

REDHOOK ALE BREWERY INC

Form 10-Q/A

March 31, 2006

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

(MARK ONE)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005  
OR**

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

**for the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**COMMISSION FILE NUMBER 0-26542  
REDHOOK ALE BREWERY, INCORPORATED  
(Exact name of registrant as specified in its charter)**

**Washington**  
(State or other jurisdiction of  
incorporation or organization)

**91-1141254**  
(I.R.S. Employer  
Identification No.)

**14300 NE 145<sup>th</sup> Street, Suite 210  
Woodinville, Washington**  
(Address of principal executive offices)

**98072-9045**  
(Zip Code)

Registrant's telephone number, including area code: **(425) 483-3232**

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

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

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

The number of shares of the registrant's Common Stock outstanding as November 10, 2005 was 8,220,768.

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**Explanatory Note**

On March 23, 2006, Redhook Ale Brewery, Incorporated (the Company) filed a Current Report on Form 8-K with the Securities and Exchange Commission (SEC), announcing that it would be restating previously reported financial statements to correct an error as of and for the year ended December 31, 2004. As more fully described in Note 2 to the Financial Statements included in this Amendment No. 1 to Quarterly Report on Form 10-Q/A, the Company inadvertently overstated its net operating loss carryforwards (NOLs) with the state of New Hampshire by recording NOLs in excess of limits prescribed by state law, leading to an understatement of the Company's income tax provision and an overstatement of the Company's deferred tax asset, which was netted against the Company's deferred income tax liability on the Company's balance sheet. This Amendment No. 1 to Form 10-Q/A (Amendment) amends the Quarterly Report on Form 10-Q for the quarter end September 30, 2005, as filed on November 10, 2005 (Original Filing), to reflect the impact of the restatement on retained earnings and deferred income taxes on the balance sheet dated September 30, 2005.

Except as required to reflect the effects of the restatement for the item above, no additional modifications or updates in this Amendment have been made to the Original Filing on Form 10-Q. Information not affected by the restatement remains unchanged and reflects the disclosures made at the time of the Original Filing. This Amendment does not describe other events occurring after the original filing, including exhibits, or modify or update those disclosures affected by subsequent events. This Amendment should be read in conjunction with the Company's filings made with the SEC subsequent to the filing of the Original Filing, as information in such reports and documents may update or supersede certain information contained in this Amendment. Accordingly, this Amendment only amends and restates Items 1, 2 and 4 of Part I of the Original Filing, in each case, solely as a result of, and to reflect, the restatement, and no other information in the Original Filing is amended hereby. Additionally, pursuant to the rules of the SEC, Item 6 of Part II of the Original Filing has been amended to contain currently dated certifications of the Chief Executive Officer and Chief Financial Officer. As required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, the certifications of the Company's Chief Executive Officer and Chief Financial Officer are attached to this Amendment as Exhibits 31.1, 31.2, 32.1 and 32.2.

**REDHOOK ALE BREWERY, INCORPORATED  
FORM 10-Q/A  
For The Quarterly Period Ended September 30, 2005  
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**REDHOOK ALE BREWERY, INCORPORATED**  
**BALANCE SHEETS**  
(Unaudited)

|   | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|---|-------------------------------|------------------------------|
|   | (Restated; See<br>Note 2)     | (Restated; See<br>Note 2)    |
| <b>ASSETS</b>   |                               |                              |
| Current Assets:                                       |                               |                              |
| Cash and Cash Equivalents                             | \$ 5,321,293                  | \$ 5,589,621                 |
| Accounts Receivable                                   | 1,842,328                     | 1,123,475                    |
| Trade Receivable from Craft Brands                    | 736,827                       | 398,707                      |
| Inventories   | 3,295,801                     | 3,000,309                    |
| Other   | 515,658                       | 506,328                      |
| Total Current Assets                                  | 11,711,907                    | 10,618,440                   |
| Fixed Assets, Net                                     | 61,227,336                    | 63,018,806                   |
| Receivable from Craft Brands                          |                               | 277,144                      |
| Investment in Craft Brands                            | 154,986                       | 192,857                      |
| Other Assets  | 13,833                        | 20,977                       |
| Total Assets  | \$ 73,108,062                 | \$ 74,128,224                |
| <b>LIABILITIES AND COMMON STOCKHOLDERS<br/>EQUITY</b> |                               |                              |
| Current Liabilities:                                  |                               |                              |
| Accounts Payable                                      | \$ 2,185,589                  | \$ 1,815,380                 |
| Trade Payable to Craft Brands                         | 371,311                       | 431,089                      |
| Accrued Salaries, Wages and Payroll Taxes             | 1,232,145                     | 1,220,248                    |
| Refundable Deposits                                   | 2,211,111                     | 2,526,088                    |
| Other Accrued Expenses                                | 403,019                       | 515,123                      |
| Current Portion of Long-Term Debt                     | 450,000                       | 450,000                      |
| Total Current Liabilities                             | 6,853,175                     | 6,957,928                    |
| Long-Term Debt, Net of Current Portion                | 4,837,500                     | 5,175,000                    |
| Deferred Income Taxes, Net                            | 699,798                       | 769,798                      |
| Other Liabilities                                     | 113,580                       | 64,903                       |
| Commitments   |                               |                              |
| Common Stockholders Equity:                           |                               |                              |

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|   |               |               |
|---|---------------|---------------|
| Common Stock, Par Value \$0.005 per Share, Authorized,<br>50,000,000 Shares; Issued and Outstanding, 8,220,768 Shares in<br>2005 and 8,188,199 Shares in 2004 | 41,104        | 40,941        |
| Additional Paid-In Capital  | 68,824,363    | 68,761,766    |
| Retained Earnings (Deficit)   | (8,261,458)   | (7,642,112)   |
| Total Common Stockholders Equity  | 60,604,009    | 61,160,595    |
| Total Liabilities and Common Stockholders Equity  | \$ 73,108,062 | \$ 74,128,224 |

See Accompanying Notes to Financial Statements

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**STATEMENTS OF OPERATIONS**

(Unaudited)

|   | <b>Three Months Ended</b> |              | <b>Nine Months Ended September</b> |               |
|---|---------------------------|--------------|------------------------------------|---------------|
|   | <b>September 30,</b>      |              | <b>30,</b>                         |               |
|   | <b>2005</b>               | <b>2004</b>  | <b>2005</b>                        | <b>2004</b>   |
| Sales   | \$ 9,497,771              | \$ 8,789,773 | \$ 26,563,961                      | \$ 29,623,658 |
| Less Excise Taxes                             | 946,680                   | 878,253      | 2,681,531                          | 2,601,464     |
| Net Sales                                     | 8,551,091                 | 7,911,520    | 23,882,430                         | 27,022,194    |
| Cost of Sales                                 | 7,429,086                 | 6,950,722    | 20,754,426                         | 21,004,133    |
| Gross Profit                                  | 1,122,005                 | 960,798      | 3,128,004                          | 6,018,061     |
| Selling, General and Administrative Expenses  | 1,905,135                 | 1,310,395    | 5,299,473                          | 6,384,759     |
| Income from Equity Investment in Craft Brands | 673,606                   | 657,705      | 1,624,604                          | 657,705       |
| Craft Brands Shared Formation Expenses        |                           | (2,947)      |                                    | 534,628       |
| Operating Income (Loss)                       | (109,524)                 | 311,055      | (546,865)                          | (243,621)     |
| Interest Expense                              | 71,882                    | 48,332       | 198,796                            | 134,732       |
| Other Income (Expense) Net                    | 20,555                    | 58,990       | 84,893                             | 82,730        |
| Income (Loss) before Income Taxes             | (160,851)                 | 321,713      | (660,768)                          | (295,623)     |
| Income Tax Provision (Benefit)                | 9,578                     | 10,000       | (41,422)                           | 20,000        |
| Net Income (Loss)                             | \$ (170,429)              | \$ 311,713   | \$ (619,346)                       | \$ (315,623)  |
| Basic Earnings (Loss) per Share               | \$ (0.02)                 | \$ 0.04      | \$ (0.08)                          | \$ (0.05)     |
| Diluted Earnings (Loss) per Share             | \$ (0.02)                 | \$ 0.04      | \$ (0.08)                          | \$ (0.05)     |

See Accompanying Notes to Financial Statements

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**REDHOOK ALE BREWERY, INCORPORATED**  
**STATEMENTS OF CASH FLOWS**  
(Unaudited)

|   | <b>Nine Months Ended September</b> |               |
|---|------------------------------------|---------------|
|   | <b>30,</b>                         |               |
|   | <b>2005</b>                        | <b>2004</b>   |
| <b>Operating Activities</b>   |                                    |               |
| Net Income (Loss)   | \$ (619,346)                       | \$ (315,623)  |
| Adjustments to Reconcile Net Income (Loss) to Net Cash (Used in) Provided by Operating Activities:  |                                    |               |
| Loss on Disposal of Fixed Assets  | 14,879                             |               |
| Depreciation and Amortization   | 2,194,505                          | 2,212,611     |
| Income from Equity Investment in Craft Brands in Excess of Cash Distribution  | (19,755)                           | (48,564)      |
| Deferred Income Taxes, Net  | (70,000)                           |               |
| Net Change in Operating Assets and Liabilities  | (1,083,101)                        | (300,950)     |
| Net Cash (Used in) Provided by Operating Activities   | 417,182                            | 1,547,474     |
| <b>Investing Activities</b>   |                                    |               |
| Expenditures for Fixed Assets   | (415,731)                          | (76,991)      |
| Investment in Craft Brands  |                                    | (250,100)     |
| Note Receivable from Craft Brands   |                                    | (150,000)     |
| Other, Net  | 4,961                              | (3,750)       |
| Net Cash (Used in) Provided by Investing Activities   | (410,770)                          | (480,841)     |
| <b>Financing Activities</b>   |                                    |               |
| Principal Payments on Debt  | (337,500)                          | (337,500)     |
| Issuance of Common Stock  | 62,760                             | 260,300       |
| Net Cash (Used in) Provided by Financing Activities   | (274,740)                          | (77,200)      |
| Increase (Decrease) in Cash and Cash Equivalents  | (268,328)                          | 989,433       |
| Cash and Cash Equivalents:  |                                    |               |
| Beginning of Period   | 5,589,621                          | 6,123,349     |
| End of Period   | \$ 5,321,293                       | \$ 7,112,782  |
| Issuance of 1,808,243 Shares of Common Stock to A-B and \$2,000,000 payable to A-B in Exchange for 1,289,872 Shares of Series B Preferred Stock Held by A-B | \$                                 | \$ 16,232,655 |





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**NOTES TO FINANCIAL STATEMENTS**

(Unaudited)

**1. Basis of Presentation**

The accompanying financial statements and related notes of Redhook Ale Brewery, Incorporated (the Company) should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004. These financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These financial statements are unaudited but, in the opinion of management, reflect all material adjustments necessary to present fairly the financial position, results of operations and cash flows of the Company for the periods presented. All such adjustments were of a normal, recurring nature. The results of operations for such interim periods are not necessarily indicative of the results of operations for the full year.

Certain reclassifications have been made to the prior year's financial statements to conform to the current year presentation. The effects of the reclassifications are not considered material. As more fully described in Note 2, the Company determined that the financial statements and the disclosures in the notes thereto for the three months ended June 30, 2005 contained in the Quarterly Report on Form 10-Q filed on November 10, 2005, require restatement. All amounts disclosed in the footnotes to the financial statements have been appropriately restated.

**2. Restatement of Financial Statements**

The Company has restated its previously reported financial statements to correct an error as of and for the year ended December 31, 2004. The Company inadvertently overstated its net operating tax loss carryforwards (NOLs) with the state of New Hampshire by recording NOLs in excess of limits prescribed by state law. This error resulted in an understatement of the Company's income tax provision for the quarter and year ended December 31, 2004 and an overstatement of the Company's deferred tax asset, which is netted against the Company's deferred income tax liability on the Company's balance sheet. This Amendment No. 1 to Form 10-Q/A amends the Quarterly Report on Form 10-Q for the quarter ended September 30, 2005, as filed on November 10, 2005, to reflect the impact of the restatement on retained earnings and deferred income taxes on the balance sheet dated September 30, 2005. The \$301,000 restatement adjustment for the quarter ended December 31, 2004 affected the following items in the Company's balance sheets as of September 30, 2005 and December 31, 2004, respectively:

|   | <b>As of September 30, 2005</b> |                    |
|---|---------------------------------|--------------------|
|   | <b>As</b>                       |                    |
|   | <b>Previously<br/>Reported</b>  | <b>As Restated</b> |
| Deferred Income Taxes, Net                        | \$ 398,798                      | \$ 699,798         |
| Retained Earnings (Deficit)                       | (7,960,458)                     | (8,261,458)        |
| Total Common Stockholders' Equity                 | 60,905,009                      | 60,604,009         |
| Total Liabilities and Common Stockholders' Equity | 73,108,062                      | 73,108,062         |
|   | <b>As of December 31, 2004</b>  |                    |
|   | <b>As</b>                       |                    |
|   | <b>Previously<br/>Reported</b>  | <b>As Restated</b> |
| Deferred Income Taxes, Net                        | \$ 468,798                      | \$ 769,798         |
| Retained Earnings (Deficit)                       | (7,341,112)                     | (7,642,112)        |
| Total Common Stockholders' Equity                 | 61,461,595                      | 61,160,595         |
| Total Liabilities and Common Stockholders' Equity | 74,128,224                      | 74,128,224         |

**3. Inventories**

Inventories consist of the following:

|                         | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|-------------------------|-----------------------------------|----------------------------------|
| Raw materials           | \$ 1,305,218                      | \$ 1,122,290                     |
| Work in process         | 1,023,393                         | 833,846                          |
| Finished goods          | 455,359                           | 350,543                          |
| Promotional merchandise | 353,903                           | 480,338                          |
| Packaging materials     | 157,928                           | 213,292                          |
|                         | <b>\$ 3,295,801</b>               | <b>\$ 3,000,309</b>              |

Work in process is beer held in fermentation tanks prior to the filtration and packaging process.

**4. Craft Brands Alliance LLC**

On July 1, 2004, the Company entered into agreements with Widmer Brothers Brewing Company ( Widmer ) with respect to the operation of a joint venture sales and marketing entity, Craft Brands Alliance LLC ( Craft Brands ). Pursuant to these agreements, the Company manufactures and sells its product to Craft Brands at a price substantially below wholesale pricing levels; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States pursuant to a distribution agreement between Craft Brands and Anheuser-Busch, Incorporated ( A-B ).

The Company and Widmer have entered into a restated operating agreement with Craft Brands (the Operating Agreement ) that governs the operations of Craft Brands and the obligations of its members, including capital contributions, loans and allocation of profits and losses.

The Operating Agreement requires the Company to make certain capital contributions to support the operations of Craft Brands. Contemporaneous with the execution of the Operating Agreement, the Company made a 2004 sales and marketing capital contribution in the amount of \$250,000. The agreement designated this sales and marketing capital contribution to be used by Craft Brands for expenses related to the marketing, advertising, and promotion of the Company's products ( Special Marketing Expense ). The Operating Agreement also requires an additional sales and marketing contribution in 2008 if the volume of sales of Redhook products in 2007 in the Craft Brands territory is less than 92% of the volume of sales of Redhook products in 2003 in the Craft Brands territory. The 2008 contribution, if one is required, cannot exceed \$750,000 and will be required to be paid by the Company in no more than three equal installments made on or before February 1, 2008, April 1, 2008 and July 1, 2008. Widmer has an identical obligation under the

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**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
(Unaudited)

Operating Agreement with respect to the 2008 sales and marketing capital contribution and sales of its product. The Operating Agreement also obligates the Company and Widmer to make other additional capital contributions only upon the request and consent of the Craft Brands board of directors.

The Operating Agreement also requires the Company and Widmer to make loans to Craft Brands to assist Craft Brands in conducting its operations and meeting its obligations. To the extent cash flow from operations and borrowings from financial institutions is not sufficient for Craft Brands to meet its obligations, the Company and Widmer are obligated to lend to Craft Brands the funds the president of Craft Brands deems necessary to meet such obligations. Contemporaneous with the execution of the Operating Agreement, the Company made a member loan of \$150,000.

The Operating Agreement additionally addresses the allocation of profits and losses of Craft Brands. After giving effect to the allocation of the Special Marketing Expense, which is allocated 100% to Redhook up to the 2004 \$250,000 sales and marketing capital contribution, and after giving effect to income attributable to the shipments of the Kona brand, which is shared differently between the Company and Widmer through 2006, the remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. Net cash flow, if any, will generally be distributed monthly to the Company and Widmer based upon these cash flow percentages. No distribution will be made to the Company or Widmer unless, after the distribution is made, the assets of Craft Brands will be in excess of its liabilities, with the exception of liabilities to members, and Craft Brands will be able to pay its debts as they become due in the ordinary course of business.

The Company has assessed its investment in Craft Brands pursuant to the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 46 Revised, *Consolidation of Variable Interest Entities an Interpretation of ARB No. 51* ( FIN 46R ). FIN 46R clarifies the application of consolidation accounting for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest; these entities are referred to as variable interest entities. Variable interest entities within the scope of FIN 46R are required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity s expected losses, receives a majority of its expected returns, or both. FIN 46R also requires disclosure of significant variable interests in variable interest entities for which a company is not the primary beneficiary. The Company has concluded that its investment in Craft Brands meets the definition of a variable interest entity but that the Company is not the primary beneficiary. In accordance with FIN46R, the Company has not consolidated the financial statements of Craft Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The equity method requires that the Company recognize its share of the net earnings of Craft Brands by increasing its investment in Craft Brands on the Company s balance sheet and recognizing income from equity investment in the Company s statement of operations. A cash distribution or the Company s share of a net loss reported by Craft Brands is reflected as a decrease in investment in Craft Brands on the Company s balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. The Company will periodically review its investment in Craft Brands to insure that it complies with the guidelines prescribed by FIN 46R.

For the three months ended September 30, 2005, the Company s share of Craft Brands net income totaled \$674,000. During the three months ended September 30, 2005, the Company received cash distributions of \$802,000, representing its share of the net cash flow of Craft Brands.

For the nine months ended September 30, 2005, the Company s share of Craft Brands net income totaled \$1,625,000. This share of Craft Brands profit was net of \$135,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company. As of September 30, 2005, the entire \$250,000 2004 sales and marketing capital contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands profits allocated to the Company.

In the nine months ended September 30, 2005, the Company received cash

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**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
(Unaudited)

distributions of \$1,940,000, of which \$335,000 related to 2004 earnings, representing its share of the net cash flow of Craft Brands.

For the three and nine months ended September 30, 2004, the Company's share of Craft Brands' net income totaled \$658,000. This share of Craft Brands' profit was net of \$78,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same periods and was fully allocated to the Company. During the three and nine months ended September 30, 2004, the Company received cash distributions of \$609,000 representing its share of the net cash flow of Craft Brands.

In conjunction with the sale of Redhook product to Craft Brands, the Company's balance sheets as of September 30, 2005 and December 31, 2004 reflect a trade payable due to Craft Brands of approximately \$371,000 and \$431,000, respectively, and a trade receivable due from Craft Brands of approximately \$737,000 and \$399,000, respectively.

During the formation of Craft Brands in 2004, both the Company and Widmer incurred certain start-up expenses, including severance expenses and legal fees. The Company's operating loss for the nine months ended September 30, 2004 reflects \$535,000 attributable to the Company's share of these start-up expenses. Additionally, during the period March 15, 2004 through September 30, 2004, while the companies sought the regulatory approval required for Craft Brands to become fully operational, the Company and Widmer agreed to share certain sales-related costs, primarily salaries and overhead. The Company's share of these costs for the nine months ended September 30, 2004 were \$554,000 and are reflected in the Company's statement of operations as selling, general and administrative expenses.

**5. Refundable Deposits**

In conjunction with the shipment of its products to wholesalers, the Company collects refundable deposits on its pallets. In certain circumstances when the pallets are returned to the Company, A-B may return the deposit to the wholesaler. In May 2005, the Company reimbursed A-B approximately \$881,000 for these pallet deposits. This payment is reflected in the Company's statement of cash flows for the nine months ended September 30, 2005 as cash used in operating activities and on the Company's balance sheet as of September 30, 2005 as a reduction of refundable deposits.

**6. Convertible Redeemable Preferred Stock**

On July 1, 2004, the Company completed the restructuring of its ongoing relationship with A-B and issued 1,808,243 shares of Common Stock to A-B in exchange for the 1,289,872 shares of Series B Preferred Stock held by A-B. The Series B Preferred Stock was then cancelled. In connection with this exchange, the Company paid \$2.0 million to A-B in November 2004. As of December 31, 2004, there was no preferred stock of the Company outstanding.

**7. Common Stockholders' Equity**

In conjunction with the exercise of stock options granted under the Company's stock option plans, the Company issued 32,600 shares of the Company's common stock ( Common Stock ) totaling \$63,000 during the nine months ended September 30, 2005, including 5,600 shares of Common Stock totaling \$11,000 during the three months ended September 30, 2005. During the nine months ended September 30, 2004, the Company issued 150,300 shares of Common Stock totaling \$260,000, including 14,800 shares of Common Stock totaling \$26,000 during the three months ended September 30, 2004.

**8. Earnings (Loss) per Share**

The Company follows FASB Statement of Financial Accounting Standard ( SFAS ) No. 128, *Earnings per Share*. Basic earnings (loss) per share is calculated using the weighted average number of shares of Common Stock outstanding. The calculation of adjusted weighted average shares outstanding for purposes of computing diluted earnings (loss) per share includes the dilutive effect of all outstanding convertible redeemable preferred stock and outstanding stock options for periods when the Company reports net income.

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**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
(Unaudited)

Outstanding stock options have been excluded from the calculation of diluted loss per share for the three and nine months ended September 30, 2005 and for the nine months ended September 30, 2004 because their effect is antidilutive. The calculation uses the treasury stock method and the "as if" converted method in determining the resulting incremental average equivalent shares outstanding as applicable.

On July 1, 2004, the Company issued 1,808,243 shares of Common Stock to A-B in exchange for 1,289,872 shares of Series B Preferred Stock held by A-B. The Series B Preferred Stock and the related accretion of offering costs were cancelled.

The following table sets forth the computation of basic and diluted earnings (loss) per common share:

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |              |
|---|---------------------------|-------------|--------------------------|--------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |              |
|   | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b>  |
| <b>Basic earnings (loss) per share computation:</b>   |                           |             |                          |              |
| Numerator:  |                           |             |                          |              |
| Net income (loss)                                     | \$ (170,429)              | \$ 311,713  | \$ (619,346)             | \$ (315,623) |
| Preferred stock accretion                             |                           |             |                          | (22,200)     |
| Income (loss) available to common stockholders        | \$ (170,429)              | \$ 311,713  | \$ (619,346)             | \$ (337,823) |
| Denominator:  |                           |             |                          |              |
| Weighted average common shares                        | 8,216,971                 | 8,181,966   | 8,201,071                | 6,906,812    |
| Basic earnings (loss) per share                       | \$ (0.02)                 | \$ 0.04     | \$ (0.08)                | \$ (0.05)    |
| <b>Diluted earnings (loss) per share computation:</b> |                           |             |                          |              |
| Numerator:  |                           |             |                          |              |
| Net income (loss)                                     | \$ (170,429)              | \$ 311,713  | \$ (619,346)             | \$ (315,623) |
| Preferred stock accretion                             |                           |             |                          | (22,200)     |
| Income (loss) available to common stockholders        | \$ (170,429)              | \$ 311,713  | \$ (619,346)             | \$ (337,823) |
| Denominator:  |                           |             |                          |              |
| Weighted average common shares                        | 8,216,971                 | 8,181,966   | 8,201,071                | 6,906,812    |
| Effect of dilutive securities:                        |                           |             |                          |              |
| Series B convertible preferred stock                  |                           |             |                          |              |
| Stock options, net                                    |                           | 292,456     |                          |              |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Denominator for diluted earnings (loss)<br>per share | 8,216,971 | 8,474,422 | 8,201,071 | 6,906,812 |
| Diluted earnings (loss) per share                    | \$ (0.02) | \$ 0.04   | \$ (0.08) | \$ (0.05) |

### 9. Stock-Based Compensation

The Company accounts for its employee stock-based compensation plans using the intrinsic value method, as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*. Under APB 25, because the Company's employee stock options are granted at an exercise price equal to the fair market value of the underlying Common Stock on the date of the grant, no compensation expense is recognized. As permitted, the Company has elected to adopt the disclosure only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148.



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**REDHOOK ALE BREWERY, INCORPORATED**  
**NOTES TO FINANCIAL STATEMENTS (Continued)**  
(Unaudited)

The following table illustrates the effect on net income (loss) and earnings (loss) per share for the three and nine months ended September 30, 2005 and 2004 had compensation cost for the Company's stock options been recognized based upon the estimated fair value on the grant date under the fair value methodology.

|  | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |              |
|--|---------------------------|-------------|--------------------------|--------------|
|  | <b>September 30,</b>      |             | <b>September 30,</b>     |              |
|  | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b>  |
| Net income (loss), as reported   | \$ (170,429)              | \$ 311,713  | \$ (619,346)             | \$ (315,623) |
| Add: Stock-based employee compensation expense as reported under APB 25  |                           |             |                          |              |
| Less: Stock-based employee compensation expense determined under fair value based method for all options, net of related tax effects | (36,595)                  | (44,883)    | (70,110)                 | (153,383)    |
| Pro forma net income (loss)  | \$ (207,024)              | \$ 266,830  | \$ (689,456)             | \$ (469,006) |
| Earnings (loss) per share:   |                           |             |                          |              |
| Basic as reported  | \$ (0.02)                 | \$ 0.04     | \$ (0.08)                | \$ (0.05)    |
| Basic pro forma  | \$ (0.03)                 | \$ 0.03     | \$ (0.08)                | \$ (0.07)    |
| Diluted as reported  | \$ (0.02)                 | \$ 0.04     | \$ (0.08)                | \$ (0.05)    |
| Diluted pro forma  | \$ (0.03)                 | \$ 0.03     | \$ (0.08)                | \$ (0.07)    |

**Table of Contents****ITEM 2. *Management's Discussion and Analysis of Financial Condition and Results of Operations***

The following discussion and analysis should be read in conjunction with the Financial Statements and Notes thereto of Redhook Ale Brewery, Incorporated (the Company or Redhook) included herein. The discussion and analysis includes period-to-period comparisons of the Company's financial results. Although period-to-period comparisons may be helpful in understanding the Company's financial results, the Company believes that they should not be relied upon as an accurate indicator of future performance.

**Overview**

Since its formation, the Company has focused its business activities on the brewing, marketing and selling of craft beers in the United States. The Company produces its specialty bottled and draft products in two Company-owned breweries, one in the Seattle suburb of Woodinville, Washington (the Washington Brewery) and the other in Portsmouth, New Hampshire (the New Hampshire Brewery). Prior to July 1, 2004, the Company's sales consisted predominantly of sales of beer to third-party distributors and Anheuser-Busch, Inc. (A-B) through the Company's Distribution Alliance with A-B (the Alliance or the Distribution Alliance). Since July 1, 2004, the Company's sales have consisted predominately of sales of product to Craft Brands Alliance LLC (Craft Brands) and A-B. Craft Brands is a joint venture sales and marketing entity between the Company and Widmer Brothers Brewing Company (Widmer). The Company and Widmer manufacture and sell their product to Craft Brands at a price substantially below wholesale pricing levels; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States through a distribution agreement between Craft Brands and A-B. Profits and losses of Craft Brands are generally shared between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively. In Washington state, due to state liquor regulations, the Company sells its products directly to third-party beer distributors and returns a portion of the revenue to Craft Brands based upon a contractually determined formula. The Company continues to sell its product in the midwest and eastern United States through sales to A-B pursuant to the July 1, 2004 A-B Distribution Agreement. For additional information regarding Craft Brands and the A-B Distribution Agreement, see Part 1, Item 1, Business Production Distribution, Relationship with Anheuser-Busch, Incorporated and Relationship with Craft Brands Alliance LLC of the Company's Annual Report on Form 10K for the fiscal year ended December 31, 2004, and Craft Brands Alliance LLC below. In addition to sales of beer, the Company derives other revenues from sources including the sale of retail beer, food, apparel and other retail items in its two brewery pubs.

The Company's gross sales and net loss for the nine months ended September 30, 2005 totaled \$26,564,000 and \$619,000, respectively, compared to gross sales and a net loss of \$29,624,000 and \$316,000, respectively, for the same period in 2004. However, comparability of the Company's 2005 operating results to 2004 operating results is significantly impacted by the July 1, 2004 formation of Craft Brands and the July 1, 2004 A-B Distribution Agreement. While sales in the western United States for the entire nine months of 2005 were made to Craft Brands at discounted rates, sales in the western United States for the nine months of 2004 were at two distinct pricing levels at historical wholesale prices for first six months of 2004; and at discounted rates for the third quarter of 2004.

The Company's sales volume (shipments) increased 3.3% to 174,800 barrels for the nine months ended September 30, 2005 as compared to 169,200 barrels for the same 2004 period. Sales in the craft beer industry generally reflect a degree of seasonality, with the first and fourth quarters historically being the slowest and the rest of the year typically demonstrating stronger sales. The Company has historically operated with little or no backlog and, therefore, its ability to predict sales for future periods is limited.

The Company's sales are affected by several factors, including consumer demand, price discounting and competitive considerations. The Company competes in the highly competitive craft brewing market as well as in the much larger specialty beer market, which encompasses producers of import beers, major national brewers that produce fuller-flavored products, and large spirit companies and national brewers that produce flavored alcohol beverages. Beyond the beer market, craft brewers also face competition from producers of wines and spirits. The craft beer segment is highly competitive due to the proliferation of small craft brewers, including contract brewers, and the large number of products offered by such brewers. Imported products from foreign brewers have enjoyed resurgence in demand since the mid-1990s. Certain national domestic brewers have also sought to appeal to this growing demand for craft beers by producing their own fuller-flavored products. In the



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last few years, the specialty segment has seen the introduction of flavored alcohol beverages, the consumers of which, industry sources generally believe, correlate closely with the consumers of the import and craft beer products. While sales of flavored alcohol beverages were initially very strong, these growth rates slowed in 2003 and 2004. The wine and spirits market has experienced a surge in the past several years, attributable to competitive pricing, increased merchandising, and increased consumer interest in spirits. Because the number of participants and number of different products offered in this segment have increased significantly in the past ten years, the competition for bottled product placements and especially for draft beer placements has intensified.

The Company is required to pay federal excise taxes on sales of its beer. The excise tax burden on beer sales increases from \$7 to \$18 per barrel on annual sales over 60,000 barrels and thus, if sales volume increases, federal excise taxes would increase as a percentage of sales. Most states also collect an excise tax on the sale of beer.

Under normal circumstances, the Company operates its brewing facilities up to six days per week with multiple shifts per day. Under ideal brewing conditions (which would include, among other factors, production of a single brand in a single package), the current production capacity is approximately 250,000 barrels per year at the Washington Brewery and 125,000 barrels per year at the New Hampshire Brewery. Because of various factors, including the following two, the Company does not believe that it is likely that actual production volume will approximate current production capacity: (1) the Company's brewing process, which management believes is similar to its competitors' brewing process, inherently results in some level of beer loss attributable to filtering, bottling, and keg filling; and (2) the Company routinely brews and packages various brands and package sizes during the year. Production capacity at the New Hampshire Brewery can be added in phases until the facility reaches its maximum designed production capacity of approximately 250,000 barrels per year, under ideal brewing conditions. Such an increase would require additional capital expenditures, primarily for fermentation equipment, and production personnel. The decision to add capacity is affected by the availability of capital, construction constraints and anticipated sales in new and existing markets.

The Company's capacity utilization has a significant impact on gross profit. Generally, when facilities are operating at their maximum designed production capacities, profitability is favorably affected because fixed and semi-variable operating costs, such as depreciation and production salaries, are spread over a larger sales base. Because current period production levels have been below the Company's current production capacity, gross margins have been negatively impacted. This negative impact could be reduced if actual production increases.

In addition to capacity utilization, other factors that could affect cost of sales and gross margin include sales to Craft Brands at a price substantially below historical wholesale pricing levels, changes in freight charges, the availability and price of raw materials and packaging materials, the mix between draft and bottled product sales, the sales mix of various bottled product packages, and fees related to the Distribution Agreement with A-B.

See Management's Discussion and Analysis of Financial Condition and Results of Operations - Certain Considerations: Issues and Uncertainties.

**Critical Accounting Policies and Estimates** (Restated; See Note 2)

The Company's financial statements are based upon the selection and application of significant accounting policies that require management to make significant estimates and assumptions. Management believes that the following are some of the more critical judgment areas in the application of the Company's accounting policies that currently affect its financial condition and results of operations. Judgments and uncertainties affecting the application of these policies may result in materially different amounts being reported under different conditions or using different assumptions.

*Income Taxes.* The Company records federal and state income taxes in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 109, *Accounting for Income Taxes*. Deferred income taxes or tax benefits reflect the tax effect of temporary

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differences between the amounts of assets and liabilities for financial reporting purposes and amounts as measured for tax purposes. The Company will establish a valuation allowance if it is more likely than not that these items will either expire before the Company is able to realize their benefits or that future deductibility is uncertain. The valuation allowance is reviewed and adjusted on a quarterly basis based on management's assessment of the realizability of the deferred tax assets. As of December 31, 2004, the Company had approximately \$11.6 million of deferred tax assets, comprised principally of federal net operating loss carryforwards ( NOLs ) that expire from 2012 through 2024 and state NOLs that expire through 2019. The recognition of these assets is dependent upon estimates of future taxable income resulting from future reversals of existing taxable temporary differences, which have been recorded as deferred tax liabilities and exceed the deferred tax assets. As of December 31, 2004, the Company also had a valuation allowance of \$1,154,000, reflected as a reduction of the Company's deferred tax assets on its balance sheet. The Company established the valuation allowance in 2002 and increased the balance in 2003 and 2004. The Company reduced the valuation allowance by \$70,000 in the first quarter of 2005. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOL carryforwards, that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company is unable to generate adequate taxable income in the future, the Company may not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering expiring NOLs.

The Company has restated its previously reported financial statements to correct an error as of and for the year ended December 31, 2004. The Company inadvertently overstated its net operating tax loss carryforwards ( NOLs ) with the state of New Hampshire by recording NOLs in excess of limits prescribed by state law. This error resulted in an understatement of the Company's income tax provision for the quarter and year ended December 31, 2004 and an overstatement of the Company's deferred tax asset, which is netted against the Company's deferred income tax liability on the Company's balance sheet.

*Long-Lived Assets.* The Company evaluates potential impairment of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 establishes procedures for review of recoverability and measurement of impairment, if necessary, of long-lived assets, goodwill and certain identifiable intangibles. When facts and circumstances indicate that the carrying values of long-lived assets may be impaired, an evaluation of recoverability is performed by comparing the carrying value of the assets to projected future undiscounted cash flows in addition to other quantitative and qualitative analyses. Upon indication that the carrying value of such assets may not be recoverable, the Company recognizes an impairment loss by a charge against current operations. Fixed assets are grouped at the lowest level for which there are identifiable cash flows when assessing impairment. During 2004, the Company performed an analysis of its brewery assets to determine if an impairment might exist. The Company's estimate of future undiscounted cash flows indicated that such carrying values were expected to be recovered. Nonetheless, it is possible that the estimate of future undiscounted cash flows may change in the future, resulting in the need to write down those assets to their fair value.

*Investment in Craft Brands Alliance LLC.* The Company has assessed its investment in Craft Brands pursuant to the provisions of FASB Interpretation No. 46 Revised, *Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51 ( FIN 46R )*. FIN 46R clarifies the application of consolidation accounting for certain entities that do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties or in which equity investors do not have the characteristics of a controlling financial interest; these entities are referred to as variable interest entities. Variable interest entities within the scope of FIN 46R are required to be consolidated by their primary beneficiary. The primary beneficiary of a variable interest entity is determined to be the party that absorbs a majority of the entity's expected losses, receives a majority of its expected returns, or both. FIN 46R also requires disclosure of significant variable interests in variable interest entities for which a company is not the primary beneficiary. The Company has concluded that its investment in Craft Brands meets the definition of a variable interest entity but that the Company is not the primary beneficiary. In accordance with FIN46R, the Company has not consolidated the financial statements of Craft Brands with the financial statements of the Company, but instead accounted for its investment in Craft Brands under the equity method, as outlined by Accounting Principle Board Opinion ( APB ) No. 18, *The Equity Method of Accounting for Investments in Common Stock*. The equity

method requires that the Company recognize its share of the net earnings of Craft Brands by increasing its investment in Craft Brands on the Company's balance sheet and recognizing income from equity investment in the Company's statement of operations. A cash distribution or the Company's share of a net loss reported by Craft Brands is reflected as a decrease in investment in Craft Brands on the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. For the nine months ended September 30, 2005, the Company recognized \$1,625,000 of undistributed earnings related to its investment in Craft Brands. During the same period in 2005, the Company received cash distributions of \$1,940,000, of which \$335,000 related to 2004 earnings, representing its share of the net cash flow of Craft Brands. The Company's share of the earnings of Craft Brands contributed a significant portion of

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income to the Company's results of operations. The Company will periodically review its investment in Craft Brands to insure that it complies with the guidelines prescribed by FIN46R.

*Revenue Recognition.* The Company recognizes revenue from product sales, net of excise taxes, discounts and certain fees the Company must pay in connection with sales to A-B, when the products are shipped to customers. Although title and risk of loss do not transfer until delivery of the Company's products to A-B or the A-B distributor, the Company recognizes revenue upon shipment rather than when title passes because the time lag between shipment and delivery is short and product damage claims and returns are immaterial. The Company recognizes revenue on retail sales at the time of sale. The Company recognizes revenue from events at the time of the event.

**Results of Operations**

The following table sets forth, for the periods indicated, certain items from the Company's Statements of Operations expressed as a percentage of net sales:

|   | <b>Three Months Ended</b> |             | <b>Nine Months Ended</b> |             |
|---|---------------------------|-------------|--------------------------|-------------|
|   | <b>September 30,</b>      |             | <b>September 30,</b>     |             |
|   | <b>2005</b>               | <b>2004</b> | <b>2005</b>              | <b>2004</b> |
| Sales   | 111.1%                    | 111.1%      | 111.2%                   | 109.6%      |
| Less Excise Taxes                             | 11.1                      | 11.1        | 11.2                     | 9.6         |
| Net Sales                                     | 100.0                     | 100.0       | 100.0                    | 100.0       |
| Cost of Sales                                 | 86.9                      | 87.9        | 86.9                     | 77.7        |
| Gross Profit                                  | 13.1                      | 12.1        | 13.1                     | 22.3        |
| Selling, General and Administrative Expenses  | 22.3                      | 16.5        | 22.2                     | 23.6        |
| Income from Equity Investment in Craft Brands | 7.9                       | 8.3         | 6.8                      | 2.4         |
| Craft Brands Shared Formation Expenses        |                           |             |                          | 2.0         |
| Operating Income (Loss)                       | (1.3)                     | 3.9         | (2.3)                    | (0.9)       |
| Interest Expense                              | 0.8                       | 0.6         | 0.8                      | 0.5         |
| Other Income (Expense) Net                    | 0.2                       | 0.8         | 0.3                      | 0.3         |
| Income (Loss) before Income Taxes             | (1.9)                     | 4.1         | (2.8)                    | (1.1)       |
| Income Tax Provision (Benefit)                | 0.1                       | 0.2         | (0.2)                    | 0.1         |
| Net Income (Loss)                             | (2.0)%                    | 3.9%        | (2.6)%                   | (1.2)%      |

**Table of Contents****Three Months Ended September 30, 2005 Compared to Three Months Ended September 30, 2004**

The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations:

|  | Three Months Ended<br>September 30, |              | Increase/<br>(Decrease) | %<br>Change |
|--|-------------------------------------|--------------|-------------------------|-------------|
|  | 2005                                | 2004         |                         |             |
| Sales  | \$ 9,497,771                        | \$ 8,789,773 | \$ 707,998              | 8.1%        |
| Less Excise Taxes                                | 946,680                             | 878,253      | 68,427                  | 7.8         |
| Net Sales  | 8,551,091                           | 7,911,520    | 639,571                 | 8.1         |
| Cost of Sales                                    | 7,429,086                           | 6,950,722    | 478,364                 | 6.9         |
| Gross Profit                                     | 1,122,005                           | 960,798      | 161,207                 | 16.8        |
| Selling, General and Administrative<br>Expenses  | 1,905,135                           | 1,310,395    | 594,740                 | 45.4        |
| Income from Equity Investment in Craft<br>Brands | 673,606                             | 657,705      | 15,901                  | 2.4         |
| Craft Brands Shared Formation Expenses           |                                     | (2,947)      | 2,947                   | 100.0       |
| Operating Income (Loss)                          | (109,524)                           | 311,055      | (420,579)               | (135.2)     |
| Interest Expense                                 | 71,882                              | 48,332       | 23,550                  | 48.7        |
| Other Income (Expense) Net                       | 20,555                              | 58,990       | (38,435)                | (65.2)      |
| Income (Loss) before Income Taxes                | (160,851)                           | 321,713      | (482,564)               | (150.0)     |
| Income Tax Provision (Benefit)                   | 9,578                               | 10,000       | (422)                   | (4.2)       |
| Net Income (Loss)                                | \$ (170,429)                        | \$ 311,713   | \$ (482,142)            | (154.7)%    |
| Beer Shipped (in barrels)                        | 61,600                              | 57,100       | 4,500                   | 7.9%        |

**Sales.** The following factors played a role in the \$708,000 increase in total sales in the third quarter of 2005 as compared to the third quarter of 2004:

**Shipments.** Total Company shipments increased 7.9% during the third quarter of 2005 as compared with the third quarter of 2004. Total sales volume for the quarter ended September 30, 2005 increased to 61,600 barrels from 57,100 barrels for the same period in 2004, the result of a 1.9% decrease in shipments of its packaged products and a 24.0% increase in shipments of the Company's draft products. In the 2005 third quarter, the Company shipped approximately 3,400 barrels of draft beer under a contract brewing arrangement; there were no shipments of contract beer in the third quarter of 2004. Excluding shipments of beer brewed on a contract basis, the Company's draft product shipments increased 8.2% in the 2005 quarter and total Company shipments increased 1.9%. In the third quarter 2005, 56.1% of total shipments were package shipments versus 61.8% in the same quarter of 2004. At September 30, 2005, the Company's products were distributed in 48 states.



Company shipments in the midwest and eastern United States increased by 7.0% compared to the same 2004 period. Company shipments in the third quarter 2005 in the western United States served by Craft Brands declined 0.9% compared to the 2004 third quarter. For the third quarter 2005, sales to Craft Brands represented approximately 54.9% of total shipments, or 33,800 barrels compared to 59.8% or 34,100 barrels in 2004. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the United States, both in terms of number of market participants and consumer awareness. The Company continues to face extreme competitive pressure in Washington state, which is not only the Company's largest market but is also its oldest market. From 1997 through 2004, the Company experienced a decline in sales volume in Washington state of approximately 17%. Management believes that the decline can be partially attributable to the relative maturity of the brand in this region and, more recently, the formation of Craft Brands. The Company believes that the beer industry is influenced by individual relationships. The transition to Craft Brands impacted its established wholesaler and retailer relationships which, prior to Craft Brands, had existed for many years. Because the transition to Craft Brands took longer than anticipated, and because nearly all the Company's sales staff responsible for Washington state left the Company, the Company and

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Craft Brands have had to re-establish many of these relationships with wholesalers and retailers. Shipments to Washington state increased by 0.6% in the third quarter of 2005 compared to the same 2004 period.

**Pricing and Fees.** The Company sells its product at wholesale pricing levels in the midwest and eastern United States, at lower than historical wholesale pricing levels to Craft Brands in the western United States, and at agreed-upon pricing levels for beer brewed on a contract basis.

Redhook continues to sell its product at wholesale pricing levels in the midwest and eastern United States through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, decreased approximately 2.3% in the third quarter of 2005 as compared to the same quarter in 2004. This decrease in pricing accounted for a decrease of approximately \$28,000 in total sales. Average wholesale revenue per barrel for bottle products, net of discounts, decreased approximately 4.7% in the third quarter of 2005 as compared to the same period in 2004. This decrease in pricing accounted for a decrease of approximately \$111,000 in total sales. Seldom, if ever, are pricing changes driven by an inflationary period. Instead, pricing changes implemented by the Company generally follow pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest pricing increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below historical wholesale pricing levels pursuant to a Supply, Distribution and Licensing Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States through a distribution agreement between Craft Brands and A-B. Average revenue per barrel for draft products sold to Craft Brands increased approximately 2.5% in the third quarter of 2005 as compared to the same quarter in 2004. This increase in pricing accounted for an increase of approximately \$25,000 in total sales. Average revenue per barrel for bottle products sold to Craft Brands increased approximately 5.7% in the third quarter of 2005 as compared to the same period in 2004. This increase in pricing accounted for an increase of approximately \$154,000 in total sales. The price charged Craft Brands is generally adjusted annually.

Average revenue per barrel on beer brewed on a contract basis is at agreed upon pricing levels between the Company and its customer and is generally at a price substantially lower than historical pricing levels.

In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The July 1, 2004 A-B Distribution Agreement modified the Margin fee structure such that the Margin per barrel shipped increased and is paid on all sales through the new A-B Distribution Agreement. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments for the same territory during fiscal 2003. In addition, the Exchange and Recapitalization Agreement provided that the Margin be retroactively increased to the rate provided in the A-B Distribution Agreement for all shipments in June 2004. For the three-month period ended September 30, 2005, the Margin was paid to A-B on shipments totaling 22,900 barrels to 388 distribution points. For the three months ended September 30, 2004, the Margin was paid to A-B on shipments totaling 21,800 barrels to 367 Alliance distribution points. The Margin is reflected as a reduction of sales in the Company's statement of operations.

**Retail Operations and Other Sales.** Sales in the Company's retail operations and other sales increased \$245,000 to \$1,753,000 for the quarter ended September 30, 2005 from \$1,508,000 for the quarter ended September 30, 2004, primarily the result of an increase in food sales.

**Excise Taxes.** Excise taxes increased \$69,000 to \$947,000 for the third quarter of 2005 compared to \$878,000 for the same 2004 period primarily a result of increased shipments. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and brewed under contract. The comparability of excise taxes as a percentage of net sales is impacted by: average revenue per barrel; the mix of sales in the midwest and eastern United States, sales to Craft Brands, sales of beer brewed on contract basis, pub sales; and the estimated annual average federal and state excise tax rates.

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*Cost of Sales.* Comparing the third quarter of 2005 to the third quarter of 2004, cost of sales increased 6.9%, or \$478,000, but decreased slightly on a per barrel basis. On a per barrel basis, the increase in the cost of packaging (a result of the new packaging design introduced in the western United States markets in May 2005) and an increase in freight costs was offset by a decrease in depreciation and salaries. Despite the Company's effort in streamlining its shipping relationships in the midwest and eastern United States, increases in fuel surcharges negatively impacted third quarter 2005 results. Based upon the breweries' combined current production capacity of 93,750 barrels for the quarters ended September 30, 2005 and 2004, the utilization rates were 65.7% and 60.9%, respectively.

In January 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer's brewing staff to insure their brand's quality and matching taste profile. The term of this agreement is for five years, with an additional one-year automatic renewal unless either party elects to terminate the arrangement. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice. The agreement may be terminated for cause by either party under certain conditions. During the term of this agreement, Redhook will not brew, advertise, market, or distribute any product that is labeled or advertised as a Hefeweizen or any similar product in the agreed upon eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. This agreement, for the eastern United States only, is expected to increase capacity utilization and has strengthened the Company's product portfolio. The Company shipped 7,500 and 5,000 barrels of *Widmer Hefeweizen* during the quarters ended September 30, 2005 and 2004, respectively. A licensing fee of \$103,000 and \$76,000 due to Widmer is reflected in the Company's statement of operations for the quarters ended September 30, 2005 and 2004, respectively.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased \$595,000 to \$1,905,000 from expenses of \$1,310,000 for the third quarter of 2004, primarily the result of increased sales and marketing costs. Increased spending in the third quarter of 2005 was primarily related to the new label and packaging design to be introduced to eastern and midwest markets in the fourth quarter of 2005 and the addition of sales personnel in eastern markets. Since July 1, 2004, all advertising, marketing and selling costs in the western United States has been the responsibility of Craft Brands.

*Income from Equity Investment in Craft Brands.* In accordance with the Craft Brands Operating Agreement, the Company made a \$250,000 sales and marketing capital contribution to Craft Brands, which was to be used by Craft Brands for expenses related to the marketing, advertising, and promotion of Redhook products ( Special Marketing Expense ). After giving effect to the allocation of the Special Marketing Expense, which is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the Cash Flow Percentages of 42% and 58%, respectively. For the quarter ended September 30, 2005, the Company's share of Craft Brands' net income totaled \$674,000. The entire \$250,000 2004 sales and marketing capital contribution made by the Company had been used by Craft Brands in the last half of 2004 and the first quarter of 2005 for designated Special Marketing Expenses and netted against Craft Brands' profits allocated to the Company during the same period and, therefore, had no impact on the third quarter of 2005 profit allocation. For the third quarter 2004, the Company's share of Craft Brands' net income totaled \$658,000; this share of Craft Brands' profit was net of \$78,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company.

Net cash flow of Craft Brands, if any, is generally distributed monthly to the Company based on the Company's cash flow percentage of 42%. In the third quarter of 2005, the Company received cash distributions of \$802,000 representing its share of the net cash flow of Craft Brands compared to cash distributions of \$609,000 received in the third quarter 2004.

*Interest Expense.* Interest expense was \$72,000 for the third quarter of 2005, up from \$48,000 for the comparable 2004 period. Higher average interest rates in the third quarter of 2005, partially offset by a declining term loan balance, resulted in an increase in interest expense.

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*Other Income (Expense) Net.* Other income (expense) net decreased by \$38,000 to income of \$21,000 for the third quarter of 2005 compared to income of \$59,000 for the third quarter of 2004. The third quarter of 2005 includes approximately \$34,000 in interest income earned on interest-bearing deposits, offset by a net \$15,000 loss on disposal of brewing equipment. The third quarter of 2004 includes approximately \$10,000 in interest income earned on interest-bearing deposits, and \$49,000 of other income primarily consisting of a filing commission from a state taxing authority.

*Income Taxes.* The Company's effective income tax rate was a 6.0% expense for the quarter ended September 30, 2005 and a 3.1% expense for the comparable 2004 period. Both periods' expense provide for current state taxes.

**Craft Brands Alliance LLC**

The Company has accounted for its investment in Craft Brands under the equity method, as outlined by APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. Pursuant to APB No. 18, the Company has recorded its share of Craft Brands' net income in the Company's statement of operations as income from equity investment in Craft Brands. The following discussion should be read in conjunction with the financial statements and notes thereto of Craft Brands Alliance LLC, filed with the Company's Form 10-K for the year ended December 31, 2004, in Item 15. *Exhibits and Financial Statement Schedules* in accordance with Rule 3-09 of Regulation S-X.

The following summarizes certain items included in Craft Brands' statement of operations for the quarter ended September 30, 2005:

*Sales.* Craft Brands' sales totaled \$14,888,000 for the third quarter 2005 compared to \$13,757,000 for the third quarter of 2004. In addition to selling 33,800 barrels of the Company's product to wholesalers in the western United States in third quarter 2005 and 34,100 barrels in the third quarter of 2004, Craft Brands also sold Widmer and Kona products. Average wholesale revenue per barrel for all draft products sold by Craft Brands, net of discounts, decreased approximately 6.5% in the third quarter of 2005 as compared to the same quarter in 2004. Average wholesale revenue per barrel for all bottle products sold by Craft Brands, net of discounts, decreased approximately 6.7% in the third quarter of 2005 as compared to the same period in 2004. For the quarter ended September 30, 2005, average wholesale revenue per barrel for all products sold by Craft Brands was 5% higher compared to the average wholesale revenue per barrel on sales to wholesalers by the Company during the same period. Craft Brands' sales efforts during the third quarter of 2005 included a reduction in discounting on the Company's products. Craft Brands also pays fees to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

*Cost of Sales.* Cost of sales of Craft Brands totaled \$10,598,000 for the third quarter 2005 compared to \$9,600,000 for the third quarter of 2004. Craft Brands purchases product from the Company and Widmer at a price substantially below historical wholesale pricing levels pursuant to a Supply, Distribution, and Licensing Agreement between Craft Brands and each of the Company and Widmer. Higher shipping costs in the 2005 third quarter contributed to the increase.

*Selling, General and Administrative Expenses.* Craft Brands' selling, general and administrative expenses totaled \$2,554,000 for the third quarter 2005 compared to \$2,322,000 for the third quarter of 2004 and include all advertising, marketing and promotion efforts for the Redhook, Widmer and Kona brands. During the quarter ended September 30, 2005, Craft Brands focused significant effort on advertising and promotion in conjunction with the second quarter 2005 introduction of new packaging for the Company's bottled product.

*Net Income.* Craft Brands' net income totaled \$1,619,000 for the third quarter 2005 compared to \$1,778,000 for the third quarter of 2004. The Company's share of Craft Brands' net income totaled \$674,000 for the third quarter of 2005 compared to \$658,000 for the third quarter of 2004. After giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively.

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The following table sets forth, for the periods indicated, a comparison of certain items from the Company's Statements of Operations:

|   | <b>Nine Months Ended<br/>September 30,</b> |              | <b>Increase/<br/>(Decrease)</b> | <b>%<br/>Change</b> |
|---|--|--------------|---------------------------------|---------------------|
|   | <b>2005</b>                                | <b>2004</b>  |                                 |                     |
| Sales   | \$ 26,563,961                              | 29,623,658   | \$ (3,059,697)                  | (10.3)%             |
| Less Excise Taxes                             | 2,681,531                                  | 2,601,464    | 80,067                          | 3.1                 |
| <br>  |  |              |                                 |                     |
| Net Sales                                     | 23,882,430                                 | 27,022,194   | (3,139,764)                     | (11.6)              |
| Cost of Sales                                 | 20,754,426                                 | 21,004,133   | (249,707)                       | (1.2)               |
| <br>  |  |              |                                 |                     |
| Gross Profit                                  | 3,128,004                                  | 6,018,061    | (2,890,057)                     | (48.0)              |
| Selling, General and Administrative Expenses  | 5,299,473                                  | 6,384,759    | (1,085,286)                     | (17.0)              |
| Income from Equity Investment in Craft Brands | 1,624,604                                  | 657,705      | 966,899                         | 147.0               |
| Craft Brands Shared Formation Expenses        |  | 534,628      | (534,628)                       | (100.0)             |
| <br>  |  |              |                                 |                     |
| Operating Income (Loss)                       | (546,865)                                  | (243,621)    | (303,244)                       | 124.5               |
| Interest Expense                              | 198,796                                    | 134,732      | 64,064                          | 47.5                |
| Other Income (Expense) Net                    | 84,893                                     | 82,730       | 2,163                           | 2.6                 |
| <br>  |  |              |                                 |                     |
| Income (Loss) before Income Taxes             | (660,768)                                  | (295,623)    | (365,145)                       | 123.5               |
| Income Tax Provision (Benefit)                | (41,422)                                   | 20,000       | (61,422)                        | (307.1)             |
| <br>  |  |              |                                 |                     |
| Net Income (Loss)                             | \$ (619,346)                               | \$ (315,623) | \$ (303,723)                    | 96.2                |
| <br>  |  |              |                                 |                     |
| Beer Shipped (in barrels)                     | 174,800                                    | 169,200      | 5,600                           | 3.3%                |

**Sales.** The following factors played a role in the \$3,060,000 decline in total sales in the first nine months of 2005 as compared to the first nine months of 2004:

**Shipments.** Total Company shipments increased 3.3% during the nine months ended 2005 as compared with the same 2004 period. Total sales volume for the nine months ended September 30, 2005 increased to 174,800 barrels from 169,200 barrels for the same period in 2004, the result of a 14.0% increase in shipments of the Company's draft products, partially offset by a 3.3% decrease in shipments of its packaged products. Excluding 8,700 barrels and 2,300 barrels of draft beer shipped under a contract brewing arrangement in the first nine months of 2005 and 2004, respectively, shipments of the Company's draft products increased 4.2% in the nine months ended 2005 and total company shipments decreased 0.5%. Since the mid 1990s, package beer sales have steadily increased as a percentage of total beer sales. The migration toward increasing package sales reversed slightly, though, in the first nine months of 2005 with 58.0% of total shipments being package shipments versus 61.9% in the same nine months of 2004. At September 30, 2005 and 2004, the Company's products were distributed in 48 states.

Shipments in the western United States declined 4.7% in the first nine months of 2005 as compared to the same 2004 period but were partially offset by a 5.9% increase in shipments in the midwest and eastern United States. Contributing most significantly to the decline in shipments in the western United States were; a 7.6% decrease in shipments to California; and a 19.7% decrease in shipments to Colorado primarily attributable to a decrease in price discounting. A significant portion of the Company's sales continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the United States, both in terms of number of market participants and consumer awareness. The Company faces extreme competitive pressure in Washington state, which is not only the Company's largest market but is also its oldest market. From 1997 through 2004, the Company experienced a decline in sales volume in Washington state of approximately 17%. Management believes that the decline can be partially attributable to the relative maturity of the brand in this region and, more recently, the formation of Craft Brands. The Company believes that the beer industry is influenced by individual relationships. The transition to Craft Brands impacted its established wholesaler and retailer relationships which, prior to Craft Brands, had existed for many years. Because the transition to Craft Brands took longer than anticipated, and

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because nearly all the Company's sales staff responsible for Washington state left the Company, the Company and Craft Brands have had to re-establish many of these relationships with wholesalers and retailers. During the second quarter of 2005, Craft Brands introduced in the western United States several major marketing initiatives aimed at updating the Redhook brand image, including a proprietary Redhook bottle and new packaging design, combined with a new marketing campaign. Shipments to Washington state decreased by 0.6% in the nine months of 2005 compared to the same 2004 period. Sales have also been impacted by a reduction in the pricing promotions historically offered in these regions.

For the nine-month period of 2005, sales to Craft Brands represented approximately 55.7% of total shipments, or 97,400 barrels, compared to 20.2% or 34,100 barrels in 2004.

**Pricing and Fees.** The Company sells its product at wholesale pricing levels in the midwest and eastern United States, at lower than historical wholesale pricing levels to Craft Brands in the western United States, and at agreed-upon pricing levels for beer brewed on a contract basis.

The Company continues to sell its product at wholesale pricing levels in the midwest and eastern United States through sales to A-B. Average wholesale revenue per barrel for draft products, net of discounts, increased approximately 5.0% in the nine months of 2005 as compared to the same period in 2004. This increase in pricing accounted for an increase of approximately \$301,000 in total sales. Average wholesale revenue per barrel for bottle products, net of discounts, decreased approximately 1.8% in the nine months of 2005 as compared to the same period in 2004. This decrease in pricing accounted for a decrease of approximately \$289,000 in total sales. Seldom, if ever, are pricing changes driven by an inflationary period. Instead, pricing changes implemented by the Company generally follow pricing changes initiated by large domestic or import brewing companies. While the Company has implemented modest pricing increases during the past few years, some of the benefit has been offset by competitive promotions and discounting. Additionally, the Company may experience a decline in sales in certain regions following a price increase.

The Company sells its product to Craft Brands at a price substantially below historical wholesale pricing levels pursuant to a Supply, Distribution and Licensing Agreement with Craft Brands; Craft Brands, in turn, advertises, markets, sells and distributes the product to wholesale outlets in the western United States through a distribution agreement between Craft Brands and A-B. Average revenue per barrel for draft products sold to Craft Brands increased approximately 2.5% in the nine months of 2005 as compared to the same period in 2004. This increase in pricing accounted for an increase of approximately \$25,000 in total sales. Average revenue per barrel for bottle products sold to Craft Brands increased approximately 3.6% in the nine months of 2005 as compared to the same period in 2004. This increase in pricing accounted for an increase of approximately \$96,000 in total sales. The price charged Craft Brands is generally adjusted annually. Because Craft Brands' formation did not occur until July 2004, approximately 68,000 barrels sold in the western United States in the first half of 2004 were at historical wholesale pricing levels.

Average revenue per barrel on beer brewed on a contract basis is at agreed upon pricing levels between the Company and its customers and is generally at a price substantially lower than historical pricing levels.

In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The July 1, 2004 A-B Distribution Agreement modified the Margin fee structure such that the Margin per barrel shipped increased and is paid on all sales through the new A-B Distribution Agreement. The Margin does not apply to sales to the Company's retail operations or to dock sales. The Margin also does not apply to the Company's sales to Craft Brands because Craft Brands pays a comparable fee to A-B on its resale of the product. The A-B Distribution Agreement also provides that the Company shall pay an additional fee on shipments that exceed shipments for the same territory during fiscal 2003. In addition, the Exchange and Recapitalization Agreement provided that the Margin be retroactively increased to the rate provided in the A-B Distribution Agreement for all shipments in June 2004. For the nine-month period ended September 30, 2005, the Margin was paid to A-B on shipments totaling 65,100 barrels to 416 distribution points. For the six months ended June 30, 2004 the Margin was paid to A-B on shipments totaling 84,000 barrels to 495 Alliance distribution points. For the three months ended September 30, 2004, the Margin was paid to A-B on shipments totaling 23,200 barrels to 367 distribution points. The incremental margin on June 2004 shipments was paid on approximately 20,000 barrels. The Margin paid is reflected

as a reduction of sales in the Company's statement of operations.



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**Retail Operations and Other Sales.** Sales in the Company's retail operations and other sales increased \$410,000 to \$4,164,000 for the nine months ended September 30, 2005 from \$3,753,000 for same 2004 period, primarily the result of an increase in food sales.

**Excise Taxes.** Excise taxes increased \$81,000 to \$2,682,000 for the first nine months of 2005 compared to \$2,601,000 for the same 2004 period, primarily the result of increased 2005 shipments compared to 2004. The Company continues to be responsible for federal and state excise taxes for all shipments, including those to Craft Brands and brewed under contract. The comparability of excise taxes as a percentage of net sales is impacted by: average revenue per barrel; the mix of sales in the midwest and eastern United States, sales to Craft Brands, sales of beer brewed on a contract basis, pub sales; and the estimated annual average federal and state excise tax rates.

**Cost of Sales.** Comparing the nine months ended September 30, 2005 and 2004, cost of sales decreased 1.2%, or \$250,000, and decreased on a per barrel basis, primarily attributable to a decrease in freight, offset by a slight increase in the cost of new packaging that was introduced in the western United States markets in May 2005. Although the Company experienced an increase in freight on shipments in the midwest and eastern markets during the third quarter of 2005, 2005 year-to-date freight costs declined by nearly 41% as compared to 2004 as the cost of shipping Redhook product in the western United States became the responsibility of Craft Brands in the third quarter of 2004. Based upon the breweries' combined current production capacity of 281,250 barrels for the nine months ended September 30, 2005 and 2004, the utilization rates were 62.1% and 60.2%, respectively.

In January 2003, the Company entered into a licensing agreement with Widmer to produce and sell the *Widmer Hefeweizen* brand in states east of the Mississippi River. Brewing of this product is conducted at the New Hampshire Brewery under the supervision and assistance of Widmer's brewing staff to insure their brand's quality and matching taste profile. The Company shipped 19,800 and 14,200 barrels of *Widmer Hefeweizen* during the nine months ended September 30, 2005 and 2004, respectively. A licensing fee of \$260,000 and \$204,000 due to Widmer is reflected in the Company's statement of operations for the nine months ended September 30, 2005 and 2004, respectively.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses decreased \$1,085,000 to \$5,299,000 from expenses of \$6,385,000 for the first nine months of 2004, significantly impacted by the formation of Craft Brands. A significant reduction in advertising, marketing and selling costs in the western United States following the transition to Craft Brands was somewhat offset by an increase in promotional spending and sales salaries in midwest and eastern markets during the third quarter of 2005. While the Company and Widmer sought the regulatory approval required for Craft Brands to become fully operational, they agreed to share certain sales-related costs, primarily salaries and overhead. The Company's share of those costs totaled \$554,000 for the nine months ended September 30, 2004 and is reflected in the Company's statement of operations as selling, general and administrative expenses.

**Income from Equity Investment in Craft Brands.** In accordance with the Craft Brands Operating Agreement, the Company made a \$250,000 sales and marketing capital contribution to Craft Brands, which was to be used by Craft Brands for expenses related to the Special Marketing Expense. After giving effect to the allocation of the Special Marketing Expense, which is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the Cash Flow Percentages of 42% and 58%, respectively. For the nine months ended September 30, 2005, the Company's share of Craft Brands' net income totaled \$1,625,000. This share of Craft Brands' profit was net of \$135,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company. As of September 30, 2005, the entire \$250,000 2004 marketing capital contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands' 2004 and 2005 profits allocated to the Company. For the nine months ending September 30, 2004, the Company's share of Craft Brands' net income totaled \$658,000 and was net of \$78,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company.

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Net cash flow of Craft Brands, if any, is generally distributed monthly to the Company based on the Company's cash flow percentage of 42%. In the first nine months of 2005, the Company received cash distributions of \$1,940,000, of which \$335,000 related to 2004 earnings, representing its share of the net cash flow of Craft Brands compared to cash distributions of \$609,000 received in 2004.

*Craft Brands Shared Formation Expenses.* In conjunction with the formation of Craft Brands, both the Company and Widmer incurred certain start-up expenses, including severance expenses and legal fees. The Company's operating income (loss) for the nine months ended September 30, 2004 reflects \$535,000 attributable to the Company's share of these expenses.

*Interest Expense.* Interest expense was \$199,000 for the first nine months of 2005, up from \$135,000 for the comparable 2004 period. Higher average interest rates in the first nine months of 2005, partially offset by a declining term loan balance, resulted in an increase in interest expense.

*Other Income (Expense) Net.* Other income (expense) net increased by \$2,000 to income of \$85,000 for the first nine months of 2005 compared to income of \$83,000 for the first nine months of 2004. The nine-month period of 2005 includes approximately \$81,000 in interest income earned on interest-bearing deposits, offset by a net \$15,000 loss on disposal of brewing equipment. The nine-month period of 2004 includes approximately \$24,000 in interest income earned on interest-bearing deposits, and \$59,000 of other income primarily consisting of a filing commission from a state taxing authority.

*Income Taxes* The Company's effective income tax rate was a 6.3% benefit for the nine months ended September 30, 2005 as compared to a 6.8% expense for the nine-month 2004 period. The \$41,000 benefit reflects a \$70,000 reduction in the Company's valuation allowance, offset by a provision for current state taxes. In the first nine months of 2004, the Company increased the valuation allowance to fully cover net tax operating loss carryforwards and other net deferred tax assets that were generated during the period. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company continues to be unable to generate adequate taxable income in future periods, the Company will not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering potentially expiring NOLs.

***Craft Brands Alliance LLC***

The following summarizes certain items included in Craft Brands' statement of operations for the nine-month period ended September 30, 2005:

*Sales.* Craft Brands' sales totaled \$42,598,000 for the nine months ended September 30, 2005. In addition to selling 97,400 barrels of the Company's product to wholesalers in the western United States, Craft Brands also sold Widmer and Kona products. For the nine months ended September 30, 2005, average wholesale revenue per barrel for all products sold by Craft Brands was slightly higher than average wholesale revenue per barrel on sales by the Company to wholesalers during the same period. Craft Brands' sales efforts during the first nine months of 2005 included a reduction in discounting on the Company's products. Craft Brands also pays fees to A-B in connection with sales to A-B that are comparable to fees paid by the Company.

*Cost of Sales.* Cost of sales of Craft Brands totaled \$30,086,000 for the nine months ended September 30, 2005. Craft Brands purchases product from the Company and Widmer at prices substantially below wholesale pricing levels pursuant to a Supply, Distribution, and Licensing Agreement between Craft Brands and each of the Company and Widmer. Craft Brands has realized improvement in its average freight cost per barrel over the Company's historical costs, largely a result of synergies created by negotiating its shipping relationships as a single larger entity.

*Selling, General and Administrative Expenses.* Craft Brands' selling, general and administrative expenses totaled \$7,947,000 for the nine months ended September 30, 2005, reflecting all advertising, marketing and promotion efforts for the Redhook, Widmer and Kona brands. During the nine-month period ended September

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30, 2005, Craft Brands focused significant effort on advertising and promotion in conjunction with the second quarter 2005 introduction of new packaging for the Company's bottled product. Selling, general and administrative expenses of Craft Brands for the nine months ended September 30, 2005 includes approximately \$135,000 designated as Special Marketing Expense. As of September 30, 2005, the entire \$250,000 2004 sales and marketing capital contribution made by the Company had been used by Craft Brands for designated Special Marketing Expenses and netted against Craft Brands' 2004 and 2005 profits allocated to the Company.

*Net Income.* Craft Brands' net income totaled \$4,222,000 for the nine months ended September 30, 2005. The Company's share of Craft Brands' net income totaled \$1,625,000. After giving effect to the allocation of the Special Marketing Expense, which is allocated 100% to Redhook, and giving effect to income attributable to the Kona brand, which is shared differently between the Company and Widmer through 2006, the Operating Agreement dictates that remaining profits and losses of Craft Brands are allocated between the Company and Widmer based on the cash flow percentages of 42% and 58%, respectively.

**Liquidity and Capital Resources**

The Company has required capital principally for the construction and development of its production facilities. To date, the Company has financed its capital requirements through cash flow from operations, bank borrowings and the sale of common and preferred stock. The Company expects to meet its future financing needs and working capital and capital expenditure requirements through cash on hand, operating cash flow and, to the extent required and available, bank borrowings and offerings of debt or equity securities.

The Company had \$5,321,000 and \$5,590,000 of cash and cash equivalents at September 30, 2005 and December 31, 2004, respectively. At September 30, 2005, the Company had working capital of \$4,859,000. The Company's long-term debt as a percentage of total capitalization (long-term debt and common stockholders' equity) was 7.99% at September 30, 2005 compared to 8.4% at December 31, 2004. Cash provided by operating activities declined to \$417,000 for the nine months ended September 30, 2005, compared to \$1,547,000 for the nine-month 2004 period, attributable to an \$881,000 payment to A-B for refundable pallet deposits and timing of collection of accounts receivable.

During the nine months ended September 30, 2005, the Company's capital expenditures totaled \$416,000, including approximately \$120,000 related to improvements to the Washington Brewery bottling line to accommodate the new packaging and bottle, \$81,000 for upgrades to the Company's information technology system and \$67,000 related to a New Hampshire Brewery chiller. Capital expenditures for fiscal year 2005 are expected to total approximately \$476,000, primarily for brewing equipment and an upgrade to the Company's information technology system.

The Company has a credit agreement with a bank under which a term loan (the Term Loan) is provided. The Term Loan, which originated in June 1997 upon the conversion of a \$9 million secured credit facility, matures on June 5, 2007 and has a 20 year amortization schedule. The credit agreement also provided for a \$2 million revolving credit facility; however, the Company did not renew the revolving facility upon the July 1, 2004 expiration of the commitment period. There were no borrowings outstanding under the revolving facility at the time of its expiration.

The Term Loan is secured by substantially all of the Company's assets. Since June 5, 2002, interest on the Term Loan has accrued at London Inter Bank Offered Rate (LIBOR) plus 1.75%. The Company has the option to fix the applicable interest rate for up to twelve months by selecting LIBOR for one- to twelve- month periods as a base. As of September 30, 2005, there was \$5.3 million outstanding on the Term Loan, and the Company's one-month LIBOR-based borrowing rate was 5.2%. The termination of the A-B Distribution Agreement for any reason would constitute an event of default under the credit agreement and the bank may declare the entire outstanding loan balance immediately due and payable. If this were to occur, the Company could seek to refinance its Term Loan with one or more banks or obtain additional equity capital; however, there can be no assurance the Company would be able to access additional capital to meet its needs or that such additional capital would be at commercially reasonable terms.

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The terms of the credit agreement require the Company to meet certain financial covenants. The Company was in compliance with all covenants for the quarter ended September 30, 2005 and expects that it will remain in compliance with its debt covenants for the next twelve months. In December 2001, March 2003, February 2004 and October 2004, the credit agreement was amended to modify several financial covenants. These revisions have reduced the likelihood that a violation of the covenants by the Company will occur in the future; however, if the Company were to report a significant net loss for one or more quarters within a time period covered by the financial covenants, one or more of the covenants would be negatively impacted and could result in a violation. Failure to meet the covenants required by the credit agreement is an event of default and, at its option, the bank could deny a request for a waiver and declare the entire outstanding loan balance immediately due and payable. In such a case, the Company would seek to refinance the loan with one or more banks, potentially at less desirable terms. However, there can be no guarantee that additional financing would be available at commercially reasonable terms, if at all.

The following table summarizes the financial covenants required by the Term Loan and the Company's current level of compliance with these covenants:

|                             | <b>Required by<br/>Term Loan</b> | <b>Quarter Ended<br/>September 30,<br/>2005</b><br>(Restated; See Note<br>2) |
|-----------------------------|----------------------------------|--|
| Tangible Net Worth          | Greater than<br>\$ 60,000,000    | \$ 60,590,177  |
| Capital Ratio               | Less than: 1.25:1                | 0.21:1   |
| Working Capital             | Greater than<br>\$ 1,900,000     | \$ 4,858,733   |
| Fixed Charge Coverage Ratio | Greater than<br>1.15:1           | 1.754:1  |

**Certain Considerations: Issues and Uncertainties**

The Company does not provide forecasts of future financial performance or sales volume, although this Quarterly Report contains certain other types of forward-looking statements that involve risks and uncertainties. The Company may, in discussions of its future plans, objectives and expected performance in periodic reports filed by the Company with the Securities and Exchange Commission (or documents incorporated by reference therein) and in written and oral presentations made by the Company, include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or Section 21E of the Securities Exchange Act of 1934, as amended. Such forward-looking statements are based on assumptions that the Company believes are reasonable, but are by their nature inherently uncertain. In all cases, there can be no assurance that such assumptions will prove correct or that projected events will occur. Actual results could differ materially from those projected depending on a variety of factors, including, but not limited to, the successful execution of market development and other plans, the availability of financing and the issues discussed below. While Company management is optimistic about the Company's long-term prospects, the following issues and uncertainties, among others, should be considered in evaluating its business prospects and any forward-looking statements.

*Relationship with Anheuser-Busch, Incorporated and Craft Brands Alliance LLC.* Nearly all of the Company's future sales are expected to be made through the A-B Distribution Agreement with A-B and through sales to Craft Brands. Craft Brands will distribute the Company's products through a separate distribution arrangement with A-B. If the relationship between A-B and the Company, between the Company and Craft Brands or between A-B and Craft Brands were to deteriorate, distribution of the Company's products would suffer significant disruption and such event would have a long-term severe negative impact on the Company's sales and results of operations, as it would be extremely difficult for the Company to rebuild its own distribution network. While the Company believes that the benefits of the Distribution Agreement and its relationship with A-B and Craft Brands, in particular distribution and material cost efficiencies, offset the costs associated with the relationship, there can be no assurance that these costs

will not have a negative impact on the Company's profit margins in the future.

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*Craft Brands Alliance LLC.* As discussed above, Craft Brands advertises, markets, sells and distributes the Company's and Widmer's products in the western United States. The Company believes that the combined sales and marketing organization will create synergies and capitalize on both companies' sales and marketing experience and complementary product portfolios. The Company anticipates that the joint organization will positively impact sales volume and decrease the Company's selling, general and administrative expenses. The Company has recognized income totaling \$1.6 million in the first nine months of 2005 and \$1.1 million in the last six months of 2004 from its investment in Craft Brands. However, Craft Brands has only been operational since July 2004 and predicting future benefits from Crafts Brands is difficult. There can be no assurance that the Company will see any further or anticipated benefits from the joint venture.

In conjunction with the formation of Craft Brands, both the Company and Widmer incurred certain start-up expenses, including severance expenses and legal fees. The Company's operating loss for the nine months ended September 30, 2004 reflects \$535,000 attributable to the Company's share of these start-up expenses. Additionally, during the period March 15, 2004 through September 30, 2004, while the companies sought the regulatory approval required for Craft Brands to become fully operational, the Company and Widmer agreed to share certain sales-related costs, primarily salaries and overhead. The Company's share of those costs totaled \$554,000 for the nine months ended September 30, 2004 and are reflected in the Company's statement of operations as selling, general and administrative expenses.

*Dependence on Distributors.* The Company relies heavily on distributors, most of which are independent wholesalers, for the sale of its products to retailers. The Company's most significant wholesaler, K&L Distributors, Inc., accounted for approximately 12% of the Company's shipments in the first nine months of 2005. A disruption of the Company's, Craft Brands', the wholesalers' or A-B's ability to distribute products efficiently due to any significant operational problems, such as wide-spread labor union strikes, the loss of K&L Distributors as a customer, or the termination of the A-B Distribution Agreement or the Supply and Distribution Agreement with Craft Brands could have a material adverse impact on the Company's sales and results of operations.

*Effect of Competition on Future Sales.* The Company competes in the highly competitive craft brewing market as well as in the much larger specialty beer market, which encompasses producers of import beers, major national brewers that have produced fuller-flavored products, and large spirit companies and national brewers that produce flavored alcohol beverages. Beyond the beer market, craft brewers also face competition from producers of wines and spirits. Primarily as a result of increased competition, the Company has experienced periods in which its sales volume has declined and pricing of the Company's products has been negatively impacted. The Company experienced declining sales volumes during the period from 1997 through 1999 when the Company's shipments declined from 2.3% to 5.7% when compared to the prior year. And although the Company saw improvements in shipments year over year from 2000 through 2003, the Company again experienced a decline in shipments in 2004. Increasing competition could cause the Company's future sales and results of operations to be adversely affected. The Company has historically operated with little or no backlog and, therefore, its ability to predict sales for future periods is limited.

*Sales Prices.* Future prices the Company charges for its products may decrease from historical levels, depending on competitive factors in the Company's various markets. The Company has participated in price promotions with its wholesalers and their retail customers in most of its markets. The number of markets in which the Company participates in price promotions and the frequency of such promotions may increase in the future.

*Dependence on Sales in Washington State.* A significant portion of the Company's shipments continue to be in the Pacific Northwest region, which the Company believes is one of the most competitive craft beer markets in the United States, both in terms of number of market participants and consumer awareness. The Company faces extreme competitive pressure in Washington state, which is not only the Company's largest market but is also its oldest market. From 1997 through 2004, the Company experienced a decline in sales volume in Washington state of approximately 17%, significantly impacted by a 12% decline in 2004 volume over 2003 volume. Washington state shipments declined 0.6% in the first nine months of 2005 compared to 2004. The Company believes that the Pacific Northwest, and Washington state in particular, offers significant competition to its products, not only from other craft brewers but also from the growing wine market and from flavored alcohol beverages. This intense competition is magnified because the Company's brand is viewed as



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being relatively mature. Recent focus studies have indicated that, while the Company's brand does possess brand awareness among target consumers, it also appears to not attract key consumers who seem to be more interested in experimenting with new products. These recent focus studies resulted in Craft Brands focusing its 2005 marketing efforts on the Pacific Northwest market in an effort to stimulate demand. During the second quarter of 2005, Craft Brands introduced in the western United States several major marketing initiatives aimed at updating the Redhook brand image, including a proprietary Redhook bottle and new packaging design, combined with a new marketing campaign. In addition, shipments in Washington state in late 2003, all of 2004 and early 2005 appear to have been significantly impacted by the formation of Craft Brands. Management believes that the beer industry is influenced, both positively and negatively, by individual relationships. In Washington state, where some of those relationships had existed for many years, the formation of Craft Brands appears to have had some short-term negative impact on those relationships. Some of the Company's relationships with wholesalers and retailers suffered as a result of the transition to Craft Brands. The transition took longer than anticipated and nearly all Company sales staff responsible for the Washington state market left the Company. While the Company believes that the Craft Brands sales staff is re-establishing those relationships and that sales of the Company's products will stabilize, the process is expected to take some time. However, there can be no assurance that the Company will see any anticipated benefits from these efforts.

*Variability of Gross Margin and Cost of Sales.* The Company anticipates that its future gross margins will fluctuate and may decline as a result of many factors, including shipments to Craft Brands at a fixed price substantially below wholesale pricing levels, disproportionate depreciation and other fixed and semi variable operating costs, depending on the level of production at the Company's breweries in relation to current production capacity. The Company's high level of fixed and semi variable operating costs causes gross margin to be very sensitive to relatively small increases or decreases in sales volume. In addition, other factors that could affect cost of sales include changes in freight charges, the availability and prices of raw materials and packaging materials, the mix between draft and bottled product sales, the sales mix of various bottled product packages, and federal or state excise taxes. Also, if sales volume through the A-B Distribution Agreement increases, the related fees would increase.

*Advertising and Promotional Costs.* The Company directly manages its co-op advertising and promotion program and limited media advertising in the midwest and eastern United States, and the Craft Brands joint sales and marketing organization serves the operations of Redhook and Widmer in the western United States by advertising, marketing, selling and distributing both companies' products to wholesale outlets. Similar to the Company, Craft Brands promotes its products through a variety of advertising programs with its wholesalers; through training and education of wholesalers and retailers; through promotions at local festivals, venues, and pubs; by utilizing the pubs located at the Company's two breweries; and through price discounting. Management believes that, in addition to achieving certain synergies, Craft Brands capitalizes on both companies' sales and marketing skills and complementary product portfolios. The Company believes that the combination of the two brewers' complementary brand portfolios, led by one focused sales and marketing organization, will not only deliver financial benefits, but will also deliver greater impact at the point of sale. However, Craft Brands has only been operational since July 2004, and predicting future benefits from Crafts Brands is difficult. There can be no assurance that the Company will see any further or anticipated benefits from the joint venture. In the midwest and eastern United States, the Company expects to continue to participate in co-op advertising and promotion programs and limited media, but market and competitive considerations could require an increase in spending in these programs.

*Customer Acceptance, Consumer Trends and Public Attitudes.* If consumers were unwilling to accept the Company's products or if general consumer trends caused a decrease in the demand for beer, including craft beer, it could adversely impact the Company's sales and results of operations. If the flavored alcohol beverage market, the wine market, or the spirits market continues to grow, they could draw consumers away from the Company's products and have an adverse effect on the Company's sales and results of operations. Further, the alcoholic beverage industry has become the subject of considerable societal and political attention in recent years due to increasing public concern over alcohol-related social problems, including drunk driving, underage drinking and health consequences from the misuse of alcohol. If beer consumption in general were to come into disfavor among domestic consumers, or if the domestic beer industry were subjected to significant additional governmental regulation, the Company's sales and



results of operations could be adversely affected.

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*Effect of Sales Trends on Brewery Efficiency and Operations.* The Company's breweries have been operating at production levels substantially below their current and maximum designed capacities. Operating breweries at low capacity utilization rates negatively impacts gross margins and operating cash flows generated by the production facilities. The Company periodically evaluates whether it expects to recover the costs of its two production facilities over the course of their useful lives. If facts and circumstances indicate that the carrying value of these long-lived assets may be impaired, an evaluation of recoverability will be performed in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, by comparing the carrying value of the assets to projected future undiscounted cash flows in addition to other quantitative and qualitative analyses. If management believes that the carrying value of such assets may not be recoverable, the Company will recognize an impairment loss by a charge against current operations.

*Income Tax Benefits.* As of December 31, 2004, the Company had approximately \$11.6 million of deferred tax assets, comprised principally of federal net operating loss carryforwards that expire from 2012 through 2024 and state NOLs that expire through 2019. Federal NOLs, generally permitted to be carried forward no more than 20 years, and state NOLs, generally permitted to be carried forward 5 to 15 years, can be used to offset regular tax liabilities in future years. The recognition of these assets is dependent upon estimates of future taxable income resulting from future reversals of existing taxable temporary differences, which have been recorded as deferred tax liabilities and exceed the deferred tax assets. As of December 31, 2004, the Company also had a valuation allowance of \$1,154,000, reflected as a reduction of the Company's deferred tax assets on its balance sheet. The Company established the valuation allowance in 2002 and increased the balance in 2003 and 2004. The Company reduced the valuation allowance by \$70,000 in the first three months of 2005. The valuation allowance covers a portion of the Company's deferred tax assets, specifically certain federal and state NOL carryforwards that may expire before the Company is able to utilize the tax benefit. Realization of the benefit is dependent on the Company's ability to generate future U.S. taxable income. To the extent that the Company is unable to generate adequate taxable income in the future, the Company may not be able to recognize additional tax benefits and may be required to record a greater valuation allowance covering expiring NOLs.

The Company has restated its previously reported financial statements to correct an error as of and for the year ended December 31, 2004. The Company inadvertently overstated its net operating tax loss carryforwards (NOLs) with the state of New Hampshire by recording NOLs in excess of limits prescribed by state law. This error resulted in an understatement of the Company's income tax provision for the quarter and year ended December 31, 2004 and an overstatement of the Company's deferred tax asset, which is netted against the Company's deferred income tax liability on the Company's balance sheet.

**Recent Accounting Pronouncements**

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs – an Amendment of ARB No. 43, Chapter 4*. SFAS No. 151 requires idle facility expenses, abnormal freight, handling costs, and wasted material (spoilage) to be recognized as current-period charges. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this Statement will not have a material effect on the Company's financial condition or results of operation.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*, which revises SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees to be recognized as expenses in the statement of operations based on their fair values and vesting periods. SFAS No. 123R is effective for fiscal years beginning after June 15, 2005. The cumulative effect of initially applying SFAS No. 123R is recognized as of the required effective date. The Company is currently in the process of determining the impact this statement will have on its financial condition and results of operations.

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**ITEM 3. *Quantitative and Qualitative Disclosures about Market Risk***

The Company has assessed its vulnerability to certain market risks, including interest rate risk associated with financial instruments included in cash and cash equivalents and long-term debt. Due to the nature of these investments and the Company's investment policies, the Company believes that the risk associated with interest rate fluctuations related to these financial instruments does not pose a material risk.

The Company did not have any derivative financial instruments as of September 30, 2005.

**ITEM 4. *Controls and Procedures***

The Company has carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e) or 15d-15(e)) as of the end of the period covered by this quarterly report on Form 10-Q. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and that such information is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Although the Company has restated previously reported financial statements to correct an error as of and for the year ended December 31, 2004, the Chief Executive Officer and Chief Financial Officer have concluded that the restatement does not indicate a deficiency in the Company's disclosure controls and procedures. As a result of the restatement, management considered the effectiveness of the disclosure controls and procedures in place with respect to the tax accounting process. Management believes that key controls were in place and the disclosure controls were functioning properly but, because the circumstances surrounding the error were unusual and infrequent, the error was not identified in a timely manner. Management believes that this error was isolated.

No changes in the Company's internal control over financial reporting were identified in connection with the evaluation that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II.**

**ITEM 6. *Exhibits***

The following exhibits are filed as part of this report.

- 31.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange Act 13a-14(b) and 18 U.S.C. Section 1350
- 32.2 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to Exchange

Act 13a-14(b) and 18 U.S.C.  
Section 1350

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**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.

**REDHOOK ALE BREWERY,  
INCORPORATED**

March 31, 2006

BY: /s/ David J. Mickelson  
David J. Mickelson  
*President, Chief Financial Officer  
and Chief Operating Officer*

March 31, 2006

BY: /s/ Lorri L. Jones  
Lorri L. Jones  
*Controller and Treasurer, Principal Accounting  
Officer*