

REDHOOK ALE BREWERY INC

Form 10-K/A

May 09, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K/A  
(Amendment No. 1)**

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

**For the fiscal year ended December 31, 2006**

**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 of incorporation)*

**91-1141254**

*(I.R.S. Employer Identification Number)*

**14300 NE 145<sup>th</sup> Street, Suite 210  
Woodinville, Washington**

*(Address of principal executive offices)*

**98072-6950**

*(Zip Code)*

**(425) 483-3232**

*(Registrant's telephone number, including area code)*

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of Each Class**

**Common Stock, Par Value \$0.005 Per Share**

**Name of Each Exchange on Which Registered**

**The NASDAQ Stock Market LLC**

**Securities registered pursuant to Section 12(g) of the Act:**

**None.**

*(Title of Class)*

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. Check one:

Large Accelerated Filer

Accelerated Filer

Non-accelerated Filer

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

The aggregate market value of the Common Stock held by non-affiliates of the registrant as of the last day of the registrant's most recently completed second quarter on June 30, 2006 (based upon the closing sale price of the registrant's Common Stock, as reported by The NASDAQ Stock Market) was \$18,493,409. (1)

The number of shares of the registrant's Common Stock outstanding as of March 20, 2007 was 8,304,639.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement relating to the registrant's 2007 Annual Meeting of Stockholders to be held on May 22, 2007 are incorporated by reference into Part III of this Report.

- (1) Excludes shares held of record on that date by directors and executive officers and greater than 10% shareholders of the registrant. Exclusion of such shares should not be construed to indicate that any such person directly or indirectly possesses the power to direct or cause the direction of the management of the policies of the registrant.
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**EXPLANATORY NOTE**

Redhook Ale Brewery, Incorporated (the Company ) is filing this Amendment No. 1 (the Amendment ) to the annual report on Form 10-K initially filed with the Securities and Exchange Commission on March 23, 2007 (the Original Filing ), solely to correct an erroneous date from March 23, 2006 to the correct date March 23, 2007 on the Report Of Independent Registered Public Accounting Firm contained in Item 8 of the Original Filing, and the date of this report referenced in Exhibit 23.1 Consent Of Independent Registered Public Accounting Firm. The Company is not making any additional changes to the financial statements included in Item 8 of this Amendment.

This Amendment contains only the sections of the Original Filing which are being amended, and those unaffected parts or exhibits are not included herein. This Amendment continues to speak as of the date of the Original Filing and the Company has not updated the disclosure contained herein to reflect events that have occurred since the filing of the Original Filing. Accordingly, this Amendment should be read in conjunction with the Original Filing and the Company s other filings, if any, made with the SEC subsequent to the filing of the Original Filing, including any amendments to those filings, if any.

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**Item 8. *Financial Statements and Supplementary Data***

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Board of Directors and Stockholders of**

**Redhook Ale Brewery, Incorporated**

We have audited the accompanying balance sheets of Redhook Ale Brewery, Incorporated ( the Company ) as of December 31, 2006 and 2005 and the related statements of operations, common stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Redhook Ale Brewery, Incorporated as of December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 3 to the financial statements, the Company adopted a new principle of accounting for share-based payments in accordance with Financial Accounting Standards Board Statement No. 123 R, Share-Based Payment.

Seattle, Washington

March 23, 2007

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****BALANCE SHEETS**

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 9,435,073	\$ 6,435,609
Accounts receivable, net of allowance for doubtful accounts of \$68,808 and \$7,599 in 2006 and 2005, respectively	1,842,388	1,297,404
Trade receivable from Craft Brands	854,507	698,272
Inventories	2,571,732	3,027,720
Deferred income tax asset, net	506,886	
Other	203,594	502,667
Total current assets	15,414,180	11,961,672
Fixed assets, net	58,076,434	60,379,901
Investment in Craft Brands	127,555	92,806
Other assets	222,573	143,326
Total assets	\$ 73,840,742	\$ 72,577,705
<b>LIABILITIES AND COMMON STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,233,689	\$ 1,990,627
Trade payable to Craft Brands	324,900	367,590
Accrued salaries, wages and payroll taxes	1,547,482	1,259,823
Refundable deposits	2,153,127	2,440,796
Other accrued expenses	380,394	211,200
Current portion of long-term debt and capital lease obligations	464,648	459,245
Total current liabilities	7,104,240	6,729,281
Long-term debt and capital lease obligations, net of current portion	4,321,616	4,751,920
Deferred income tax liability, net	1,548,699	946,395
Other liabilities	173,768	123,542
Common stockholders equity:		
Common stock, par value \$0.005 per share, authorized, 50,000,000 Shares; issued and outstanding, 8,281,489 shares in 2006 and 8,222,609 shares in 2005	41,407	41,113
Additional paid-in capital	68,977,402	68,828,009
Retained deficit	(8,326,390)	(8,842,555)

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Total common stockholders' equity	60,692,419	60,026,567
Total liabilities and common stockholders' equity	\$ 73,840,742	\$ 72,577,705

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



Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****STATEMENTS OF OPERATIONS**

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Sales	\$ 40,006,708	\$ 34,520,401	\$ 36,639,552
Less excise taxes	4,292,324	3,421,494	3,267,513
Net sales	35,714,384	31,098,907	33,372,039
Cost of sales	30,918,137	27,543,639	27,171,255
Gross profit	4,796,247	3,555,268	6,200,784
Selling, general and administrative expenses	6,848,050	6,783,821	7,639,290
Income from equity investment in Craft Brands	2,655,248	2,391,936	1,123,283
Craft Brands shared formation expenses			534,628
Operating income (loss)	603,445	(836,617)	(849,851)
Interest expense	346,455	271,460	189,662
Other income, net	384,025	125,308	115,619
Income (loss) before income taxes	641,015	(982,769)	(923,894)
Income tax provision	124,850	217,674	331,000
Net income (loss)	\$ 516,165	\$ (1,200,443)	\$ (1,254,894)
Basic earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)
Diluted earnings (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)

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

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****STATEMENTS OF COMMON STOCKHOLDERS EQUITY**

	<b>Common Stock Shares</b>	<b>Par Value</b>	<b>Additional Paid-In Capital</b>	<b>Retained Deficit</b>	<b>Total Common Stockholders Equity</b>
Balance as of January 1, 2004	6,226,306	\$ 31,132	\$ 54,250,059	\$ (6,365,018)	\$ 47,916,173
Issuance of common stock to A-B in exchange for Series B preferred stock	1,808,243	9,041	14,245,814		14,254,855
Issuance of common stock	153,650	768	265,893		266,661
Other				(22,200)	(22,200)
Net loss				(1,254,894)	(1,254,894)
Balance as of December 31, 2004	8,188,199	40,941	68,761,766	(7,642,112)	61,160,595
Issuance of common stock	34,410	172	66,243		66,415
Net loss				(1,200,443)	(1,200,443)
Balance as of December 31, 2005	8,222,609	41,113	68,828,009	(8,842,555)	60,026,567
Issuance of common stock	58,880	294	149,393		149,687
Net income				516,165	516,165
Balance as of December 31, 2006	8,281,489	\$ 41,407	\$ 68,977,402	\$ (8,326,390)	\$ 60,692,419

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

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****STATEMENTS OF CASH FLOWS**

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Operating Activities</b>			
Net income (loss)	\$ 516,165	\$ (1,200,443)	\$ (1,254,894)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	2,999,916	2,938,088	2,944,412
Deferred income taxes	95,418	176,597	301,000
Loss on disposition of fixed assets		25,631	
Income from equity investment in Craft Brands less than (in excess of) cash distributions	(34,749)	377,195	(219,901)
Stock-based compensation	53,760		
Changes in operating assets and liabilities:			
Accounts receivable	(544,984)	(173,929)	563,260
Trade receivables from Craft Brands	(156,235)	(299,565)	(398,707)
Inventories	455,988	(27,411)	341,697
Other current assets	299,073	3,661	(259,290)
Other assets	(86,146)	(131,140)	4,400
Accounts payable and other accrued expenses	243,062	(128,676)	(274,059)
Trade payable to Craft Brands	(42,690)	(63,499)	431,089
Accrued salaries, wages and payroll taxes	287,659	39,575	(341,278)
Refundable deposits	354,850	(85,292)	253,760
Other liabilities	219,420	58,639	64,903
Net cash provided by operating activities	4,660,507	1,509,431	2,156,392
<b>Investing Activities</b>			
Expenditures for fixed assets	(1,295,668)	(585,392)	(252,098)
Investment in Craft Brands			(250,100)
Proceeds from disposition of fixed assets		305,260	
Other, net		4,961	(4,583)
Net cash used in investing activities	(1,295,668)	(275,171)	(506,781)
<b>Financing Activities</b>			
Payment to A-B pursuant to exchange and recapitalization agreement			(2,000,000)
Principal payments on debt and capital lease obligations	(461,302)	(454,687)	(450,000)
Issuance of common stock	95,927	66,415	266,661
Net cash used in financing activities	(365,375)	(388,272)	(2,183,339)
Increase (decrease) in cash and cash equivalents	2,999,464	845,988	(533,728)

Cash and cash equivalents:			
Beginning of period	6,435,609	5,589,621	6,123,349
End of period	\$ 9,435,073	\$ 6,435,609	\$ 5,589,621
<b>Supplemental Disclosures</b>			
Cash paid for interest	\$ 343,629	\$ 182,202	\$ 186,888
Cash paid for taxes Acquisition of fixed assets under capital leases	\$ 36,401	\$ 40,852	\$
Issuance of 1,808,243 shares of common stock to A-B and payment of \$2,000,000 to A-B in exchange for 1,289,872 shares of preferred stock held by A-B	\$	\$	\$ 14,232,655

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

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS**

**1. Nature of Operations**

Redhook Ale Brewery, Incorporated (the Company) was formed in 1981 to brew and sell craft beer. The Company produces its specialty bottled and draft products in its two Company-owned breweries. The Washington Brewery, located in the Seattle suburb of Woodinville, Washington, began limited operations in late 1994 and became fully operational after additional phases of construction were completed in 1996 and 1997. The Company's New Hampshire Brewery, located in Portsmouth, New Hampshire, began brewing operations in late 1996 and expanded its operations in 2002, 2003 and 2006 by increasing its fermentation capacity. Each brewery also operates a pub on the premises, promoting the Company's products, offering dining and entertainment facilities, and selling retail merchandise.

Since 1997, the Company's products have been distributed in the U.S. in 48 states. Prior to establishing a distribution relationship with Anheuser-Busch, Incorporated (A-B) in 1994, the Company distributed its products regionally through distributors in eight western states: Washington, California (northern), Oregon, Idaho, Montana, Wyoming, Colorado and Alaska. In October 1994, the Company entered into a distribution alliance (Distribution Alliance or the Alliance) with A-B, consisting of a national distribution agreement and an investment by A-B in the Company (the A-B Investment Agreement). The Alliance gave the Company access to A-B's national distribution network to distribute its products while existing wholesalers, many of which were part of the A-B distribution network, continued to distribute the Company's products outside of the Distribution Alliance. Pursuant to the A-B Investment Agreement, A-B invested approximately \$30 million to purchase 1,289,872 shares of the Company's convertible redeemable Series B Preferred Stock (the Series B Preferred Stock) and 953,470 shares of the Company's common stock (Common Stock), including 716,714 shares issued concurrent with the Company's initial public offering.

In August 1995, the Company completed the sale of 2,193,492 shares of Common Stock through an initial public offering in addition to the 716,714 common shares purchased by A-B. The net proceeds of the offerings totaled approximately \$46 million.

On July 1, 2004, the Company completed a restructuring of its ongoing relationship with A-B by executing two new agreements: an exchange and recapitalization agreement and a distribution agreement. The terms of the exchange and recapitalization agreement provided that the Company issue 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, reflected on the Company's balance sheet at approximately \$16.3 million, was cancelled. In connection with the exchange, the Company also paid \$2.0 million to A-B in November 2004. The terms of the new distribution agreement with A-B (the A-B Distribution Agreement) provided for the Company to continue to distribute its product in the midwest and eastern U.S. through A-B's national distribution network by selling its product to A-B. The new A-B Distribution Agreement has a term that expires on December 31, 2014, subject to automatic renewal for an additional ten-year period unless A-B provides written notice of non-renewal to the Company on or prior to June 30, 2014. The A-B Distribution Agreement is subject to early termination, by either party, upon the occurrence of certain events.

On July 1, 2004, the Company also entered into definitive agreements with Widmer Brothers Brewing Company (Widmer) with respect to the operation of a joint venture, Craft Brands Alliance LLC (Craft Brands). Pursuant to these agreements, 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 Company's and Widmer's products to wholesale outlets in the western U.S. through a distribution agreement between Craft Brands and A-B.

## **2. Subsequent Events**

On January 3, 2007 the Company publicly disseminated a press release announcing it is entering into preliminary discussions with Widmer Brothers Brewing Company regarding the possibility of combining the two

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

companies. These negotiations are continuing. As a result of these discussions, on January 2, 2007, the Company adopted a Company-wide severance plan that permits the payment of severance benefits to all full-time employees, other than executive officers, in the event an employee's employment is terminated as a result of a merger or other business combination with Widmer Brothers Brewing Company.

**3. Significant Accounting Policies**

***Cash and Cash Equivalents***

The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company maintains cash and cash equivalent balances with financial institutions that exceed federally insured limits. The carrying amount of cash equivalents approximates fair value because of the short-term maturity of these instruments.

***Accounts Receivable***

Accounts receivable is comprised of trade receivables due from wholesalers and A-B for beer and promotional product sales. Because of state liquor laws and each wholesaler's agreement with A-B, the Company does not have collectibility issues related to the sale of its beer products. Accordingly, the Company does not regularly provide an allowance for doubtful accounts for beer sales. The Company has provided an allowance for promotional merchandise that has been invoiced to the wholesaler. This allowance for doubtful accounts reflects the Company's best estimate of probable losses inherent in the accounts receivable balance. The Company determines the allowance based on historical customer experience and other currently available evidence. When a specific account is deemed uncollectible, the account is written off against the allowance. Accounts receivable on the Company's balance sheets included an allowance for doubtful accounts of \$69,000 and \$8,000 as of December 31, 2006 and 2005, respectively.

***Inventories***

Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method. The Company regularly reviews its inventories for the presence of obsolete product attributed to age, seasonality and quality. Inventories that are considered obsolete are written off or adjusted to carrying value. Inventories on the Company's balance sheet as of December 31, 2006 are reduced by a \$12,000 reserve for obsolescence. Inventories on the Company's balance sheet as of December 31, 2005 do not include a reserve for obsolescence.

***Fixed Assets***

Fixed assets are carried at cost less accumulated depreciation and accumulated amortization. The cost of repairs and maintenance are expensed when incurred, while expenditures for improvements that extend the useful life of an asset are capitalized. When assets are retired or sold, the asset cost and related accumulated depreciation or accumulated amortization are eliminated with any remaining gain or loss reflected in the statement of operations. Depreciation and amortization of fixed assets is provided on the straight-line method over the following estimated useful lives:

Buildings	31 - 40 years
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Brewery equipment	10 - 25 years
Furniture, fixtures and other equipment	2 - 10 years
Vehicles	5 years



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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

***Investment in Craft Brands Alliance LLC***

The Company has assessed its investment in Craft Brands pursuant to the provisions of FASB FIN No. 46 Revised, *Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51* ( FIN No. 46R ). FIN No. 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 No. 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 No. 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 FIN No. 46R, 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 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 in 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 in the Company's balance sheet. The Company does not control the amount or timing of cash distributions by Craft Brands. The Company periodically reviews its investment in Craft Brands to ensure that it complies with the guidelines prescribed by FIN No. 46R.

***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 2006, the Company performed an analysis of its brewery assets to determine if impairment might exist. The Company's estimate of future undiscounted cash flows indicated that such carrying values were expected to be recovered.

***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 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.

***Excise Taxes***

The federal government levies excise taxes on the sale of alcoholic beverages, including beer. For brewers producing less than 2.0 million barrels of beer per calendar year, the federal excise tax is \$7 per barrel on the first 60,000 barrels of beer removed for consumption or sale during a calendar year, and \$18 per barrel for each barrel in

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

excess of 60,000. Individual states also impose excise taxes on alcoholic beverages in varying amounts, which have also been subject to change. Sales as presented in the Company's statements of operations, reflect the amount invoiced to the Company's wholesalers and other customers. Excise taxes due to federal and state agencies are not collected from the Company's customers, but rather are the responsibility of the Company. Net sales, as presented in the Company's statements of operations, are reduced by applicable federal and state excise taxes.

***Shipping and Handling Costs***

Costs incurred for the shipping of finished goods are included in cost of sales in the Company's statements of operations.

***Income Taxes***

The Company records federal and state income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, whereby deferred taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities as well as for tax net operating loss and credit carry forwards. These deferred tax assets and liabilities are measured under the provisions of the currently enacted tax laws. 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.

***Advertising Expenses***

Advertising costs, comprised of radio, print and outdoor advertising, sponsorships and printed product information, as well as costs to produce these media, are expensed as incurred. For the years ended December 31, 2006, 2005 and 2004, advertising expenses totaling \$365,000, \$533,000 and \$728,000, respectively, are reflected as selling, general and administrative expenses in the Company's statements of operations.

***Segment Information***

The Company operates in one principal business segment as a manufacturer of beer and ales across domestic markets. The Company believes that its pub operations and brewery operations, whether considered individually or in combination, do not constitute a separate segment under SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The Company believes that its two brewery operations are functionally and financially similar. The Company operates its two pubs as an extension of its marketing of the Company's products and views their primary function to be promotion of the Company's products.

***Stock-Based Compensation***

The Company may grant non-qualified stock options and incentive stock options to employees and non-employee directors and independent consultants or advisors under its 2002 Stock Option Plan (the 2002 Plan). The Company issues new shares of Common Stock upon exercise of stock options.

Prior to the January 1, 2006 adoption of the SFAS No. 123R, *Share-Based Payment*, the Company accounted for its employee and director stock-based compensation plans using the intrinsic value method, as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*. Under the intrinsic value method, no stock-based compensation

expense had been recognized in the Company's statement of operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying Common Stock on the date of grant. As permitted, for all periods prior to January 1, 2006, the Company elected to adopt the disclosure only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*.

On January 1, 2006, the Company adopted SFAS No. 123R, which revises SFAS No. 123 and supersedes APB No. 25. SFAS No. 123R requires all share-based payments to employees and directors be recognized as expense in

Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

the statement of operations based on their fair values and vesting periods. The Company is required to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's statement of operations. The Company elected to follow the modified prospective transition method, one of two methods prescribed by the standard, for implementing SFAS No. 123R. Under the modified prospective method, compensation cost is recognized beginning with the effective date (i) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date.

On November 29, 2005, the board of directors of the Company approved an acceleration of vesting of all of the Company's unvested stock options (the Acceleration). The Acceleration was effective for stock options outstanding as of December 30, 2005. These options were granted under the Company's 1992 Stock Incentive Plan and 2002 Stock Option Plan. As a result of the Acceleration, options to acquire approximately 136,000 shares of the Company's Common Stock, or 16% of total outstanding options, became exercisable on December 30, 2005. Of the approximately 136,000 shares subject to the Acceleration, options to acquire approximately 70,000 shares of the Company's Common Stock at an exercise price of \$1.865 would have otherwise fully vested in August 2006, and options to acquire approximately 66,000 shares of the Company's Common Stock at an exercise price of \$2.019 would have otherwise vested in August 2006 and August 2007. As a result of the Acceleration, the Company's 2005 stock-based employee compensation expense determined under the fair value based method disclosed in the table below was higher than it would have been had the Acceleration not occurred. The Acceleration did not have a material impact on 2006 or 2005 results of operations.

The following table illustrates the effect on net loss and loss per share for the years ended December 31, 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 as prescribed by the disclosure only provisions of SFAS No. 123, Accounting for Stock-Based Compensation, as amended by SFAS No. 148:

	<b>Year Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Net loss as reported</b>	\$ (1,200,443)	\$ (1,254,894)
<i>Add:</i> Stock compensation as reported under APB 25		
<i>Less:</i> Stock-based employee compensation expense determined under the fair value based method for all options, net of related tax effects	(244,585)	(256,161)
<b>Pro forma net loss</b>	\$ (1,445,028)	\$ (1,511,055)
<b>Net loss per share</b>		
Basic		
As reported	\$ (0.15)	\$ (0.18)
Proforma	\$ (0.18)	\$ (0.21)
Diluted		

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As reported	\$	(0.15)	\$	(0.18)
Proforma	\$	(0.18)	\$	(0.21)

Stock compensation disclosure for the year ended December 31, 2006 is not presented above because the amount of this expense is recognized in the financial statements. Stock-based compensation expense recognized in the Company's statement of operations for the year ended December 31, 2006 totaled \$54,000 and is solely attributable to stock options granted to the board of directors in May 2006. No compensation expense was

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

recognized in 2006 for stock options outstanding as of December 31, 2005 because these options were fully vested prior to the January 1, 2006 adoption of SFAS No. 123R.

On May 23, 2006, following the Company's Annual Meeting of Shareholders, each non-employee director (other than A-B designated directors) was granted an immediately exercisable option to purchase 3,500 shares of Common Stock at \$0.01 per share (the Options). The Options expired on June 30, 2006 and were granted under the Company's 2002 Plan. On May 23, 2006, each grantee exercised his option to purchase 3,500 shares of Common Stock. The option grant resulted in stock compensation expense of \$54,000. There were no other grants of options to purchase Common Stock in 2006.

On May 25, 2005, each non-employee director (other than A-B designated directors) was granted an option to purchase 4,000 shares of Common Stock at an exercise price of \$3.15 per share. The options were granted at an exercise price equal to the fair market value on the grant date, became exercisable six months after the grant date, and will terminate on the tenth anniversary of the grant date. The options were granted under the Company's 2002 Plan. There were no other grants of options to purchase Common Stock in 2005.

The fair value of options granted (which is amortized to expense over the option vesting period in determining the pro forma impact) is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Expected life (years)	0 days	5 yrs.	5 yrs.
Risk-free interest rate	4.70%	3.88%	3.88%
Expected volatility rate	0.00%	46.0%	52.0%
Expected dividend yield	0.00%	0.0%	0.0%

The fair value of options granted in 2006, 2005 and 2004 is estimated on the date of grant using the Black-Scholes single option-pricing model with the following weighted average assumptions:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
Total number of options granted	14,000	16,000	16,000
Estimated fair value of each option granted	\$ 3.84	\$ 1.24	\$ 1.08
Total estimated fair value of all options granted	\$ 54,000	\$ 20,000	\$ 17,000

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. The risk-free interest rate is based on the implied yield currently available on U.S. Treasury securities with an equivalent remaining term. Prior to the adoption of SFAS No. 123R, expected stock price volatility was estimated using only historical volatility. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future. Because the 2006 grant of options to purchase Common Stock were immediately

exercised by the director grantees, the expected life of the option and the stock price volatility were known and not estimated. Refer to the table of options currently outstanding in Note 8 for the weighted average exercise price for options granted during 2006, 2005 and 2004.

***Earnings (Loss) per Share***

The Company follows 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 the periods when the Company reports net income. The calculation uses the treasury stock method and the as if converted method in determining the resulting incremental average equivalent shares outstanding as applicable.



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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

***Use of Estimates***

The preparation of the financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results may differ from those estimates.

***Fair Value of Financial Instruments***

The Company's balance sheets include the following financial instruments: cash and cash equivalents, accounts receivable, inventory, accounts payable, accrued expenses, capital lease obligations and long-term debt. The Company believes the carrying amounts of current assets and liabilities and indebtedness in the balance sheets approximate the fair value.

***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 will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this SFAS No. 151 has not had a material effect on the Company's financial condition or results of operations.

On January 1, 2006, the Company adopted 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 and directors be recognized as expense in the statement of operations based on their fair values and vesting periods. The Company is required to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's statement of operations. The Company elected to follow the modified prospective transition method, one of two methods prescribed by the standard, for implementing SFAS No. 123R. Under the modified prospective method, compensation cost is recognized beginning with the effective date (i) based on the requirements of SFAS No. 123R for all share-based payments granted after the effective date and (ii) based on the requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of SFAS No. 123R that remain unvested on the effective date. Stock-based compensation expense recognized in the Company's statement of operations for the year ended December 31, 2006 totaled \$54,000 and is solely attributable to stock options granted to the board of directors in May 2006. No compensation expense was recognized in 2006 for stock options outstanding as of December 31, 2005 because these options were fully vested prior to the January 1, 2006 adoption of SFAS No. 123R.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, which is a replacement of APB No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements*. Among other changes, SFAS No. 154 requires that a voluntary change in accounting principle be applied retrospectively such that all prior period financial statements are presented in accordance with the new accounting principle, unless impracticable to do so. SFAS No. 154 also provides that (1) a change in method of depreciating or amortizing a long-lived non-financial asset be accounted for as a change in estimate (prospectively) that was effected by a change in accounting principle, and (2) correction of errors in previously issued financial statements should be

termed a restatement . SFAS No. 154 is effective for accounting changes and correction of errors made in fiscal years beginning after December 15, 2005. The Company is not currently contemplating an accounting change which would be impacted by SFAS No. 154.

In September 2004, the consensus of Emerging Issues Task Force ( EITF ) Issue No. 04-10, *Determining Whether to Aggregate Operating Segments That Do Not Meet the Quantitative Thresholds*, was published.

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

EITF No. 04-10 addresses how an enterprise should evaluate the aggregation criteria of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, when determining whether operating segments that do not meet the quantitative thresholds may be aggregated in accordance with SFAS No. 131. The consensus in EITF No. 04-10 was applied for fiscal years ending after September 15, 2005. This consensus did not have an impact on the Company's disclosures.

In September 2005, the FASB ratified EITF No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*. EITF No. 04-13 provides guidance on whether two or more inventory purchase and sales transactions with the same counterparty should be viewed as a single exchange transaction within the scope of APB No. 29, *Accounting for Nonmonetary Transactions*. In addition, EITF No. 04-13 indicates whether nonmonetary exchanges of inventory within the same line of business should be recognized at cost or fair value. EITF No. 04-13 was effective as of April 1, 2006. This consensus did not have an impact on the Company's financial statements.

In June 2006, the FASB ratified the consensus of EITF No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. EITF No. 06-3 indicates that the income statement presentation on either a gross basis or a net basis of the taxes within the scope of the issue is an accounting policy decision. The Company's accounting policy is to present the taxes within the scope of EITF No. 06-3 on a gross basis. In accordance with the guidance presented in EITF No. 06-3, the Company's statements of operations separately disclose excise taxes, thus following the approach described as the gross basis.

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. An enterprise shall disclose the cumulative effect of the change on retained earnings in the statement of financial position as of the date of adoption and such disclosure is required only in the year of adoption. The Company is in the process of analyzing the implications of FIN No. 48. The Company does not anticipate this statement will have a material effect on its results of operations or financial condition.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB No. 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 clarifies the SEC staff's beliefs regarding the process of quantifying financial statement misstatements and is effective for fiscal years ending after November 15, 2006. The Company does not expect SAB No. 108 to have a material impact on the financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. The standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the requirements of SFAS No. 157 and has not yet determined the impact on the financial statements.

In February 2007, FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Early adoption is permitted. The Company is currently evaluating the requirements of SFAS No. 159 and has not yet determined the impact on the financial statements.

Table of Contents**REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)****4. Inventories**

Inventories consist of the following:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Raw materials	\$ 666,938	\$ 1,180,831
Work in process	622,352	950,827
Finished goods	247,333	262,618
Promotional merchandise	538,339	372,073
Packaging materials	496,770	261,371
	<b>\$ 2,571,732</b>	<b>\$ 3,027,720</b>

Work in process is beer held in fermentation tanks prior to the filtration and packaging process. Finished goods is presented net of an inventory reserve of \$12,000 related to obsolete items.

**5. Fixed Assets**

Fixed assets consist of the following:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Brewery equipment	\$ 46,387,322	\$ 46,119,789
Buildings	35,838,145	35,831,040
Land and improvements	4,601,427	4,601,427
Furniture, fixtures and other equipment	2,284,062	2,277,994
Vehicles	81,730	81,730
Construction in progress	460,389	51,544
	<b>89,653,075</b>	<b>88,963,524</b>
Less accumulated depreciation and amortization	31,576,641	28,583,623
	<b>\$ 58,076,434</b>	<b>\$ 60,379,901</b>

As of December 31, 2006 and 2005, brewery equipment included property acquired under a capital lease with a cost of \$77,000 and \$41,000 and accumulated amortization of \$18,000 and \$6,000, respectively. The Company's statement

of operations for the years ended December 31, 2006 and 2005 includes \$12,000 and \$6,000 in amortization expense related to this leased property.

#### **6. Craft Brands Alliance LLC**

On July 1, 2004, the Company entered into agreements with Widmer with respect to the operation of a joint venture sales and marketing entity, 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 U.S. pursuant to a distribution agreement between Craft Brands and 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.

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

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 be used by Craft Brands for expenses related to the marketing, advertising and promotion of the Company's products. 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. In 2007, Widmer and Redhook entered into an amendment to the Operating Agreement to reduce the Redhook 2008 sales and marketing contribution to reflect the Company's commitment to expand the production capacity of its Washington and New Hampshire Breweries to produce more Widmer products. Redhook's 2008 sales and marketing contribution, if one is required, cannot exceed \$310,000 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 a similar obligation under the Operating Agreement with respect to a 2008 sales and marketing capital contribution that is capped at \$750,000. 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 that 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. As of December 31, 2006 and 2005, there are no loan obligations due to the Company.

The Operating Agreement also addresses the allocation of profits and losses of Craft Brands. After giving effect to the allocation of the sales and marketing capital contribution, if any, 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.

For the years ended December 31, 2006 and 2005 shipments of the Company's products to Craft Brands represented 45% and 56%, or 122,600 barrels and 126,500 barrels, respectively. For the year ended December 31, 2004 shipments of the Company's products to Craft Brands represented 30% of total Company shipments, or 63,600 barrels. The amounts here for 2004 are for the last six months ended December 31, 2004.

For the year ended December 31, 2006, the Company's share of Craft Brands net income totaled \$2,655,000. For the year ended December 31, 2005, the Company's share of Craft Brands net income totaled \$2,392,000. 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 December 31, 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. For the six months ended December 31, 2004, the Company's share of Craft Brands' net income totaled \$1,123,000. This share of Craft Brands

profit was net of \$115,000 of the Special Marketing Expense that had been incurred by Craft Brands during the same period and was fully allocated to the Company.

In conjunction with the sale of Redhook product to Craft Brands, the Company's balance sheets as of December 31, 2006 and 2005 reflect a trade receivable due from Craft Brands of \$855,000 and \$698,000, respectively, and a trade payable due to Craft Brands of \$325,000 and \$368,000, respectively.



**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

During 2006 and 2005, the Company received cash distributions of \$2,621,000 and \$2,769,000, respectively, representing its share of the net cash flow of Craft Brands. As of December 31, 2006 and 2005, the Company's investment in Craft Brands totaled \$128,000 and \$93,000, respectively.

Separate financial statements for Craft Brands are filed with the Company's Form 10-K for the year ended December 31, 2005, Part IV., in Item 15. *Exhibits and Financial Statement Schedules*, in accordance with Rule 3-09 of Regulation S-X.

During the formation of Craft Brands, both the Company and Widmer incurred certain start-up expenses. During the period March 15, 2004 through June 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 \$535,000 for the year ended December 31, 2004 and are reflected in the Company's statement of operations for 2004.

**7. Debt and Capital Lease Obligations**

Long-term debt and capital lease obligations consist of the following:

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Term loan, payable to bank monthly at \$37,500 plus accrued interest; interest at 7.1% at December 31, 2006; due June 5, 2012	\$ 4,725,000	\$ 5,175,000
Various capital lease obligations	61,264	36,165
	4,786,264	5,211,165
Current portion, term loan	(450,000)	(450,000)
Current portion, capital leases	(14,648)	(9,245)
Total current portion of term loan and capital leases	(464,648)	(459,245)
Long-term portion of term loan and capital leases	\$ 4,321,616	\$ 4,751,920

**Term Loan**

The Company has a credit agreement with a bank under which a term loan (the Term Loan) is provided. In June 2006, the credit agreement was amended to extend the maturity date from June 5, 2007 to June 5, 2012. The Term Loan is secured by substantially all of the Company's assets. Interest on the Term Loan accrues at London Inter Bank Offered Rate (LIBOR) plus 1.75% and 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 December 31, 2006, there was \$4,725,000 outstanding on the Term Loan, and the Company's one-month LIBOR-based borrowing rate was 7.1%. 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.

The terms of the credit agreement require the Company to meet certain financial covenants. The Company was in compliance with all covenants as of year end 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. In January 2006, the credit agreement was amended to eliminate the tangible net worth covenant (shareholders' equity less intangible assets) as of the year ended December 31, 2005. These modifications to the financial covenants have reduced the likelihood that a violation of

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

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 Company made interest payments on the Term Loan totaling \$312,000, \$263,000, and \$185,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

Annual principal payments required on the Term Loan as of December 31, 2006 are as follows:

2007	\$ 450,000
2008	450,000
2009	450,000
2010	450,000
2011	450,000
Thereafter	2,475,000
	\$ 4,725,000

***Capital Leases Obligations***

The Company has acquired small production equipment under various capital leases. As of December 31, 2006, future minimum lease payments under capital leases are as follows:

2007	\$ 17,854
2008	17,854
2009	17,854
2010	11,710
2011	3,669
Total minimum lease payments	68,941
Less amount representing interest	(7,677)
Present value of minimum lease payments	\$ 61,264

Interest on each capital lease is calculated at the Company's incremental borrowing rate at the inception of each lease.

## **8. Common Stockholders Equity**

### *Issuance of Common Stock*

In August 1995, the Company completed the sale of 2,193,492 shares of Common Stock through an initial public offering and 716,714 common shares in a concurrent private placement to A-B (collectively, the Offerings ) at a price of \$17.00 per share. The net proceeds of the Offerings totaled approximately \$46 million. All of the 1,242,857 shares of Series A convertible preferred stock automatically converted to an equal number of common shares upon closing of the Offerings.

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 was cancelled. A-B

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

was also granted certain contractual registration rights with respect to the shares of Common Stock held by A-B. In connection with the exchange, the Company paid \$2,000,000 to A-B in November 2004. The impact of this exchange and recapitalization on the balance sheet as of December 31, 2004 was to reduce convertible preferred stock by \$16,300,000, increase common stock by \$9,000, increase additional paid-in capital by \$14,200,000 and reduce cash by \$2,000,000. As of December 31, 2006 and 2005, A-B held 33.3% and 33.6% of the Company's outstanding shares of Common Stock, respectively.

In conjunction with the exercise of stock options granted under the Company's stock option plans, the Company issued 58,880 shares of the Company's Common Stock totaling \$150,000 during the year ended December 31, 2006 and 34,410 shares of the Company's Common Stock totaling \$66,000 during the year ended December 31, 2005.

***Stock Option Plans***

In 1993, the Company's shareholders approved the 1992 Stock Incentive Plan (the 1992 Plan) and the Directors Stock Option Plan (the Directors Plan). The plans, amended in May 1996, provided for 1,270,000 and 170,000 shares of Common Stock for option grants, respectively. Employee options were generally designated to vest over a five-year period while director options became exercisable six months after the grant date. Vested options are generally exercisable for ten years from the date of grant. Although the expiration of the 1992 Plan and the Directors Plan in October 2002 prevents any further option grants under these plans, the provisions of these plans remain in effect until all options terminate or are exercised. As of December 31, 2002, there were no options available for future grant under the 1992 Plan or Directors Plan.

In 2002, the Company's shareholders approved the 2002 Plan. The maximum number of shares of Common Stock for which options may be granted during the term of the 2002 Plan is 346,000. The compensation committee of the board of directors administers the 2002 Plan, determining to whom options are to be granted, the number of shares of Common Stock for which the options are exercisable, the purchase prices of such shares, and all other terms and conditions.

Options granted to employees of the Company in 2002 under the 2002 Plan were designated to vest over a five-year period, and options granted to the Company's directors in 2002, 2003, 2004 and 2005 under the 2002 Plan became exercisable six months after the grant date. Options were granted at an exercise price equal to fair market value of the underlying Common Stock on the grant date and terminate on the tenth anniversary of the grant date. On May 23, 2006, options under the 2002 Plan were granted to the Company's directors (other than A-B designated directors) at an exercise price less than the fair market value of the underlying Common Stock on the grant date. These options were immediately exercisable and expired on June 30, 2006. Each grantee exercised his option to purchase this Common Stock on May 23, 2006. There were no other grants of options to purchase Common Stock in 2006.

On November 29, 2005, the board of directors approved an acceleration of vesting of all of the Company's unvested stock options. The Acceleration was effective for stock options outstanding as of December 30, 2005. These options were granted under the 1992 Plan and 2002 Plan. As a result of the Acceleration, options to acquire approximately 136,000 shares of the Company's common stock, or 16% of total outstanding options, became exercisable on December 30, 2005. Of the approximately 136,000 shares subject to the Acceleration, options to acquire approximately 70,000 shares of the Company's Common Stock at an exercise price of \$1.865 would have otherwise fully vested in August 2006, and options to acquire approximately 66,000 shares of the Company's Common Stock at an exercise price of \$2.019 would have otherwise vested in August 2006 and August 2007. The Acceleration did not

have a material impact on 2005 results of operations and the Company does not expect that the Acceleration will have a material impact on future periods.

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

Presented below is a summary of stock option plans activity for the years shown:

	<b>Shares Subject to Options</b>	<b>Weighted Average Price per Share</b>	<b>Weighted Average Remaining Contractual Life</b>	<b>Aggregate Intrinsic Value</b>	<b>Options Exercisable at End of Year</b>	<b>Weighted Average Exercise Price per Share</b>
Balance at January 1, 2004	1,372,322	\$ 3.61	6.71	\$ 285,124	766,562	\$ 4.85
Granted	16,000	\$ 2.45				
Exercised	(153,650)	\$ 1.74				
Canceled	(180,142)	\$ 6.19				
Balance at December 31, 2004	1,054,530	\$ 3.43	5.89	\$ 624,841	703,760	\$ 4.18
Granted	16,000	\$ 3.15				
Exercised	(34,410)	\$ 1.93				
Canceled	(189,800)	\$ 4.92				
Balance at December 31, 2005	846,320	\$ 3.15	5.08	\$ 700,258	846,320	\$ 3.15
Granted	14,000	\$ 0.01				
Exercised	(58,880)	\$ 1.63				
Canceled	(18,000)	\$ 17.04				
Balance at December 31, 2006	783,440	\$ 2.89	4.10	\$ 1,950,534	783,440	\$ 2.89

The aggregate intrinsic value of the outstanding stock options is calculated as the difference between the stock closing price as reported by NASDAQ on of the last day of the period and the exercise price of the shares. The market values as of December 31, 2006, 2005, 2004 and 2003 were \$5.20, \$3.17, \$3.51 and \$2.60, respectively. For 2006, there was no unrecognized stock-based compensation expense related to unvested stock options. For 2006, 2005 and 2004, the total intrinsic value of stock options exercised was \$125,000, \$38,000 and \$74,000, respectively. For 2006, the total fair value of options vested was \$54,000.

The following table summarizes information for options currently outstanding and exercisable at December 31, 2006:

**Options Outstanding**

Range of Exercise Price	Number of Outstanding	Weighted Average	Weighted Average Exercise Price per Share	Options Exercisable	Weighted Average Exercise Price per Share
		Remaining Contractual Life (Years)		Number of Exercisable	
\$1.49 to \$ 1.86	345,190	4.57	\$ 1.86	345,190	\$ 1.86
1.87 to 2.02	153,334	5.65	\$ 2.02	153,334	\$ 2.02
2.03 to 2.18	8,000	6.38	\$ 2.18	8,000	\$ 2.18
2.19 to 2.45	18,666	6.67	\$ 2.44	18,666	\$ 2.44
2.46 to 3.15	16,000	8.39	\$ 3.15	16,000	\$ 3.15
3.15 to 3.97	163,600	2.38	\$ 3.97	163,600	\$ 3.97
3.98 to 5.73	43,050	1.38	\$ 5.73	43,050	\$ 5.73
5.74 to 7.63	24,000	0.39	\$ 7.63	24,000	\$ 7.63
7.64 to 10.13	11,600	0.10	\$ 10.13	11,600	\$ 10.13
\$1.49 to \$10.13	783,440	4.10	\$ 2.89	783,440	\$ 2.89

Under the terms of the Company's incentive stock option plans, employees and directors may be granted options to purchase the Company's Common Stock at the market price on the date the option is granted. Under these



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stock option plans, stock options granted at less than the fair market value on the date of grant are considered to be non-qualified stock options rather than incentive stock options. At December 31, 2006, 2005 and 2004, a total of 95,959, 109,559 and 87,109 options, respectively, were available for future grants under the 2002 plan. The Company had reserved approximately 879,399 shares of Common Stock for future issuance related to potential stock option exercises.

***Shareholder Rights Agreement***

The Company's shareholder rights agreement, which was adopted by the board of directors in September 1995 and subsequently amended in May 1999 and May 2004, expired on September 22, 2005.

**9. Earnings (Loss) Per Share**

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

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Net income (loss)	\$ 516,165	\$ (1,200,443)	\$ (1,254,894)
Preferred stock accretion			(22,200)
Income (loss) available to common stockholders	516,165	(1,200,443)	(1,277,094)
Weighted average common shares outstanding	8,250,613	8,206,219	7,228,674
Dilutive effect of stock options on weighted average common shares outstanding	274,542		
Diluted weighted average common shares outstanding	8,525,155	8,206,219	7,228,674
Basic net income (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)
Diluted net income (loss) per share	\$ 0.06	\$ (0.15)	\$ (0.18)

The outstanding stock options have been excluded from the calculation of diluted loss per share for the year ended December 31, 2005 because their effect is antidilutive. The convertible redeemable preferred stock and outstanding stock options have been excluded from the calculation of diluted loss per share for the year ended December 31, 2004 because their effect is antidilutive.

**10. Income Taxes**

The components of income tax expense (benefit) are as follows:

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Current	\$ 29,432	\$ 41,077	\$ 30,000
Deferred	95,418	176,597	301,000
Income tax provision	124,850	217,674	331,000

Current tax expense is attributable to state taxes. The Company paid income, equity and franchise taxes totaling \$52,000, \$42,000 and \$30,000 during 2006, 2005 and 2004, respectively.

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A reconciliation between the U.S. federal statutory tax rate and the Company's effective tax rate is presented below:

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Federal statutory rate	34.0%	(34.0)%	(34.0)%
State taxes, net of federal benefit	2.9%	(2.9)%	(2.7)%
Permanent differences, primarily meals and entertainment	11.6%	6.8%	6.9%
Other items, net	11.7%	1.1%	20.6%
Adjustment to deferred tax asset tax rate	52.4%	0.0%	0.0%
Valuation allowance	(93.1)%	51.1%	45.0%
Effective income tax rate	19.5%	22.1%	35.8%

The Company assessed the tax rate utilized to record its deferred tax assets and liabilities during 2006. As a result of this assessment the deferred tax assets and liabilities were adjusted by \$337,000 for a 52.4% effect on the net effective income tax rate.

Significant components of the Company's deferred tax liabilities and assets are as follows:

	<b>Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Deferred tax liabilities:		
Tax-over-book depreciation	\$ 9,760,169	\$ 10,549,576
Other		154,349
	9,760,169	10,703,925
Deferred tax assets:		
NOL and AMT credit carryforwards	9,405,515	10,938,218
Other	372,163	475,445
Valuation allowance	(1,059,322)	(1,656,133)
	8,718,356	9,757,530
Net deferred tax liability, net	\$ 1,041,813	\$ 946,395

As of December 31, 2006, the Company had federal NOLs of \$26.5 million, or \$9.0 million tax-effected; federal and state alternative minimum tax credit carry forwards of \$166,000; and state NOL carry forwards of \$219,000

tax-effected. The federal NOLs expire from 2012 through 2023; the alternative minimum tax credit can be utilized to offset regular tax liabilities in future years and has no expiration date; and the state NOLs expire from 2007 through 2024.

As of December 31, 2006 and 2005, the Company's valuation allowance was \$1,059,000 and \$1,656,000, respectively. The Company established the valuation allowance in 2002 and increased it further in 2003, 2004 and 2005 to cover certain federal and state NOLs that may expire before the Company is able to utilize the tax benefit. The valuation allowance was decreased in 2006 by \$597,000 and increased in 2005 by \$502,000. In assessing the realizability of the deferred tax assets, the Company considered whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the existence of, or generation of, taxable income during the periods in which those temporary differences become deductible. The Company considered the scheduled reversal of deferred tax liabilities, projected future taxable income and other factors in making this assessment. The Company's estimates of future taxable income take into consideration, among other items, estimates of future taxable income related to depreciation. Based upon the

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)**

available evidence, the Company does not believe it is more likely than not that all of the deferred tax assets will be realized. To the extent that the Company will not be able 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.

**11. Commitments**

The Company's non-cancelable operating lease arrangements include a lease of the land on which the New Hampshire Brewery sits as well as leases of various small equipment. The land lease began in May 1995 and runs through April 2047. The lease arrangement may be extended at the Company's option for two additional seven-year terms. Monthly lease payments did not commence until completion of construction of the New Hampshire Brewery facility in July 1996. The lease agreement also includes an escalation clause, allowing for a 5% increase in the monthly lease payment at the end of every five-year period. The first five-year period expired in May 2005 and the lessor increased the monthly lease payment by the 5% as provided for in the agreement. Escalating rent expense is recorded on a straight-line basis over the term of the lease. The land lease also provides the Company with the first right of refusal to purchase the property should the lessor receive an offer to sell the property to a third party. The Company's leases of various equipment generally have a term of five years.

Minimum aggregate future lease payments under non-cancelable operating leases as of December 31, 2006 are as follows:

2007	\$ 69,957
2008	69,957
2009	102,147
2010	271,866
2011	276,251
Thereafter	11,727,947
	\$ 12,518,125

Rent expense under all operating leases, including short-term rentals as well as cancelable and noncancelable operating leases, totaled \$328,000, \$320,000 and \$315,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

The Company periodically enters into commitments to purchase certain raw materials in the normal course of business. Furthermore, the Company has entered into purchase commitments to ensure it has the necessary supply of malt and hops to meet future production requirements. Malt and hop commitments are for crop years through 2008. The Company believes that malt and hop commitments in excess of future requirements, if any, will not materially affect its financial condition or results of operations.

Aggregate payments under unrecorded, unconditional purchase commitments as of December 31, 2006 are as follows:

2007	\$ 2,671,015
2008	680,445
2009	30,515
2010	20,789
2011	18,528
Thereafter	772
	\$ 3,422,064

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

The Company leases corporate office space to an unrelated party. The lease agreement expires in 2009. The Company recognized rental income for the years ended December 31, 2006, 2005 and 2004 of \$194,000, \$167,000 and \$162,000, respectively. Future minimum lease rentals under the agreement total \$547,000.

**12. Employee Benefit Plan**

The Company maintains a 401(k) savings plan for employees age 21 years or older with at least six months of service. Employee contributions may not exceed a specific dollar amount determined by law and rules of the Internal Revenue Service. The Company matches 100% of each dollar contributed by a participant employed by the Company on the last day of the calendar year who has worked 1,000 or more hours with a maximum matching contribution of 4% of a participant's eligible compensation. The Company's contributions to the plan vest incrementally over five years of service by the employee. The Company's contributions to the plan totaled \$195,000, \$167,000 and \$205,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

**13. Financial Instruments, Major Customers, and Related-Party Transactions**

Financial instruments that potentially subject the Company to credit risk consist principally of trade receivables and interest-bearing deposits. While wholesale distributors, A-B and Craft Brands account for substantially all accounts receivable, this concentration risk is limited due to the number of distributors, their geographic dispersion, and state laws regulating the financial affairs of distributors of alcoholic beverages. The Company's interest-bearing deposits are placed with major financial institutions.

The Company's most significant wholesaler, K&L Distributors, Inc. ( K&L ), is responsible for distribution of the Company's products in most of King County, Washington, which includes Seattle. K&L accounted for approximately 11%, 12% and 13% of total sales volume in 2006, 2005 and 2004, respectively. Shipments of the Company's product to K&L during 2006, 2005 and the last six months of 2004 were made through Craft Brands. Due to state liquor regulations, the Company sells its product in Washington State directly to third-party beer distributors and returns a portion of the revenue to Craft Brands based upon a contractually determined formula.

For the year ended December 31, 2006, sales to A-B through the A-B Distribution Agreement represented 50% of total sales during the same period, or \$17,159,000. For the year ended December 31, 2005, sales to A-B through the A-B Distribution Agreement represented 41% of total sales during the same period, or \$14,124,000. For the six months ended December 31, 2004, sales to A-B through the A-B Distribution Agreement represented 40% of total sales during the same period, or \$6,275,000. For the six months ended June 30, 2004, sales to A-B through the Distribution Alliance represented 67% of total sales during the same period, or \$14,041,000.

In connection with all sales through the Distribution Alliance prior to July 1, 2004, the Company paid a Margin fee to A-B. The Margin did not apply to sales to wholesalers and others that were part of the A-B distribution network but that were not part of the Distribution Alliance, including most sales to Washington State wholesalers, sales to non-A-B wholesalers, sales by the Company's retail operations, and dock sales. 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 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 (the Additional Margin ). 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 years ended December 31, 2006 and 2005, the Margin was paid to A-B on shipments totaling 101,400 and 85,100 barrels to 503 and 472 distribution points. Because 2006 and 2005 shipments in the midwest and eastern U.S. exceeded 2003 shipments in the same territory, the Company paid A-B the Additional Margin on 23,000 and 7,000 barrels. For the six month period ended December 31, 2004, the Margin was paid to A-B on shipments totaling 38,000 barrels to 371 distribution points, and the retroactive increase on June 2004 shipments was paid on



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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

approximately 20,000 barrels. 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.

In connection with all sales through the Distribution Alliance prior to July 1, 2004 and all sales through the A-B Distribution Agreement since July 1, 2004, the Company also paid additional fees to A-B related to administration and handling. Invoicing costs, staging costs, cooperage handling charges and inventory manager fees are reflected in cost of sales in the Company's statement of operations. These fees collectively totaled approximately \$129,000, \$249,000 and \$406,000 for the years ended December 31, 2006, 2005 and 2004, respectively. These fees were lower in 2006 compared to prior years as the Company recognized a refund of \$124,000 from A-B in 2006 from over billed invoicing costs from 1995 through 2005.

The Company purchased certain materials through A-B totaling \$7,308,000, \$5,942,000 and \$5,584,000 in 2006, 2005 and 2004, respectively.

In December 2003, the Company entered into a purchase and sale agreement with A-B for the purchase of the *Pacific Ridge* brand, trademark and related intellectual property. In consideration, the Company agreed to pay A-B a fee for 20 years based upon the shipments of the brand by the Company. A fee of \$80,000, \$83,000 and \$80,000 due to A-B is reflected in the Company's statements of operations for the years ended December 31, 2006, 2005 and 2004, respectively.

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.

The Company periodically leases kegs from A-B pursuant to an October 2001 letter of agreement. A lease and handling fee of \$79,000, \$32,000 and \$20,000 is reflected in the Company's statements of operations for the years ended December 31, 2006, 2005 and 2004, respectively.

In connection with the shipment of its draft products to wholesalers through the A-B Distribution Agreement, the Company collects refundable deposits on its kegs. Because wholesalers generally hold an inventory of the Company's kegs at their warehouse and in retail establishments, A-B assists in monitoring the inventory of kegs to insure that the wholesaler can account for all kegs shipped. When a wholesaler cannot account for some of the Company's kegs for which it is responsible, the wholesaler pays the Company, for each keg determined to be lost, a fixed fee and also forfeits the deposit. For the years ended December 31, 2006 and 2005, the Company reduced its brewery equipment by \$643,000 and \$305,000, which consists of lost keg fees and forfeited deposits.

In certain instances, the Company may ship its product to A-B wholesaler support centers rather than directly to the wholesaler. Wholesaler support centers assist the Company by consolidating small wholesaler orders with orders of other A-B products prior to shipping to the wholesaler. A wholesaler support center fee of \$158,000 and \$32,000 is reflected in the Company's statements of operations for the years ended December 31, 2006 and 2005.

In 2005, the Company began using a proprietary A-B production planning system, customized for the Company's processes. Fees of \$269,000 for the customization, implementation and use of the system were paid to A-B and reflected in the statement of operations for the year ended December 31, 2005.

The net amount due to (from) A-B was \$247,000, \$(163,000) and \$196,000 as of December 31, 2006, 2005 and 2004.

In 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. In March 2005, the *Widmer Hefeweizen* distribution territory was expanded to include all of the Company's midwest and eastern markets. 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 expires February 1, 2008, with an additional one-year automatic renewals unless either party notifies the other of its desire to have the term expire at

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**REDHOOK ALE BREWERY, INCORPORATED**

**NOTES TO FINANCIAL STATEMENTS (Continued)**

the end of the then existing term at least 150 days prior to such expiration. The agreement may be terminated by either party at any time without cause pursuant to 150 days notice or for cause by either party under certain conditions. Additionally, Redhook and Widmer have entered into a side agreement providing that if Widmer terminates the licensing agreement or causes it to expire before December 31, 2009, Widmer will pay the Company a lump sum payment to partially compensate the Company for capital equipment expenditures made at the New Hampshire Brewery to support Widmer's growth. 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 midwest and eastern territory. Brewing and selling of Redhook's Hefe-weizen was discontinued in conjunction with this agreement. The Company believes that the agreement increases capacity utilization and has strengthened the Company's product portfolio. The Company shipped 30,600, 25,600 and 17,800 barrels of *Widmer Hefeweizen* during the years ended December 31, 2006, 2005 and 2004, respectively. A licensing fee of \$437,000, \$399,000 and \$266,000 due to Widmer is reflected in the Company's statement of operations for the years ended December 31, 2006, 2005 and 2004, respectively. If the Widmer Licensing Agreement were terminated early, or if Widmer gave notice of its election to terminate the agreement according to its term on February 1, 2008, the Company would need to look to replace the lost volume, either through new and existing Redhook products or alternative brewing relationships. If the Company is unable to replace the lost Widmer volume, the loss of revenue and the resulting excess capacity in the New Hampshire Brewery would have an adverse effect on the Company's financial performance.

In connection with a contract brewing arrangement, the Company brewed and shipped 43,000 and 8,900 barrels of Widmer draft beer during the years ended December 31, 2006 and 2005, and 2,300 barrels during the six months ended December 31, 2004. Pursuant to the Supply, Distribution and Licensing Agreement with Craft Brands, if shipments of the Company's products in the western U.S. decrease as compared to the previous year's shipments, the Company has the right to brew Widmer products in an amount equal to the lower of (i) the Company's product shipment decrease or (ii) the Widmer product shipment increase. In addition, the Company may, pursuant to a Manufacturing and Licensing Agreement with Widmer, brew more beer for Widmer than the amount obligated by the Supply, Distribution and Licensing Agreement with Craft Brands. This Manufacturing and Licensing Agreement with Widmer expires December 31, 2007.

**Table of Contents****REDHOOK ALE BREWERY, INCORPORATED****NOTES TO FINANCIAL STATEMENTS (Continued)****14. Quarterly Financial Data (Unaudited)**

	<b>Quarter Ended</b>							
	<b>12/31/06</b>	<b>9/30/06</b>	<b>6/30/06</b>	<b>3/31/06</b>	<b>12/31/05</b>	<b>9/30/05</b>	<b>6/30/05</b>	<b>3/31/05</b>
Sales	\$ 9,381	\$ 10,813	\$ 11,144	\$ 8,669	\$ 7,956	\$ 9,498	\$ 9,741	\$ 7,325
Less excise taxes	1,046	1,169	1,187	890	740	947	982	752
Net sales	8,335	9,644	9,957	7,779	7,216	8,551	8,759	6,573
Cost of sales	7,554	8,012	8,110	7,242	6,789	7,429	7,277	6,048
Gross profit	781	1,632	1,847	537	427	1,122	1,482	525
Selling, general and administrative expenses	1,557	1,777	1,800	1,714	1,484	1,905	1,852	1,543
Income from equity investment in Craft Brands	579	743	819	514	767	674	691	259
Operating income (loss)	(197)	598	866	(663)	(290)	(109)	321	(759)
Interest expense	88	92	84	83	72	72	66	61
Other income, net	185	57	88	54	40	20	36	29
Income (loss) before income taxes	(100)	563	870	(692)	(322)	(161)	291	(791)
Income tax provision (benefit)	(93)	199	11	8	259	10	8	(59)
Net income (loss)	\$ (7)	\$ 364	\$ 859	\$ (700)	\$ (581)	\$ (171)	\$ 283	\$ (732)
Basic earnings (loss) per share *	\$	\$ 0.04	\$ 0.10	\$ (0.09)	\$ (0.07)	\$ (0.02)	\$ 0.03	\$ (0.09)
Diluted earnings (loss) per share *	\$	\$ 0.04	\$ 0.10	\$ (0.09)	\$ (0.07)	\$ (0.02)	\$ 0.03	\$ (0.09)
Barrels shipped	64.7	72.9	76.0	58.0	50.5	61.6	64.0	49.2

\* Summing the earnings per share amounts for each of the quarters will not equal the full year earnings per share due to rounding.

*Seasonality*

Sales of the Company's products are somewhat seasonal, with the first and fourth quarters historically being the slowest and the rest of the year generating stronger sales. The volume of sales may also be affected by weather conditions. Because of the seasonality of the Company's business, results for any one quarter are not necessarily indicative of the results that may be achieved for the full fiscal year.

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**PART IV.**

***Item 15. Exhibits and Financial Statement Schedules***

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

**1. Audited Financial Statements**

	<b>Page</b>
Report of Moss Adams LLP, Independent Registered Public Accountants	3
Balance Sheets as of December 31, 2006 and 2005	4
Statements of Operations for the Years Ended December 31, 2006, 2005 and 2004	5
Statements of Common Stockholders' Equity for the Years Ended December 31, 2006, 2005 and 2004	6
Statements of Cash Flows for the Years Ended December 31, 2006, 2005 and 2004	7
Notes to Financial Statements	8

**2. Financial Statement Schedules**

Report of Moss Adams LLP, Independent Registered Public Accountants	
Craft Brands Alliance LLC Balance Sheets as of December 31, 2006 and 2005	
Craft Brands Alliance LLC Statement of Income for the Years Ended December 31, 2006 and 2005	
Craft Brands Alliance LLC Statement of Members' Equity for the Years Ended December 31, 2006 and 2005	
Craft Brands Alliance LLC Statement of Cash Flows for the Years Ended December 31, 2006 and 2005	
Notes to Financial Statements	

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**3. Exhibits**

The following exhibits are filed with or incorporated by reference into this report pursuant to Item 601 of Regulation S-K:

EXHIBIT NO. 3 Articles of Incorporation and Bylaws

3.1 Restated Articles of Incorporation of Registrant, dated July 7, 2004 (Incorporated by reference from Exhibit 3.1 to the Company's Form 10-Q for the quarter ended June 30, 2004)

3.2 Amended and Restated Bylaws of Registrant, dated April 7, 2004 (Incorporated by reference from Exhibit 3.1 to the Company's Form 10-Q for the quarter ended March 31, 2004)

EXHIBIT NO. 10 Material Contracts

Executive Compensation Plans and Agreements

10.1 Registrant's Incentive Stock Option Plan, dated September 12, 1990 (Incorporated by reference from Exhibit 10.15 to the Company's Registration Statement on Form S-1, No. 33-94166)

10.2 Amended and Restated Registrant's Directors Stock Option Plan (Incorporated by reference from Exhibit 10.14 to the Company's Registration Statement on Form S-1, No. 33-94166)

10.3 Amendment dated as of February 27, 1996, to Amended and Restated Registrant's Directors Stock Option Plan (Incorporated by reference from Exhibit 10.32 to the Company's Form 10-Q for the quarter ended June 30, 1996, No. 0-26542)

10.4 Form of Stock Option Agreement for Registrant's Directors Stock Option Plan (Incorporated by reference from Exhibit 10.4 to the Company's Form 10-K for the year ended December 31, 2004)

10.5 Registrant's 1992 Stock Incentive Plan, approved October 20, 1992, as amended, October 11, 1994 and May 25, 1995 (Incorporated by reference from Exhibit 10.16 to the Company's Registration Statement on Form S-1, No. 33-94166)

10.6 Amendment dated as of July 25, 1996, to Registrant's 1992 Stock Incentive Plan, as amended (Incorporated by reference from Exhibit 10.33 to the Company's Form 10-Q for the quarter ended June 30, 1996, No. 0-26542)

10.7 Amendment dated as of February 27, 1996, to Registrant's 1992 Stock Incentive Plan, as amended (Incorporated by reference from Exhibit 10.31 to the Company's Form 10-Q for the quarter ended June 30, 1996, No. 0-26542)

10.8 Form of Stock Option Agreement for Registrant's 1992 Stock Incentive Plan, as amended (Incorporated by reference from Exhibit 10.8 to the Company's Form 10-K for the year ended December 31, 2004)

10.9 Registrant's 2002 Stock Option Plan (Incorporated by reference from the Addendum to the Company's Proxy Statement for 2002 Annual Meeting of Shareholders)

10.10 Form of Stock Option Agreement (Directors Grants) for Registrant's 2002 Stock Option Plan (Incorporated by reference from Exhibit 10.10 to the Company's Form 10-K for the year ended December 31, 2004)

10.11 Form of Stock Option Agreement (Executive Officer Grants) for Registrant's 2002 Stock Option Plan (Incorporated by reference from Exhibit 10.11 to the Company's Form 10-K for the year ended December 31, 2004)

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- 10.12 Employment Agreement between Registrant and Paul Shipman, dated November 1, 2000 (Incorporated by reference from Exhibit 10.43 to the Company's Form 10-K for the year ended December 31, 2000)
- 10.13 Letter of agreement regarding employment between Registrant and Paul S. Shipman, dated June 23, 2005 (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on June 28, 2005)
- 10.14 Employment Agreement between Registrant and David J. Mickelson, dated August 1, 2000 (Incorporated by reference from Exhibit 10.27 to the Company's Form 10-Q for the quarter ended September 30, 2000)
- 10.15 Letter of agreement regarding employment between Registrant and David J. Mickelson, dated June 23, 2005 (Incorporated by reference from Exhibit 10.2 to the Company's Form 8-K filed on June 28, 2005)
- 10.16 Employment Agreement between Registrant and Allen L. Triplett, dated August 1, 2000 (Incorporated by reference from Exhibit 10.28 to the Company's Form 10-Q for the quarter ended September 30, 2000)
- 10.17 Letter of agreement regarding employment between Registrant and Allen L. Triplett, dated December 6, 2005 (Incorporated by reference from Exhibit 10.2 to the Company's Form 8-K filed on December 7, 2005)
- 10.18 Employment Agreement between Registrant and Pamela J. Hinckley, dated August 1, 2000 (Incorporated by reference from Exhibit 10.29 to the Company's Form 10-Q for the quarter ended September 30, 2000)
- 10.19 Employment Agreement between Registrant and Greg Marquina, dated August 1, 2000 (Incorporated by reference from Exhibit 10.41 to the Company's Form 10-Q for the quarter ended September 30, 2000)
- 10.20 Employment Agreement between Registrant and Gerard C. Prial, dated August 1, 2000 (Incorporated by reference from Exhibit 10.46 to the Company's Form 10-K for the year ended December 31, 2001)
- 10.21 Letter of agreement regarding employment between Registrant and Gerard C. Prial, dated December 6, 2005 (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on December 7, 2005)
- 10.22 Summary Sheet of Director Compensation and Executive Cash Compensation (Incorporated by reference from Exhibit 10.22 to the Company's Form 10-K for the year ended December 31, 2006)
- Other Material Contracts
- 10.23 Investment Agreement dated as of October 18, 1994, between the Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.4 to the Company's Registration Statement on Form S-1, No. 33-94166)
- 10.24 Registration Rights Agreement dated as of October 18, 1994, between Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.7 to the Company's Registration Statement on Form S-1, No. 33-94166)



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- 10.25 Master Distributor Agreement between Registrant and Anheuser-Busch, Incorporated, dated October 18, 1994 (Incorporated by reference from Exhibit 10.21 to the Company's Registration Statement on Form S-1, No. 33-94166)\*
- 10.26 Amendment No. 1 dated as of June 26, 1996, to Master Distribution Agreement between Registrant and Anheuser-Busch, Incorporated, dated October 18, 1994 (Incorporated by reference from Exhibit 10.30 to the Company's Form 10-Q for the quarter ended June 30, 1996, No. 0-26542)
- 10.27 Letter Agreement dated as of July 31, 1995, between Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.25 to the Company's Registration Statement on Form S-1, No. 33-94166)
- 10.28 Consent, Waiver and Amendment, dated September 19, 1997, to Master Distributor Agreement between Registrant and Anheuser-Busch, Incorporated, dated October 18, 1994 (Incorporated by reference from Exhibit 10.36 to the Company's Form 10-Q for the quarter ended September 30, 1997, No. 0-26542)
- 10.29 Purchasing Agreement dated as of March 27, 1998, between Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.37 to the Company's Form 10-Q for the quarter ended March 31, 1998)
- 10.30 Purchasing Agreement dated as of November 21, 2002, between Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.21 to the Company's Form 10-K for the year ended December 31, 2002)
- 10.31 Sublease between Pease Development Authority as Sublessor and Registrant as Sublessee, dated May 30, 1995 (Incorporated by reference from Exhibit 10.11 to the Company's Registration Statement on Form S-1, No. 33-94166)
- 10.32 Assignment of Sublease and Assumption Agreement dated as of July 1, 1995, between Registrant and Redhook of New Hampshire, Inc. (Incorporated by reference from Exhibit 10.24 to the Company's Registration Statement on Form S-1, No. 33-94166)
- 10.33 Amended and Restated Credit Agreement between U.S. Bank of Washington, National Association and Registrant, dated June 5, 1995 (Incorporated by reference from Exhibit 10.18 to the Company's Registration Statement on Form S-1, No. 33-94166)
- 10.34 First Amendment dated as of July 25, 1996, to Amended and Restated Credit Agreement between U.S. Bank of Washington, National Association and Registrant, dated June 5, 1995 (Incorporated by reference from Exhibit 10.34 to the Company's Form 10-Q for the quarter ended September 30, 1996, No. 0-26542)
- 10.35 Second Amendment to Amended and Restated Credit Agreement between U.S. Bank of Washington, National Association and Registrant, dated September 15, 1997 (Incorporated by reference from Exhibit 10.35 to the Company's Form 10-Q for the quarter ended September 30, 1997, No. 0-26542)
- 10.36 Third Amendment to Amended and Restated Credit Agreement between U.S. Bank of Washington, National Association and Registrant, dated February 22, 1999 (Incorporated by reference from Exhibit 10.38 to the Company's Form 10-Q for the quarter ended March 31, 1999)
- 10.37 Fourth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated August 10, 2000 (Incorporated by reference from Exhibit 10.42 to the Company's Form 10-Q for the quarter ended September 30, 2000)

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- 10.38 Fifth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated June 19, 2001 (Incorporated by reference from Exhibit 10.44 to the Company's Form 10-Q for the quarter ended June 30, 2001)
- 10.39 Sixth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated December 31, 2001 (Incorporated by reference from Exhibit 10.45 to the Company's Form 10-K for the year ended December 31, 2001)
- 10.40 Seventh Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated June 21, 2002 (Incorporated by reference from Exhibit 10.47 to the Company's Form 10-Q for the quarter ended June 30, 2002)
- 10.41 Eighth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated March 18, 2003 (Incorporated by reference from Exhibit 10.1 to the Company's Form 10-Q for the quarter ended March 31, 2003)
- 10.42 Ninth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated as of October 31, 2003 (Incorporated by reference from Exhibit 10.34 to the Company's Form 10-K for the year ended December 31, 2003)
- 10.43 Tenth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registrant, dated as of February 9, 2004 (Incorporated by reference from Exhibit 10.35 to the Company's Form 10-K for the year ended December 31, 2003)
- 10.44 Eleventh Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registration, dated as of September 28, 2004 (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on October 26, 2004)
- 10.45 Twelfth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registration, dated as of January 30, 2006 (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on February 15, 2006)
- 10.46 Thirteenth Amendment to Amended and Restated Credit Agreement between U.S. Bank National Association and Registration, dated as of June 5, 2006 (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on June 8, 2006)
- 10.47 Exchange and Recapitalization Agreement dated as of June 30, 2004 between the Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.1 to the Company's Form 8-K filed on July 2, 2004)
- 10.48 Master Distributor Agreement dated as of July 1, 2004 between the Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.2 to the Company's Form 8-K filed on July 2, 2004)\*
- 10.49 Registration Rights Agreement dated as of July 1, 2004 between the Registrant and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.3 to the Company's Form 8-K filed on July 2, 2004)
- 10.50 Supply, Distribution and Licensing Agreement dated as of July 1, 2004 between the Registrant and Craft Brands Alliance LLC (Incorporated by reference from Exhibit 10.4 to the Company's Form 8-K filed on July 2, 2004)\*
- 10.51 Master Distributor Agreement dated as of July 1, 2004 between Craft Brands Alliance LLC and Anheuser-Busch, Incorporated (Incorporated by reference from Exhibit 10.5 to the Company's Form 8-K filed on July 2, 2004)\*

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- 10.52 Amendment No. 1, dated as of May 18, 2004, to Amended and Restated Rights Agreement dated May 12, 1999 between Redhook Ale Brewery, Incorporated and Mellon Investor Services LLC (formerly known as ChaseMellon Shareholder Services, L.L.C.), as Rights Agent (Incorporated by reference from Exhibit 1 to the Company's Form 8-A/A filed on June 28, 2004)
- 10.53 Licensing Agreement dated as of February 1, 2003 between the Registrant and Widmer Brothers Brewing Company (Incorporated by reference from Exhibit 10.1 to the Company's Form 10-Q filed on May 15, 2006)\*
- 10.54 Manufacturing and Licensing Agreement dated as of August 28, 2006 between the Registrant and Widmer Brothers Brewing Company (Incorporated by reference from Exhibit 10.54 to the Company's Form 10-K for the year ended December 31, 2006)
- 10.55 Amendment No. 1, dated as of December 31, 2006, to Manufacturing and Licensing Agreement dated August 28, 2006 between the Registrant and Widmer Brothers Brewing Company (Incorporated by reference from Exhibit 10.55 to the Company's Form 10-K for the year ended December 31, 2006)
- EXHIBIT NO. 16 Letter regarding Change in Certifying Accountant
- 16.1 Letter dated July 29, 2004 from the Company's former principal independent accountants (Incorporated by reference from Exhibit 16.1 to the Company's Form 8-K filed on July 30, 2004)
- 16.2 Letter dated August 20, 2004 from the Company's former principal independent accountants (Incorporated by reference from Exhibit 16.1 to the Company's Form 8-K/A filed on August 20, 2004)
- EXHIBIT NO. 21 Subsidiaries of the Registrant
- 21.1 Subsidiaries of the Registrant (Incorporated by reference from Exhibit 21.1 to the Company's Registration Statement on Form S-1, No. 33-94166)
- EXHIBIT NO. 23 Consents of Experts and Counsel
- 23.1 Consent of Moss Adams LLP, Independent Registered Public Accountants
- EXHIBIT NO. 31 & 32 Certifications
- 31.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of President of Redhook Ale Brewery, Incorporated pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.3 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer of Redhook Ale Brewery, Incorporated pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of President of Redhook Ale Brewery, Incorporated pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.3 Certification of Chief Financial Officer of Redhook Ale Brewery, Incorporated pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(\*) Confidential treatment has been granted for portions of this document.

( ) Filed herewith.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Woodinville, State of Washington, on May 9, 2007.

**REDHOOK ALE BREWERY,  
INCORPORATED**

By /s/ JAY T. CALDWELL

Jay T. Caldwell  
*Chief Financial Officer and Treasurer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ Paul S. Shipman Paul S. Shipman	Chief Executive Officer and Chairman of the Board (Principal Executive Officer)	May 9, 2007
/s/ David J. Mickelson David J. Mickelson	President	May 9, 2007
/s/ Jay T. Caldwell Jay T. Caldwell	Chief Financial Officer and Treasurer (Principal Financial Officer)	May 9, 2007
/s/ Frank H. Clement Frank H. Clement	Director	May 9, 2007
/s/ Michael Loughran Michael Loughran	Director	May 9, 2007
/s/ David R. Lord David R. Lord	Director	May 9, 2007
/s/ John W. Glick John W. Glick	Director	May 9, 2007
/s/ John D. Rogers, Jr. John D. Rogers, Jr.	Director	May 9, 2007

/s/ Anthony J. Short

Director

May 9, 2007

Anthony J. Short

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