,561)	(946,859)
Other – net	<u>(54,404)</u>	<u>(18,744)</u>	<u>43,984</u>	<u>161,359</u>
Total other - net	<u>(476,524)</u>	<u>(455,985)</u>	<u>(911,577)</u>	<u>(785,500)</u>
INCOME BEFORE INCOME TAXES	7,196,502	5,000,849	9,432,195	5,676,921
INCOME TAX EXPENSE	<u>2,309,143</u>	<u>1,533,254</u>	<u>3,024,563</u>	<u>1,736,076</u>
NET INCOME	<u>\$ 4,887,359</u>	<u>\$ 3,467,595</u>	<u>\$ 6,407,632</u>	<u>\$ 3,940,845</u>
NET INCOME PER SHARE				
Basic	<u>\$ 1.06</u>	<u>\$ 0.84</u>	<u>\$ 1.41</u>	<u>\$ 0.94</u>
Diluted	<u>\$ 0.98</u>	<u>\$ 0.77</u>	<u>\$ 1.30</u>	<u>\$ 0.88</u>
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING				
Basic	<u>4,605,800</u>	<u>4,109,147</u>	<u>4,530,867</u>	<u>4,178,942</u>
Diluted	<u>4,992,319</u>	<u>4,512,886</u>	<u>4,943,929</u>	<u>4,459,783</u>

See notes to the interim unaudited condensed consolidated financial statements.

**Rocky Shoes & Boots, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Cash Flows**  
**(Unaudited)**

	Nine Months Ended September 30,	
	<u>2004</u>	<u>2003</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 6,407,632	\$ 3,940,845
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	2,464,937	2,674,593
Deferred income taxes	-	439,499
Deferred compensation and pension - net	(394,922)	433,939
Loss on sale of fixed assets	-	8,743
Stock issued as directors' compensation	66,885	-
Change in assets and liabilities:		
Receivables	(25,942,003)	(24,172,447)
Inventories	(669,966)	(16,994,356)
Other current assets	235,756	(366,807)
Other assets	(402,958)	136,614
Accounts payable	3,940,097	5,364,170
Accrued and other liabilities	<u>760,740</u>	<u>2,701,903</u>
Net cash used in operating activities	(13,533,802)	(25,833,304)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchase of fixed assets	(4,467,840)	(1,444,034)
Acquisition of business	-	(3,510,070)
Proceeds from sale of fixed assets	<u>-</u>	<u>51,029</u>
Net cash used in investing activities	(4,467,840)	(4,903,075)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from long term debt	91,920,037	86,558,753
Payments on long term debt	(77,024,456)	(56,255,485)
Purchase of treasury stock	-	(3,106,156)
Proceeds from exercise of stock options	<u>1,727,750</u>	<u>636,607</u>
Net cash provided by financing activities	<u>16,623,331</u>	<u>27,833,719</u>
<b>DECREASE IN CASH AND CASH EQUIVALENTS</b>	(1,378,311)	(2,902,660)
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<u>2,159,050</u>	<u>4,276,722</u>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<u>\$ 780,739</u>	<u>\$ 1,374,062</u>

See notes to the interim unaudited condensed consolidated financial statements.

**Rocky Shoes & Boots, Inc.  
and Subsidiaries**

**Notes to the Interim Unaudited Condensed Consolidated Financial Statements  
For the Periods Ended September 30, 2004 and 2003**

**1. INTERIM FINANCIAL REPORTING**

In the opinion of management, the accompanying interim unaudited condensed consolidated financial statements reflect all adjustments which are necessary for a fair presentation of the financial results. All such adjustments reflected in the interim unaudited condensed consolidated financial statements are considered to be of a normal and recurring nature. The results of the operations for the three-month and nine-month periods ended September 30, 2004 and 2003 are not necessarily indicative of the results to be expected for the whole year. Accordingly, these consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report to the Shareholders on Form 10-K for the year ended December 31, 2003.

Certain reclassifications have been made to the prior year amounts in order to conform to the current year presentation.

The Company accounts for its stock option plans in accordance with APB Opinion No. 25, under which no compensation cost has been recognized. Had compensation cost for all stock option plans been determined consistent with the SFAS No. 123, "Accounting for Stock Based Compensation," the Company's net income and income per share would have resulted in the amounts as reported below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net income as reported	\$ 4,887,359	\$ 3,467,595	\$ 6,407,632	\$ 3,940,845
Deduct: Stock based employee compensation expense determined under fair value based method for all awards, net	<u>205,125</u>	<u>-</u>	<u>634,970</u>	<u>333,640</u>
Pro forma net income	<u>\$ 4,682,234</u>	<u>\$ 3,467,595</u>	<u>\$ 5,772,663</u>	<u>\$ 3,607,205</u>
Earnings per share:				
Basic - as reported	\$ 1.06	\$ 0.84	\$ 1.41	\$ 0.94
Basic - pro forma	\$ 1.02	\$ 0.84	\$ 1.27	\$ 0.86
Diluted - as reported	\$ 0.98	\$ 0.77	\$ 1.30	\$ 0.88
Diluted - pro forma	\$ 0.94	\$ 0.77	\$ 1.17	\$ 0.82

The pro forma amounts are not representative of the effects on reported net income for future years.

## 2. INVENTORIES

Inventories are comprised of the following:

	September 30, <u>2004</u>	December 31, <u>2003</u>	September 30, <u>2002</u>
Raw materials	\$ 6,110,035	\$ 5,087,468	\$ 5,424,458
Work-in-Process	1,690,521	878,091	949,095
Finished goods	29,166,558	31,168,371	34,486,579
Factory outlet finished goods	1,996,039	1,299,257	1,728,283
Reserve for obsolescence or lower of cost or market	<u>(225,000)</u>	<u>(365,000)</u>	<u>(372,000)</u>
Total	<u>\$ 38,738,153</u>	<u>\$ 38,068,187</u>	<u>\$ 42,216,415</u>

## 3. SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest and Federal, state and local income taxes was as follows:

	Nine Months Ended September 30,	
	<u>2004</u>	<u>2003</u>
Interest	<u>\$ 877,324</u>	<u>\$ 937,343</u>
Federal, state and local income taxes - net	<u>\$2,580,000</u>	<u>\$ 90,000</u>
Non-cash payments:		
Capital lease	<u>\$ 505,000</u>	

Accounts payable at September 30, 2004 and September 30, 2003 include a total of \$45,582 and \$177,276, respectively, relating to the purchase of fixed assets.

## 4. PER SHARE INFORMATION

Basic earnings per share (EPS) is computed by dividing net income applicable to common shareholders by the basic weighted average number of common shares outstanding during each period. The diluted earnings per share computation includes common share equivalents, when dilutive. There are no adjustments to net income necessary in the calculation of basic and diluted earnings per share.

A reconciliation of the shares used in the basic and diluted income per common share computation for the three months and nine months ended September 30, 2004 and 2003 is as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Basic weighted average shares outstanding	4,605,800	4,109,147	4,530,867	4,178,942
Diluted securities: Stock options	<u>386,519</u>	<u>403,739</u>	<u>413,062</u>	<u>280,841</u>
Diluted weighted average shares outstanding	<u>4,992,319</u>	<u>4,512,886</u>	<u>4,943,929</u>	<u>4,459,783</u>

## 5. RECENTLY ADOPTED FINANCIAL ACCOUNTING STANDARDS

In December 2003, the FASB issued Revised SFAS No. 132, “Employers’ Disclosures about Pensions and Other Postretirement Benefits” (“SFAS No. 132”). SFAS No. 132 revises the annual disclosure requirements for pensions and postretirement plans to include additional disclosures about assets, obligations, cash flows, and net periodic benefit costs of defined benefit pension and other defined benefit postretirement plans. SFAS No. 132 also revises the interim disclosure requirements to include disclosures of the net periodic benefit costs for each period in which an income statement is presented and the employer’s contributions paid and expected to be paid during the current fiscal year, if the contributions are significantly different than previously disclosed amounts. The Statement is effective for financial statements with fiscal years ending after December 15, 2003. For interim-period disclosures, the Statement is effective for interim periods beginning after December 15, 2003. We have adopted this Statement for interim-period disclosures in these condensed consolidated financial statements, and we will adopt the annual disclosures with our December 31, 2004 Form 10-K. The adoption of FAS No. 132 does not have an impact on our financial condition or results of operations, as it pertains only to disclosure provisions.

## 6. ACQUISITION

On April 15, 2003, the Company completed the purchase of certain assets from Gates-Mills, Inc. (“Gates”). Under the terms of the Purchase Agreement, Rocky acquired all of the intellectual property of Gates, including ownership of the Gates ® trademark, selected raw material and finished goods inventory, and certain records in connection with the Gates business in exchange for a total purchase price of \$4.9 million, of which \$3.5 million had been expended through September 30, 2003.

## 7. CAPITAL STOCK

The Company was authorized to repurchase up to 500,000 shares of our outstanding common shares. Purchases occurred on the open market and/or in privately negotiated transactions as market conditions warranted. As of March 31, 2003, the Company had purchased a total of 499,933 shares at an average price of \$6.38. No additional shares have been repurchased since March 31, 2003.

For the nine months ended September 30, 2004, options for 256,200 of the Company's common stock were exercised at an average price of \$6.68. The outside members of the Board of Directors received a total of 3,570 shares in lieu of cash as part of their director compensation.

## 8. RETIREMENT PLANS

SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits," generally requires additional disclosures to those in the original Statement 132 about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans.

Net pension cost of the Company's plans is as follows:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2004	2003	2004	2003
Service cost	\$ 128,080	\$ 96,923	\$ 384,238	\$ 290,769
Interest	90,758	150,870	378,406	\$ 452,610
Expected return on assets	(86,391)	(138,247)	(386,198)	\$ (414,741)
Amortization of unrecognized net loss	32,141	44,660	101,327	\$ 133,980
Amortization of unrecognized transition obligation	4,076	4,077	12,230	\$ 12,231
Amortization of unrecognized prior service cost	33,849	33,848	101,545	\$ 101,544
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net pension cost	<u>\$ 202,513</u>	<u>\$ 192,131</u>	<u>\$ 591,548</u>	<u>\$ 576,393</u>

The Company's unrecognized benefit obligations existing at the date of transition for the non-union plan is being amortized over 21 years. Actuarial assumptions used in the accounting for the plans were as follows:

	September 30,	
	2004	2003
Discount rate	5.75 %	5.75 %
Average rate of increase in compensation levels (non-union only)	3.0 %	3.0 %
Expected long-term rate of return on plan assets	8.0 %	8.0 %

The Company's desired investment result is a long-term rate of return on assets that is at least a 8%. The target rate of return for the plans have been based upon the assumption that returns will approximate the long-term rates of return experienced for each asset class in the Company's investment policy. The Company's investment guidelines are based upon an investment horizon of greater than five years, so that interim fluctuations should be viewed with appropriate perspective. Similarly, the Plan's strategic asset allocation is based on this long-term perspective.

The Company contributed \$1.0 million to the plan in the nine months ended September 30, 2004. At this time the Company does not plan any further contributions in 2004.

In 2001, the Company announced a restructuring plan to consolidate and realign the Company's footwear manufacturing operations. As part of the plan, 67 employees were eliminated and the plan assets were frozen as of September 30, 2001. In April of 2004 the remaining assets of the Union pension plan were used to purchase individual annuities for the terminated employees. In September of 2004, the remaining restructuring accrual balance of \$63,228 was recorded as pension liability. No further contributions will be made to the plan.

## **9. LONG-TERM DEBT**

On September 18, 2000, the Company entered into a three-year loan and security agreement with GMAC Business Credit, LLC ("GMAC") refinancing its former bank revolving line of credit based on the collateral value of its accounts receivable and inventory. On October 21, 2002 the Company extended the agreement two years. On September 14, 2004, the Company extended the agreement two additional months. This loan and security agreement permits a borrowing base to a maximum of \$45,000,000. Interest on the revolving credit facility is payable monthly at GMAC's prime rate, and the entire principal is due November 30, 2005.

On July 26, 2004 the Second Amendment to Lease Agreement by and between William Brooks Real Estate Company ("Lessor"), an Ohio corporation, 25% of which is currently owned by Mike Brooks, and the Company ("Lessee") was signed. The Lessor agrees to sell and convey to Lessee and the Lessee agrees to buy and pay for the Leased Premises on or before January 31, 2005, for a purchase price of \$505,000. The Company believes that these terms are no less favorable to the Company than it could have obtained from unrelated parties. The Company has recorded the lease as a capital lease, and the debt is recorded as a current liability.

**PART 1 - FINANCIAL INFORMATION**  
**ITEM 2**

**Management's Discussion and Analysis**  
**of Financial Condition and Results of Operations**

**Results of Operations**

The following table sets forth, for the periods indicated, information derived from the Company's Interim Unaudited Condensed Consolidated Financial Statements, expressed as a percentage of net sales. The discussion that follows the table should be read in conjunction with the Interim Unaudited Condensed Consolidated Financial Statements of the Company.

	<b>Percentage of Net Sales</b>			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Net Sales	100.0%	100.0%	100.0%	100.0%
Cost of Goods Sold	<u>68.0%</u>	<u>68.4%</u>	<u>70.4%</u>	<u>69.7%</u>
Gross Margin	32.0%	31.6%	29.6%	30.3%
SG&A expenses	<u>16.6%</u>	<u>18.4%</u>	<u>19.2%</u>	<u>21.9%</u>
Income from Operations	<u>15.4%</u>	<u>13.2%</u>	<u>10.4%</u>	<u>8.4%</u>

**Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2003**

*Net Sales*

Net sales increased in the third quarter 2004 to \$50.1 million compared to \$41.3 million for the same period in 2003. This 21.3% increase was attributable to an increase in branded sales of 15.2% and shipments of boots to the U.S. military. The \$4.0 million increase in branded sales was lead by increased sales of rugged outdoor and occupational footwear and ROCKY® apparel. Shipments of boots for delivery to the U.S. military were \$5.1 million in third quarter 2004 compared to none for the same period last year.

*Gross Margin*

Gross profit was \$16.0 million, or 32% of net sales for the third quarter 2004 compared to \$13.1 million, or 31.6% of net sales, for the same period in the prior year. The increase in gross margin percentage resulted from the sales mix of increased branded sales with higher gross profit margin, which offset lower profit margins on boots the Company manufactures for delivery to the U.S. military.

### *Selling, General and Administrative Expenses*

Selling, general and administrative (“SG&A”) expenses were \$8.3 million, or 16.6% of net sales, for the quarter ended September 30, 2004 compared to \$7.6 million, or 18.4% of net sales, for the same period in the prior year. The decline in SG&A expenses as a percentage of sales was attributable to nominal SG&A expenses related to the sales of boots for delivery to the U.S. military. The increase in SG&A expenses was primarily due to expenses related to the Sarbanes-Oxley Act of 2002 of \$0.3 million, and distribution costs associated with the growth in branded product sales that increased \$0.3 million as compared to a year ago.

### *Interest Expense*

Interest expense was \$0.4 million in the third quarter 2004 compared to \$0.4 million for the same period the prior year. The Company’s funded debt as of September 30, 2004 was \$32.9 million. This is \$8.4 million or 20.3% below funded debt on the same date last year. The Company’s average debt was \$31.5 million for the three months ended September 30, 2004, compared with \$38.8 the same period in 2003. The average rate of interest for the three months ended September 30 was 5.2% in 2004 compared to 4.4% in 2003.

### *Income Taxes*

Income tax expense for the quarter ended September 30, 2004 was \$2.3 million compared to \$1.5 million for the same period a year ago. The Company’s effective tax rate was 32.1% for the three months ended September 30, 2004 versus 30.7% for the same period in 2003. The increase in the effective tax rate in 2004 over 2003 is due primarily to the increase in sales of sourced products and boots sold to the U. S. military, which are taxed at U.S. effective tax rates.

## **Nine Months Ended September 30, 2004 compared to the Nine Months Ended September 30, 2003**

### *Net Sales*

Net sales increased in the nine months ended September 30, 2004 to \$99.4 million compared to \$77.0 million for the same period in 2003. This represents a 29.1% increase and is attributable to a \$9.6 million increase in branded sales and \$12.8 million increase in sales to the U.S. military when compared to the prior year. The branded sales increase was led by sales of occupational footwear, ROCKY<sup>®</sup> apparel and rugged outdoor footwear.

### *Gross Margin*

Gross profit for the nine months ended September 30, 2004 was \$29.4 million, or 29.6% of net sales compared to \$23.3 million, or 30.3% of net sales, the prior year. The decrease in gross margin percentage was due to shipments of boots for delivery to the U.S. military and related start-up costs for these boots in 2004 compared to none for the same period last year. The Company sells military boots at lower gross margin than its branded products.

### *Selling, General and Administrative Expenses*

Selling, general and administrative (“SG&A”) expenses were \$19.0 million, or 19.2% of net sales, for the nine months ended September 30, 2004 compared to \$16.8 million, or 21.9% of net sales, the prior year. The decline in SG&A expenses as a percentage of sales was attributable to nominal SG&A expenses related to the sales of boots for delivery to the U.S. military. The increase in SG&A expenses was primarily due to commissions that increased \$0.4 million, advertising expenses that increased \$0.3 million, distribution costs associated with the growth in branded product sales that increased \$0.5 million, industry trade show expense that increased \$0.3 million and expenses related to the Sarbanes-Oxley Act of 2002 that increased \$0.3 when compared to a year ago.

### *Interest Expense*

Interest expense for the nine months ended September 30, 2004 increased to \$1.0 million versus \$0.9 million for the same period a year ago. The increase in interest is the result of a higher effective rate of interest for the nine months ended September 30, 2004. The Company’s average debt was \$21.3 million for the nine months ended September 30, 2004, compared with \$22.7 the same period in 2003. The average rate of interest for the nine months ended September 30 was 6.0% in 2004 compared to 5.6% in 2003.

### *Income Taxes*

Income taxes for the nine months ended September 30, 2004 increased to \$3.0 million compared to \$1.7 million the same period last year. The Company's effective tax rate of 32.1% for the nine months ended September 30, 2004 compares with an effective tax rate 30.6% for the same period a year ago. The increase in the effective tax rate in 2004 over 2003 is due primarily to the increase in sales of sourced products and boots sold to the U.S. military, which are taxed at U.S. effective tax rates.

### *Liquidity and Capital Resources*

The Company principally funds working capital requirements and capital expenditures through income from operations, borrowings under its credit facility and other indebtedness. Working capital is primarily used to support changes in accounts receivable and inventory because of the Company’s seasonal business cycle and business expansion. These requirements are generally lowest in the months of January through March of each year and highest during the months of May through October. At September 30, 2004, the Company had working capital of \$74.0 million versus \$73.1 million on the same date last year and \$54.2 million at December 31, 2003.

The Company's line of credit provides for advances based on a percentage of eligible accounts receivable and inventory with maximum borrowings under the line of credit of \$45.0 million. As of September 30, 2004, the Company had borrowed \$27.8 million against its then currently available line of credit of \$44.3 million compared with \$35.7 million and \$41.5 million respectively in the same period of 2003.

The Company's cash flow used in operations was \$13.5 million in the first nine months of 2004 compared to \$25.8 million in the same period of 2003. Increases in accounts receivable was partially offset by an increase in accounts payable, both the result of increased sales volume. The increase in accrued liabilities was due to the increase of income taxes that resulted from the increased year-to-date operating results of fiscal 2004. Most of the respective balance sheet fluctuations reflect the seasonal nature of the Company's business, and the increased sales and bookings for the current year.

The principal use of cash flows in investing activities for the first nine months of 2004 and 2003 has been for the acquisition and investment in property, plant, and equipment. In the first nine months of 2003 the Company acquired certain assets of Gates-Mills, Inc. The Gates-Mills, Inc. assets were acquired for \$3.5 million in 2003. In the first nine months of 2004, property, plant, and equipment expenditures were \$4.5 million versus \$1.4 million in the same period of 2003. The current year expenditures primarily represent investments in expansion of the workspace at the Company's distribution center, retail outlet, as well as sales fixtures and displays.

The Company's net cash provided by financing activities for the nine months ended September 30, 2004 was \$16.6 million, comprised of the proceeds from the exercise of stock options of \$1.7 million, as well as a net increase on its revolving credit facility and long-term mortgage facility of \$14.9 million.

### *Inflation*

The Company cannot determine the precise effects of inflation; however, inflation continues to have an influence on the cost of materials, salaries, and employee benefits. The Company attempts to offset the effects of inflation through increased selling prices, productivity improvements, and reduction of costs.

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations discuss the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period.

Management regularly reviews its accounting policies to make certain they are current and also provide readers of the consolidated financial statements with useful and reliable information about our operating results and financial condition. These include, but are not limited to, matters related to accounts receivable, inventories, pension benefits, and income taxes. Implementation of these accounting policies includes estimates and judgments by management based on historical experience and other factors believed to be reasonable. This may include judgments about the carrying value of assets and liabilities based on considerations that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following critical accounting policies are most important to the portrayal of the Company's financial condition and results of operations, and require more significant judgments and estimates in the preparation of its consolidated financial statements.

*Revenue Recognition:*

Customer sales are recognized when revenue is realized and earned. The Company recognizes revenue when the risk and title passes to the customer. Customer sales are recorded net of allowances for estimated returns, trade promotions and other discounts, which are recognized as a deduction from sales at the time of sale.

*Sales returns and allowances:*

Revenue principally consists of sales to customers, and, to a lesser extent, license fees. Revenue is recognized upon passage of title to customers, while license fees are recognized when earned. The Company records a reduction to gross sales based on estimated customer returns and allowances. These reductions are influenced by historical experience, based on customer returns and allowances. The actual amount of sales returns and allowances realized may differ from the Company's estimates. If the Company determines that sales returns or allowances should be either increased or decreased, then the adjustment would be made to net sales in the period in which such a determination is made.

*Accounts receivable allowances:*

Management maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Management also records estimates for discounts offered to customers. Should a greater proportion of customers return goods and take advantage of discounts than estimated by the Company, additional allowances may be required.

*Inventories:*

Management identifies slow moving or obsolete inventories and estimates appropriate loss provisions related to these inventories. Historically, these loss provisions have not been significant as the vast majority of the Company's inventories are considered saleable and the Company has been able to liquidate slow moving or obsolete inventories through the Company's factory outlet stores or through various discounts to customers. Should management encounter difficulties liquidating slow moving or obsolete inventories, additional provisions may be necessary. Management regularly reviews the adequacy of its inventory reserves and makes adjustments to them as required.

*Pension benefits:*

Accounting for pensions and other postretirement benefits involves estimating the cost of benefits to be provided well into the future and attributing that cost over the time period each employee works. To accomplish this, extensive use is made of assumptions about inflation, investment returns, mortality, turnover, medical costs and discount rates. These assumptions are reviewed at least annually.

Pension and post-retirement benefit expenses are determined by actuaries using assumptions concerning the discount rate, expected return on plan assets and rate of compensation increase. An actuarial analysis of benefit obligations and plan assets is determined as of September 30 each year. The funded status of the Company's plans and reconciliation of accrued pension cost is determined annually as of December 31. Further discussion of the Company's pension and post-retirement benefit plans and related assumptions is included in Note 9, Retirement Plans, to the consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2003. Actual results would be different using other assumptions. Management records an accrual for pension costs associated with the Company sponsored noncontributory defined benefit pension plans covering the union and non-union workers of the Company. The union plan was frozen in 2001 and no additional benefits have been earned under this plan since that time; the obligations under this plan were settled in April 2004. Future adverse changes in market conditions or poor operating results of underlying plan assets could result in losses or a higher accrual.

*Income taxes:*

Currently, management has not recorded a valuation allowance to reduce its deferred tax assets. The Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance, however in the event the Company were to determine that it would not be able to realize all or part of its net deferred tax assets in the future, an adjustment to the deferred tax assets would be charged to income in the period such determination was made. Finally, if the Company decided to repatriate all or a portion of its earnings in its Five Star subsidiary to the United States, the Company's effective tax rate would increase.

*Intangible Assets:*

The Company had \$4.3 million of intangible assets at September 30, 2004 and \$4.1 million at December 31, 2003. Goodwill and trademarks are tested for impairment at least annually by comparing the fair value of the reporting units to their carrying values. Fair values are estimated using discounted cash flow methodologies that are based on projections of the amounts and timing of future revenues and cash flows. Based on this testing, none of our goodwill nor trademarks were impaired as of December 31, 2003, and no impairment indicators have occurred since that date.

**SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995.**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, which are intended to be covered by the safe harbors created thereby. Those statements include, but may not be limited to, all statements regarding intent, beliefs, expectations, projections, forecasts, and plans of the Company and its management. Investors are cautioned that such statements involve risks and uncertainties, including, but not limited to, changes in consumer demand, seasonality, impact of weather, competition, reliance on suppliers, changing retailing trends, reliance on foreign manufacturing, changes in tax rates, limited protection of proprietary technology, and other risks, uncertainties and factors described in the Company's most recent Annual Report on Form 10-K and other filings from time to time

with the Securities and Exchange Commission. One or more of these factors have affected, and in the future could affect the Company's business and financial results and cause actual results to differ materially from plans and projections. Although the Company and its management believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate. Therefore, there can be no assurance that the forward-looking statements included herein will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements contained herein, the inclusion of such information should not be regarded as a representation by the Company, its management or any other person that the Company's objectives and plans will be achieved. All forward-looking statements made herein are based on information presently available to the management of the Company. The Company undertakes no obligation to publicly update or revise any forward-looking statements.

**PART 1 - FINANCIAL INFORMATION**

**ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes since December 31, 2003.

**ITEM 4 – CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, the Company's management carried out an evaluation, with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934). Based upon that evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

There were no changes in the Company's internal controls over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II -- OTHER INFORMATION**

### Item 1. Legal Proceedings.

None

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

See Note 7 to the Condensed Consolidated Financial Statements for further discussion.

### Item 3. Defaults Upon Senior Securities.

None

### Item 4. Submission of Matters to a Vote of Security Holders.

None

### Item 5. Other Information.

None

### Item 6. Exhibits and Reports on Form 8-K.

#### (a) Exhibits.

- 10.1 Second Amendment to Lease Agreement, dated as of July 26, 2004, between Rocky Shoes & Boots, Inc. and the William Brooks Real Estate Company.
- 31.1 Certification of CEO under Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of CFO under Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of CEO under Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of CFO under Section 906 of the Sarbanes-Oxley Act of 2002.

#### (b) Reports on Form 8-K.

- 1) Form 8-K dated July 27, 2004, filed with the Securities and Exchange Commission on July 29, 2004 pursuant to Item 12, regarding the Company's financial results for the second quarter ended June 30, 2004.

## SIGNATURES

Pursuant to the requirements 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 SHOES & BOOTS, INC.

Date: November 3, 2004

/s/ James E. McDonald  
James E. McDonald, Vice President and  
Chief Financial Officer\*

\* In his capacity as Vice President and Chief Financial Officer, Mr. McDonald is duly authorized to sign this report on behalf of the Registrant.

## SECOND AMENDMENT TO LEASE AGREEMENT

This Second Amendment to Lease Agreement (this "Amendment") is entered into as of the 26<sup>th</sup> day of July, 2004, by and between William Brooks Real Estate Company, an Ohio corporation ("Lessor"), and Rocky Shoes & Boots, Inc., an Ohio corporation ("Lessee").

### RECITALS

A. Lessor and Lessee entered into that certain Lease Agreement dated as of May 1, 1998, which was amended in that Amended and Restated Lease Agreement dated March 1, 2002 (collectively, the "Lease"), whereby Lessee agreed to lease from Lessor the shoe factory located at 45 East Canal Street, Nelsonville, Ohio and the parking lot located at 13-78 Myers Street in Nelsonville, Ohio and more particularly described on Exhibit A (the "Leased Premises");

B. Lessee is operating the Leased Premises under a Renewal Option, which commenced March 1, 2004 and expires February 28, 2005;

C. Lessor and Lessee now desire to amend the Lease to change the Rent, to amend the terms and conditions of the Option to Purchase the Leased Premises and to otherwise modify the Lease as herein provided, all on and subject to the terms and conditions hereof.

NOW, THEREFORE, for and in consideration of the mutual agreements contained herein and for other good and valuable consideration, the parties agree as follows:

1. Lease: The term "Lease" shall hereinafter be meant to include both the Lease and this Amendment.
2. Section 13.01, Renewal Option, of Article 13, OPTION TO RENEW OR EXTEND, is hereby deleted in its entirety and replaced with the following:

13.01 If the Lessee is not then in default of its obligation to pay rent or of any other obligations hereunder, Lessee shall have the right to renew this Lease for Renewal Terms of one year beginning on March 1, 2004, under the same terms and conditions as this Lease; provided, however, that the monthly base Rent during the Renewal Terms shall be increased to an amount equal to 104% of the base Rent of the immediately preceding Lease year, except that the monthly base rent during the Renewal Option beginning March 31, 2004 and expiring February 28, 2005 shall be Five Thousand Dollars (\$5,000.00). Lessee may exercise the options to renew by giving Lessor written notice thereof at least six months prior to the expiration of the Initial Term and each subsequent Renewal Term;

3. Article 14, Option to Purchase Leases Premises, is hereby deleted in its entirety and replaced with the following:

Article 14. Purchase and Sale

- 14.1 Lessor agrees to sell and convey to Lessee and Lessee agrees to buy and pay for the Leased Premises on or before January 31, 2005.
- 14.2 Lessor agrees at the time of closing to convey fee simple title to the Leases Premises to Lessee by general warranty deed subject to (a) zoning ordinances affecting the Leased Premises, (b) ad valorem taxes not yet due and payable and (c) such other matters as may be agreed to in writing by the Lessee.
- 14.3 The purchase price (the "Purchase Price") of the Leased Premises shall be Five Hundred Five Thousand Dollars and 00/100 (\$505,000.00), and shall be paid by Lessee's certified check, bank check or wire transfer at the closing of the sale of the Leased Premises.
- 14.4 Lessor warrants and represents to Lessee that as of the date hereof and as of the date of closing:
- a. Lessor is the owner of good and marketable fee simple title to the Leased Premises, free and clear of all liens, easements, restrictions, options, reservations, mortgages, security titles and interest, covenants, conditions, rights of way, licenses, permits, encumbrances, leases, tenancies, claims of lessees in possession and rights of any kind, except for matters set forth in Exhibit B attached hereto and incorporated herein by reference (the "Permitted Encumbrances").
  - b. So long as this agreement remains in force, Lessor will not lease, rent or convey all or any portion of the Leased Premises or any interest therein, or enter into any agreement granting to any person or entity any right with respect to the Leased Premises, or any portion thereof, without first obtaining the written consent of Lessee.
  - c. Lessor is not now a party to any litigation, investigation or other proceeding nor to the knowledge of Lessor is any such litigation, investigation or proceeding threatened, which relates to the Leased Premises, directly or indirectly, or Lessor's right to sell the Leased Premises.

- d. Lessor has no knowledge of any pending, threatened or contemplated condemnation proceedings, which will or may affect the Leased Premises in any, respect whatsoever.
- e. Lessor has no notice of and is not aware of any violation of any laws, ordinances, orders, restrictive covenants or other requirements affecting the Leased Premises, and there are no violations of record of any of the foregoing.
- f. There are no commitments to governmental authorities or agencies or utilities or quasi governmental entities, which affect the Lease Premises and no conditions of zoning of the Leased Premises, which have not been completed, fulfilled.
- g. There are no taxes, assessments or levies of any type (except ad valorem taxes for year 2004) relating to the Leased Premises which are presently due and payable or which may become a lien or other charge against any part of the Leased Premises.
- h. The improvements (if any) are within the boundary lines of the Leased Premises described in Exhibit A and there are no encroachments on the Leased Premises of any adjoining landowner.
- i. To the best of Lessor's knowledge, the Leased Premises has never been used as a landfill to receive solid waste, whether or not hazardous and has never been used for the disposal, storage or treatment of any waste, trash, garbage, industrial by-product, chemical or hazardous substance of any nature, including without limitation radioactive materials, PCBs, asbestos, pesticides, herbicides, pesticide or herbicide containers, untreated sewage, industrial process sludge or any "hazardous substance" as such term is defined in the following sources as amended from time to time: (i) the Resource and Conservation and Recovery Act of 1976, 42 U.S.C. § 6901 et seq. ("RCRA"); (ii) the Hazardous Material Transportation Act, 49 U.S.C. § 1801, et. seq. ("HMTA"); (iii) the Comprehensive Environmental Response Compensation and Liability Act of 1980, 42 U.S.C. § 9601 et. seq. ("CERCLA"); (iv) applicable laws of the jurisdiction where the Leased Premises is located, and (v) any federal, state or local statutes, regulations, ordinances, or rules or orders

issued or promulgated under or pursuant to any of those laws or otherwise by any department, agency or other administrative, regulatory or judicial body. The Leased Premises does not contain asbestos insulation or electrical transformers cooled by phenylchlorobenzene or biphenyls. Lessor hereby agrees to indemnify Lessee for any liability, costs, damage, loss, claim, expense or cause of action (including but not limited to attorneys' fees and court costs) incurred by or threatened against Lessee as a result of a breach of any of the warranties or representations contained in this paragraph.

- 14.5 Prior to the closing, Lessee may, but is not obligated, deliver to Lessor, at its sole discretion and cost, a boundary survey (the "Survey") of the Leased Premises, prepared by a surveyor licensed in Ohio.

14.6 At closing, Lessor's title to the Leased Premises shall be good and marketable and free and clear of all liens and encumbrances except: (a) the lien of real estate taxes not then due and payable, (b) easements of record which do not interfere with Lessee's proposed use, and (c) all applicable zoning and building laws, ordinances and regulations. Lessee shall secure and Lessor shall pay for a preliminary title insurance commitment and, after the date of closing, an owner's title insurance policy with extended coverage or comparable form issued by a title insurance company selected by Lessee (the "Title Company") in the amount of the purchase price. The title policy shall insure title to the Leased Premises (including all access, parking and utility easements) in Lessee, free and clear of all liens and encumbrances, except as limited above. If title shall prove defective, Lessor shall perfect the same promptly, but if title cannot be perfected by closing, Lessee may terminate this contract or may, at its election, take title as it then is (with the right to deduct from the purchase price liens or encumbrances of a definite or ascertainable amount), upon giving written notice of such election to Lessor. Marketable title as used herein shall mean title which the Title Company will insure at its regular rates, subject only to standard exceptions and matters referred to in this paragraph.

- 14.7 The purchase and sale herein shall be closed on or before January 31, 2005.
  - 14.8 At the closing, each party shall execute and deliver all documents necessary to effect and complete the closing.
  - 14.9 Lessor shall pay all conveyance or other taxes payable in connection with the recordation of the general warranty deed.
  - 14.10 Lessee shall pay all costs of recording the general warranty deed and all other documents related to the transaction.
  - 14.11 Rent shall be prorated as of the date of closing. Any other prepaid rent previously paid by Lessee to Lessor will be credited to Lessee against the Purchase Price.
  - 14.12 At the closing, the Lessor shall convey the Leased Premises by general warranty deed and deliver such general warranty deed to the Lessee at the closing. At the closing, Lessor shall deliver to Lessee an affidavit in form reasonably satisfactory to Lessee certifying that Lessor is not a "non-foreign person" which would subject Lessor to withholding tax provisions under Section 1445 of the Internal Revenue Code of 1986 as amended. At closing, Lessor will deliver a lien waiver, acceptable to Lessee and Lessee's title insurer.
  - 14.13 Ad valorem taxes on the Leased Premises for the year in which the purchase and sale hereunder is closed shall be prorated as of the end of the day of the closing on a calendar year basis. In the event tax bills have not been issued for the year of closing, taxes shall be prorated based on the previous year's tax bill. All income received and expenses incurred with respect to the Leased Premises shall also be prorated as of the date of the closing and appropriate payments or credits made at closing. Lessor shall deliver possession of the Leased Premises to the Lessee on or before the date of closing.
4. Each party represents to the other that it has had no dealings with any realtor, broker or agent in connection with the negotiation of this Amendment and each agrees to indemnify and hold the other harmless from and against the claims of or liability to any other realtor, broker or agent claiming by, through or on behalf of such party with respect to this Amendment.
  5. The Lease, as amended, constitutes the entire agreement of the Lessor and Lessee with respect to the matters stated in the Lease and may not be amended or modified unless such amendment or modification shall be in writing and signed by Lessor and Lessee.
  6. The Lease shall be governed in all respects by the laws of the State of Ohio.
  7. This Amendment may be executed in one or more counterparts, each of which shall be

deemed to be an original, and all of which, when taken together, shall constitute one agreement binding upon the parties thereto.

8. Except as amended or modified hereby, all terms, covenants and conditions of the Lease as heretofore in effect, shall remain in full force and effect through the term as extended, and, as amended and modified hereby, all of the terms, covenants and conditions of the Lease are hereby ratified and confirmed in all respects. In the event of any conflict between the terms of this Amendment and the terms of the original Lease, the terms of this Amendment shall control.
9. All capitalized terms used herein, and not otherwise defined, shall have the meanings ascribed to said terms in the Lease.

IN WITNESS WHEREOF, the parties have executed this Second Amendment to Lease Agreement effective as of the date first set forth above.

LESSOR:

WILLIAM BROOKS REAL ESTATE  
COMPANY, an Ohio corporation

By: /s/ Patricia Brooks Robey  
Patricia Brooks Robey  
President

LESSEE:

ROCKY SHOES & BOOTS, INC.,  
an Ohio corporation

By: /s/ James E. McDonald  
James E. McDonald  
Vice President and Chief Financial Officer





CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Rocky Shoes & Boots, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mike Brooks, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Mike Brooks

*Mike Brooks, President and Chief Executive Officer*  
*November 3, 2004*

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of Rocky Shoes & Boots, Inc. (the "Company") on Form 10-Q for the period ending September 30, 2004, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James E. McDonald, Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ James E. McDonald

*James E. McDonald, Vice President and Chief Financial Officer*  
*November 3, 2004*