



2007 ANNUAL REPORT

# CHAIRMAN'S LETTER

DEAR FELLOW SHAREHOLDERS:

Fiscal 2007 was a pivotal and exciting year for Castle Brands. We began the fiscal year with our initial public offering and ended the fiscal year with a major re-launch of our flagship brand, Boru Vodka.

During fiscal 2007, we continued to make substantial progress in the implementation of our long-term strategy. With the successful completion of our initial public offering in April 2006, our company achieved increased visibility with our distributors, retailers and consumers and expanded and diversified our shareholder base. With our improved financial strength, our management team focused on our company's long-term goals. We increased consumer recognition of the brands in our portfolio, added an important new category to our brands, enhanced our management team with experienced professionals, and increased the capital of our company. We continue to work diligently to build our brands, to increase sales and margins, and to enhance shareholder value.

Globally, our case volume for the year grew 18% to 314,000 nine liter cases. In the United States, case sales increased 25% with our largest brand, Boru Vodka, up about 54%, resulting in record case sales in the U.S. for our company. With the recent re-launch of Boru, including enhanced packaging and a new marketing campaign, we expect to continue building on this momentum this year.

While we expect that the United States will continue to be our fastest growing market, we expect the international market to become a dynamic growth market for us as well and one we intend to pursue aggressively. International sales increased approximately 7%, but it was a very important year of change and repositioning for us internationally. In March 2006, we welcomed our new International Managing Director, John Soden. Mr. Soden, whose experience includes over 13 years with one of Ireland's largest manufacturers and distributors of alcoholic beverages, was charged with the implementation of several key initiatives, each of which he has already well advanced. They include identifying and implementing improved routes to market in Ireland, attracting and working with an aggressive distributor for our brands throughout the United Kingdom, strengthening our international sales team, and instituting cost reductions and margin improvements. We expect good progress from his team this year and in the years ahead.

As part of the re-launch of Boru Vodka, and to further stimulate growth and contribution from all of our brands, we created the position of Chief Commercial and Marketing Officer with the responsibility to oversee and develop all of our brands on a worldwide basis. Our Chief Commercial and Marketing Officer, Claes Fick, brings to Castle Brands over 17 years of experience, most notably having been responsible for managing Absolut Vodka in the U.S. Both John and Claes have the knowledge and experience to promote and grow the Castle Brands portfolio. Each of these individuals represents a major asset to the company as we continue to grow organically and through acquisitions and agency relationships both in the U.S. market and internationally.

As with any beverage company, distribution is key. In the U.S., our Senior Vice President, Kelley Spillane, and his team extended our distribution system and we now have distribution in place in all 50 states. Throughout the year, we leveraged this extensive network by adding approximately 5,000 points of distribution in the U.S. This enabled us to achieve record case sales in our most recent fiscal year. In the current year, both increased focus on expanding our

on-premise initiatives and the new Boru packaging and marketing will be important contributors to this effort. We expect this to result in increased case sales and improved margins for our brands.

We expanded our portfolio of products by acquiring McLain & Kyne, Ltd., a developer and marketer of premium small batch bourbon brands, in October. With this acquisition we entered the premium bourbon market with three distinct products: Jefferson's Reserve, Jefferson's and Sam Houston. We believe that these brands are positioned for growth and fit in well with our long-term strategy. We will continue to look for similar acquisitions and agency opportunities that satisfy our criteria for growth and shareholder benefit.

We successfully executed several promotional, advertising and marketing campaigns to further enhance brand awareness. Although we incurred substantial expense in promoting our brands, we truly believe that these marketing campaigns will yield long-term increases in the sales of our products. Our marketing promotion for Gosling's Rum in Gillette Stadium in Foxborough, Massachusetts, provided us with outstanding product placement and promotional opportunities for Gosling's Rum to a targeted core demographic customer. We also sponsored several sailing events, including the Annapolis Race Week in Maryland during the Labor Day weekend. We continue to believe that events such as these are instrumental to gaining consumer recognition and brand awareness of our products, and we look forward to introducing a growing number of consumers to our products through our marketing efforts over the course of the coming year.

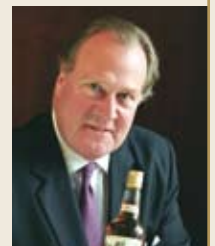
As we enter a new fiscal year, I am very excited about the opportunities that lie ahead for our company. On the product side, we entered the current fiscal year with new packaging and our new "Defend the Spirit" marketing campaign for Boru Vodka. The new sleek packaging reflects the boldness, clarity and quality of this outstanding premium vodka, a theme that is carried through the "fight and defend" expressions of our marketing campaign. On the financial side, we improved our capital structure through the private placement of approximately \$21 million of our common stock. The funds from the offering will be used to further brand development as well as possible acquisitions. The private placement was a significant achievement for our company as it not only raised required capital but also enhanced our shareholder base with new institutional investors.

As we review our accomplishments for the year, I believe we have made significant progress in building brand recognition of our products and improving our platform for growth. Although we have accomplished a lot in the past year and I am very proud of what we have achieved so far, there is still much more to be done. As we enter our second year as a public company, we are well positioned to continue to implement our long-term plan to take advantage of a dynamic and growing marketplace. You can be assured that the entire management team is focused on achieving profitability and enhancing shareholder value.

Thank you for your support.



MARK ANDREWS  
*Chairman and Chief Executive Officer*



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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
**FOR THE FISCAL YEAR ENDED MARCH 31, 2007**

**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 001-32849**

**Castle Brands Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**41-2103550**

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

**570 Lexington Avenue, 29th Floor  
New York, New York**

(Address of principal executive offices)

**10022**

(Zip Code)

**Registrant's telephone number, including area code (646) 356-0200**

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

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common stock, \$0.01 par value	American Stock Exchange

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

None.

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark whether 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 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, accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

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 Act). Yes  No

The aggregate market value of registrant's common stock held by non-affiliates, based upon the closing price of the common stock on March 31, 2007, as reported by the American Stock Exchange, was approximately \$79,560,998 million. Shares of common stock held by each executive officer and director and by each person who owns 5% or more of the outstanding common stock, based on Schedule 13G filings, have been excluded since such persons may be deemed affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The registrant had 15,627,329 shares of \$0.01 par value common stock outstanding at June 27, 2007.

**DOCUMENTS INCORPORATED BY REFERENCE**

Certain information required in Part III of this Form 10-K is incorporated by reference to the proxy statement for the registrant's 2007 meeting of stockholders, which proxy statement will be filed no later than 120 days after the close of the registrant's fiscal year ended March 31, 2007.

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## PART I

### Cautionary Note Regarding Forward-Looking Statements

This annual report includes statements of our expectations, intentions plans and beliefs that constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and are intended to come within the safe harbor protection provided by those sections. These statements, which involve risks and uncertainties, relate to the discussion of our business strategies and our expectations concerning future operations, margins, profitability, liquidity and capital resources and to analyses and other information that are based on forecasts of future results and estimates of amounts not yet determinable. We have used words such as “may,” “will,” “should,” “expects,” “intends,” “plans,” “anticipates,” “believes,” “thinks,” “estimates,” “seeks,” “expects,” “predicts,” “could,” “projects,” “potential” and other similar terms and phrases, including references to assumptions, in this report to identify forward-looking statements. These forward-looking statements are made based on expectations and beliefs concerning future events affecting us and are subject to uncertainties, risks and factors relating to our operations and business environments, all of which are difficult to predict and many of which are beyond our control, that could cause our actual results to differ materially from those matters expressed or implied by these forward-looking statements. These risks and other factors include those listed under “Risk Factors” and elsewhere in this report. The following factors, among others, could cause our actual results and performance to differ materially from the results and performance projected in, or implied by, the forward-looking statements:

- our history of losses and expectation of further losses;
- the effect of poor operating results on our company;
- the effect of growth on our infrastructure, resources, and existing sales;
- our ability to expand our operations in both new and existing markets and our ability to develop or acquire new brands;
- the impact of supply shortages and alcohol and packaging costs in general;
- our ability to raise capital;
- our ability to fully utilize and retain new executives;
- negative publicity surrounding our products or the consumption of beverage alcohol products in general;
- our ability to acquire and/or maintain brand recognition and acceptance;
- trends in consumer tastes;
- our ability to protect trademarks and other proprietary information;
- the impact of litigation;
- the impact of federal, state, local or foreign government regulations;
- the effect of competition in our industry; and
- economic and political conditions generally.

We assume no obligation to publicly update or revise these forward-looking statements for any reason, or to update the reasons actual results could differ materially from those anticipated in, or implied by, these forward-looking statements, even if new information becomes available in the future.

### Currency Translation

The functional currencies for our foreign operations are the euro in Ireland and the British pound in the United Kingdom. With respect to our consolidated financial statements, the translation from the applicable foreign currencies to U.S. dollars is performed for balance sheet accounts using exchange

rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income. Gains or losses resulting from foreign currency transactions are included in other income/expenses.

Where in this annual report we refer to amounts in euros or British pounds, we have for your convenience also in certain cases provided a translation of those amounts to U.S. dollars in parenthesis. Where the numbers refer to a specific balance sheet date or financial statement period, we have used the exchange rate that was used to perform the translations in connection with the applicable financial statement. In all other instances, unless otherwise indicated, the translations have been made using the exchange rates as of March 31, 2007, each as calculated from the Interbank exchange rates as reported by Oanda.com. On March 31, 2007, the exchange rate of the euro in exchange for U.S. dollars and the exchange rate of the British pound in exchange for U.S. dollars were €1.00 = U.S. \$1.3335 (equivalent to U.S. \$1.00 = €0.7500) for euros and £1.00 = U.S. \$1.9625 (equivalent to U.S. \$1.00 = £0.5096) for British pounds.

These translations should not be construed as representations that the euro and British pound amounts actually represent U.S. dollar amounts or could be converted into U.S. dollars at the rates indicated.

## **Item 1. Business**

### **Overview**

We are an emerging developer and global marketer of premium branded spirits within four growing categories of the spirits industry: vodka, rum, whiskey and liqueurs. Our premium spirits brands include brands that we own, including Boru vodka, Knappogue Castle Whiskey, the Clontarf Irish whiskeys, Sea Wynde rum, and Brady's Irish cream liqueur, brands for which we possess certain marketing and distribution rights, either directly or indirectly, including Goslings' rums and Celtic Crossing liqueur and Pallini liqueurs, a brand that we distribute through an agency relationship.

We were formed as a Delaware corporation in July 2003. Our predecessor company, Great Spirits Company LLC, a Delaware limited liability company was formed in February 1998 by our chief executive officer, Mark Andrews, through one of his affiliated entities, Knappogue Corp. In early 2003, Great Spirits Company entered into negotiations with The Roaring Water Bay Spirits Group Limited to acquire the Boru vodka brand and, in July 2003, we were formed as a holding company to effectuate the merger of Great Spirits Company and the Roaring Water Bay entities. This merger was accomplished on December 1, 2003, with the simultaneous (a) merger of Great Spirits Company into a wholly owned subsidiary established by us for such purpose, now known as Castle Brands (USA) Corp., and (b) acquisition by us of The Roaring Water Bay Spirits Group Limited and its affiliated companies, referred to by us as Roaring Water Bay, making them our subsidiaries, now known as Castle Brands Spirits Group Limited and Castle Brands Spirits Marketing and Sales Company Limited. As a result of this acquisition, we acquired ownership of Boru vodka, the Clontarf family of Irish whiskeys and Brady's Irish cream. We completed our initial public offering of common stock in April 2006.

For our fiscal year ended March 31, 2007, we recorded sales of 314,644 cases, which are measured based on the industry standard of nine-liter equivalent cases, and revenues of approximately \$25.2 million, which represents an increase of 19.0% from revenues recorded for the prior fiscal year. These increases primarily reflect organic growth within our brand portfolio. We intend to continue our current growth through further market penetration of our brands, as well as through strategic relationships and acquisitions of both established and emerging spirits brands with global growth potential.

### **Our brands**

We market our premium spirits brands in the following distilled spirit categories: vodka, rum, whiskey and liqueurs.



**Boru vodka.** Boru vodka is our leading brand and accounted for approximately 35%, 36% and 55% of our revenues for the fiscal years ended March 31, 2007, March 31, 2006 and March 31, 2005, respectively. Boru vodka is premium vodka produced in Ireland. It was developed in 1998 and named after the legendary High King of Ireland, Brian Boru, an Irish national hero known for uniting the Irish clans and driving foreign invaders out of Ireland in 1014 A.D. It is quintuple distilled using pure spring water for smoothness and filtered through ten feet of charcoal made from Irish oak for increased purity. We have three flavor extensions of Boru vodka: Boru Citrus, Boru Orange and Boru Crazzberry (a cranberry/raspberry flavor fusion).

**Gosling's rum.** We are the exclusive U.S. distributor for the Gosling's rums, including Gosling's Black Seal dark rum, Gosling's Gold Bermuda Rum and Gosling's Old Rum. These are all produced by the Gosling family in Bermuda, where Gosling's rums have been under continuous production and ownership by the Gosling family for over 150 years. In February 2005, we expanded our relationship with the Gosling family by acquiring a 60% controlling interest in Gosling-Castle Partners Inc., a global export venture between us and the Gosling family. Effective April 1, 2005, Gosling-Castle Partners secured the exclusive long-term export and distribution rights for the Gosling's rum products for all countries other than Bermuda, including an assignment of the Gosling's rights under our existing distribution agreement with them. The Gosling's rum brands accounted for approximately 29% and 28% of our revenues for the fiscal years ended March 31, 2007 and March 31, 2006, respectively.

**Sea Wynde.** In 2001 we introduced Sea Wynde, premium rum. Sea Wynde is distinctive in that it is made entirely from aged, pure pot still rums from the Caribbean and South America.

**Knappogue Castle Whiskey.** We developed our Knappogue Castle Whiskey, a single malt Irish whiskey, in 1998, taking advantage of an opportunity to build both on the popularity of single malt Scotch whisky and the growth in the Irish whiskey category. Knappogue Castle Whiskey is distilled in pot stills using malted barley and is distinctive in that it is vintage-dated based on the year of distillation.

**Knappogue Castle 1951.** Knappogue Castle 1951 is a pure pot-still whiskey that was distilled in 1951 and then aged for 36 years in sherry casks. The name comes from a castle in Ireland, formerly owned by Mark Edwin Andrews, the originator of the brand and the father of Mark Andrews, our chairman and chief executive officer. Currently, we only offer 300 bottles of this rare Irish whiskey for sale each year.

**Clontarf Irish whiskeys.** Our family of Clontarf Irish whiskeys currently represents a majority of our case sales of Irish whiskey. Clontarf was launched in 2000 to meet the growing demand for an accessible and smooth premium Irish whiskey. Clontarf is distilled using quality grains and pure Irish spring water and is then aged in bourbon barrels and mellowed through Irish oak charcoal. Clontarf is available in single malt, reserve and classic versions.

**McLain & Kyne Bourbons.** In 2006, we acquired McLain & Kyne, Ltd., the developers and marketers of three premium very small batch bourbons, including Jefferson's, Jefferson's Reserve and Sam Houston. Under the McLain & Kyne label, we offer these three distinct premium Kentucky bourbons, each of which is blended from only eight to twelve barrels to produce specific flavor profiles. For a further description of this acquisition, see "— Our growth strategy" below.

**Brady's Irish cream liqueur.** We launched Brady's Irish cream in late 2003 to capitalize on the demand for high quality Irish creams. Brady's Irish cream is made in small batches using Irish whiskey, dairy fresh cream and natural flavors.

**Celtic Crossing liqueur.** As a result of our strategic venture with Gaelic Heritage Corporation Limited, an affiliate of Terra Limited, which is one of our primary bottlers, we have obtained the exclusive worldwide distribution rights with respect to Celtic Crossing, a premium brand of Irish liqueur, and a 60% ownership interest in Celtic Crossing in the United States, Canada, Mexico, Puerto Rico and the islands between North and South America. As part of this strategic venture arrangement, Gaelic Heritage has retained the exclusive rights to produce and supply us with Celtic Crossing. Celtic Crossing was developed in the mid 1990s by Gaelic Heritage, and is a unique combination of Irish spirits, cognac and a taste of honey.

***Pallini liqueurs.*** Pursuant to an exclusive marketing agreement with I.L.A.R. S.p.A., we have obtained the long-term exclusive U.S. distribution rights (excluding duty free sales) with respect to Pallini Limoncello and its related brand extensions. Pallini Limoncello is a premium lemon liqueur, which is served on the rocks or as an ingredient in a wide variety of drinks, ranging from martinis to iced tea. It is also used in cooking, particularly for pastries and cakes. Pallini Limoncello is crafted from an authentic family recipe created more than 100 years ago by the Pallini family. It is made with Italy's finest Sfusato Amalfitano lemons that are hand-selected for optimal freshness and flavor. There are also two other flavor extensions of this Italian liqueur: Pallini Peachcello, made with white peaches, and Pallini Raspicello, made from a combination of raspberries and other berries.

### **Our growth strategy**

Our objective is to continue building a distinctive portfolio of global premium spirits brands, with a primary focus on increasing both our total and individual brand case sales. To achieve this, we intend to continue:

- ***increasing market penetration of our existing spirits brands.*** We intend to utilize our existing distribution relationships, sales expertise and targeted marketing activities to achieve growth and gain additional market share for our brands within retail stores, bars and restaurants, and thereby with end consumers, both in the United States and internationally; add experienced salespeople in selected markets; increase sales to national chain accounts; and expand our international distribution relationships;
- ***building brand awareness through innovative marketing, advertising and promotional activities.*** We place a significant emphasis on our bottle design, labeling and packaging, as well as on our advertising and promotional activities, to establish and reinforce the image of our brands and have invested significant capital over the last several years in developing our brands. In March 2007, we introduced newly upgraded packaging for Boru vodka and its related flavor extensions, along with our "Defend the Spirit" advertising campaign. We intend to continue developing compelling campaigns for our spirits brands through the coordinated efforts of our experienced internal marketing personnel and leading third-party design and advertising firms, principally using billboards, print advertisements and in-store promotional materials, to increase consumer brand awareness; and
- ***selectively adding new premium brands to our spirits portfolio.*** We intend to continue developing new brands and pursuing strategic relationships, joint ventures and acquisitions to selectively expand our portfolio of premium spirits brands, particularly by capitalizing on and expanding our already demonstrated partnering capabilities. The spirits industry is characterized by a relatively small number of very large companies, as a result of continuing industry consolidation, and a sizable number of smaller brands, many of which are family owned. We believe that by partnering with these smaller and family-owned companies, we provide them with the potential opportunity to achieve global growth and the other benefits of a larger organization while, in many cases, maintaining their local identities and traditional distillation and production businesses. In addition, we will seek to opportunistically acquire brands divested by our larger competitors that have market presence and significant growth potential. We continued this strategy this year by acquiring all of the outstanding capital stock of McLain & Kyne, Ltd., a Louisville, Kentucky based developer and marketer of three premium small batch bourbons: Jefferson's, Jefferson's Reserve and Sam Houston. As consideration for the acquisition, which closed on October 12, 2006, we paid \$1,294,800 in cash to the sellers and issued to the sellers 100,000 shares of our common stock. We will also pay an earn-out to the sellers based on the financial performance of the acquired business, in an amount no to exceed \$4,000,000. We intend to continue to pursue strategies to maximize stockholder value, which may continue to include acquisitions that will help us further expand our product offerings. We expect that future acquisitions, if consummated, would involve some combination of cash, debt and the issuance of our stock.

## **Production and supply**

There are several steps in the production and supply process for spirits products. First, all of our products are distilled. This is a multi-stage process that converts basic ingredients, such as grain or sugar cane, into alcohol. Next, the alcohol is processed and/or aged in various ways depending on the requirements of the specific brand. In the case of our vodka, this processing is designed to remove all other chemicals, so that the resulting liquid will be odorless and colorless, and have a smooth quality with minimal harshness. Achieving a high level of purity involves a series of distillations and filtration processes.

In the case of our flavored vodkas and all of our other spirits brands, rather than removing flavor, various complex flavor profiles are achieved through one or more of the following techniques: infusion of fruit, addition of various flavoring substances, and, in the case of our rums and whiskeys, aging of the brands in various types of casks for extended periods of time and the blending of several rums or whiskeys to achieve a unique flavor profile for each brand. After the distillation, purification and flavoring processes are completed, the various liquids are bottled. This involves several important stages, including bottle and label design and procurement, filling of the bottles and packaging the bottles in various configurations for shipment.

We do not have significant investment in distillation, bottling or other production facilities or equipment. Instead, we have entered into relationships with several companies to provide those services to us for our various brands. We believe that these types of arrangements allow us to avoid committing significant amounts of capital to fixed assets and permit us to have the flexibility to meet growing sales levels by dealing with companies whose capacity significantly exceeds our current needs. These relationships vary on a brand-by-brand basis as discussed below.

### ***Boru vodka***

We have a supply agreement with Carbery Milk Products Limited, a member of the Carbery Group, a distiller and food producer based in Ballineen, Ireland, to provide us with the distilled alcohol used in our Boru vodka. This supply agreement with Carbery was originally entered into by Roaring Water Bay in 1998 and became ours in 2003, when we acquired Roaring Water Bay and, with it, our Boru vodka brand. The supply agreement provides for Carbery to produce natural spirit for us with specified levels of alcohol content pursuant to specifications set forth in the agreement and at specified prices through its expiration in December 2008, in quantities to be designated by us annually. We believe that Carbery has sufficient distilling capacity to meet our needs for Boru vodka for the foreseeable future. Carbery also produces the flavoring ingredients used in the Boru vodka flavor extensions and in our Brady's Irish cream.

From Carbery, the quintuple distilled alcohol is delivered by them to the bottling premises at Terra Limited in Baileyboro, Ireland, where pursuant to our bottling and services agreement with Terra, it is filtered in several proprietary ways, pure water is added to achieve the desired proof, and, in the case of the citrus, orange and cazzberry versions of Boru vodka, flavorings (obtained from Carbery) are added. Each of our Boru vodka products is then bottled in various sized bottles. We believe that Terra, which also acts as bottler for all of our Irish whiskeys and as producer and bottler of our Brady's Irish cream (and as bottler for Celtic Crossing, which is supplied to us by one of Terra's affiliates), has sufficient bottling capacity to meet our current needs, and its facility can be expanded to meet future supply needs, should this be required.

Pursuant to our bottling and services agreement with Terra, which extends through February 28, 2009, Terra provides intake, storage, sampling, testing, filtering, filling, capping and labeling of bottles, case packing, warehousing and loading and inventory control for our Boru vodka brands and our Knappogue Castle and Clontarf Irish whiskeys at prices that are adjusted annually by mutual agreement based on changes in raw materials and price indexes for consumer price index increases up to 3½%. This agreement also provides for maintenance of product specifications and minimum processing procedures, including compliance with applicable food and alcohol regulations and maintenance, storage and stock control of all raw products and finished products delivered to Terra. All alcohol is held on the premises by Terra under its customs and excise bond.

### ***Gosling's rum***

The Gosling's rums have been produced by Gosling's Brothers Limited in Hamilton, Bermuda for approximately 150 years and, pursuant to our distribution arrangements with the Goslings, they have retained the right to act as the sole supplier to Gosling-Castle Partners Inc. with respect to our Gosling's rum requirements. They source their rums in the Caribbean and transport them to Bermuda where they are blended according to proprietary recipes. The rums are then sent to the Heaven Hill plant in Bardstown, Kentucky where they are bottled, packaged, stored and shipped to our various distributors. Gosling's Brothers recently increased its blending and storage facilities in Bermuda to accommodate our supply needs for the foreseeable future. We believe Heaven Hill has ample capacity to meet our projected supply needs. See "— Strategic brand – partner relationships."

### ***Knappogue Castle and Clontarf Irish whiskeys***

In 2005, we entered into a long-term supply agreement with Irish Distillers, a subsidiary of Pernod Ricard, pursuant to which it has agreed to supply us with the aged single malt and grain whiskeys used in our Knappogue Castle Whiskey and a Knappogue Castle Whiskey blend we may produce in the future and all three of our Clontarf Irish whiskey products. The supply agreement provides for Irish Distillers to meet our running ten-year estimate of supply needs for these products, each of which is produced to a flavor profile prescribed by us. At the beginning of each year of the agreement, we must nominate our specific supply needs for each product for that year, which amounts we are then obligated to purchase over the course of that year. These amounts may not exceed the annual amounts set forth in the running ten-year estimate unless approved by Irish Distillers. The agreement provides for fixed prices for the whiskeys used in each product, with escalations based on certain cost increases. The whiskeys for the four products are then sent to Terra Limited where they are bottled in bottles designed by us and packaged for shipment.

### ***McLain & Kyne bourbons***

Jefferson's, Jefferson's Reserve and Sam Houston bourbons are produced for us by Kentucky Bourbon Distillers in Bardstown, Kentucky. Kentucky Bourbon Distillers sells barrels of aged bourbon to us, from which we blend no more than eight to twelve barrels to produce specific flavor profiles of each of our bourbon products. The bourbons are then bottled by Kentucky Bourbon Distillers in bottles designed and decorated for us and through third party suppliers. While bourbon supply in the United States has been in short supply in recent years, we believe that Kentucky Bourbon Distillers has the capacity to meet our foreseeable supply needs for these brands.

### ***Pallini liqueur***

The Pallini liqueurs are produced by I.L.A.R. S.p.A., an Italian company based in Rome and owned since 1875 by the Pallini family. The Pallinis make their Limoncello using Sfusato Amalfitano lemons in a proprietary infusion process. Once made, the Limoncello is then bottled in their plant in Rome and shipped to us pursuant to our long-term exclusive U.S. marketing and distribution agreement. In addition to Pallini Limoncello, I.L.A.R. produces Pallini Raspicello, using a combination of raspberries and other berries and Pallini Peachcello using white peaches, and we are the exclusive U.S. importer for both of these brands as well. We believe that I.L.A.R. has adequate facilities in Rome to produce and bottle sufficient Limoncello, Raspicello and Peachcello to meet our foreseeable needs. See "— Strategic brand-partner relationships."

### ***Brady's Irish cream***

Brady's Irish cream is produced for us by Terra. Fresh cream is combined with Irish whiskey, grain neutral spirits and various flavorings procured from the Carbery Group, to our specifications, and then bottled by Terra in bottles designed for us. We believe that Terra has the capacity to meet our foreseeable supply needs for this brand.

### ***Celtic Crossing liqueur***

We acquired the exclusive worldwide distribution rights to the Celtic Crossing brand of Irish liqueur and a 60% ownership interest in the Celtic Crossing brand in the United States, Canada,

Mexico, Puerto Rico and the islands between North and South America, from Gaelic Heritage Corporation Limited, an affiliate of Terra. In connection with these arrangements, Gaelic Heritage retained the right to act as the sole supplier to us of Celtic Crossing. Gaelic Heritage mixes the ingredients comprising Celtic Crossing using a proprietary formula and then Terra bottles it for them in bottles designed for us. We believe that the necessary ingredients are available to Gaelic Heritage in sufficient supply and that Terra's bottling capacity is currently adequate to meet our projected supply needs. See "— Strategic brand-partner relationships."

### ***Sea Wynde rum***

With the assistance of a master blender, we source several aged rums from Jamaica and Guyana for our Sea Wynde rum and then send them to a bottling facility near Edinburgh, Scotland where they are married together and bottled for us in bottles designed by us.

### ***Distribution network***

We believe that one of our strengths is the distribution network that we have developed with our sales team and our independent distributors and brokers. We currently have distribution and brokerage relationships with third-party distributors in all 50 states in the United States, as well as material distribution arrangements in approximately six other countries.

### ***U.S. distribution***

***Background.*** Importers of distilled spirits in the United States must sell their products through a three-tier distribution system. Typically, an imported brand is first sold to a U.S. importer, who then sells it to a network of distributors, or wholesalers, covering the United States, in either "open" states or "control" states. In the 32 open states, the distributors are generally large, privately held companies. In the 18 control states, the states themselves function as the distributor, and suppliers such as us are regulated by these states. The distributors and wholesalers in turn sell to the individual liquor retailers, such as liquor stores, restaurants, bars, supermarkets and other outlets in the states in which they are licensed to sell beverage alcohol. In larger states such as New York, more than one distributor may handle a brand in separate geographical areas. In control states, where liquor sales are controlled by the state governments, importers must sell their products directly to the state liquor authorities, which also act as the distributors and either maintain control over the retail outlets or license the retail sales function to private companies, while maintaining strict control over pricing and profit.

The U.S. spirits industry has undergone dramatic consolidation over the last ten years and the number of companies and importers has significantly declined due to merger and acquisition activity. There are currently six major spirits companies, each of which own and operate their own importing business. All companies, including these large companies, are required by law to sell their products through wholesale distributors in the United States. The major companies are increasingly exerting significant influence over the regional distributors and as a result, it has become more difficult for smaller companies to get their products recognized by the distributors. Therefore, with the establishment of our distribution network in all 50 states, we believe we have overcome a significant barrier to entry in the U.S. spirits business and enhanced our attractiveness as a strategic partner for smaller companies lacking comparable distribution.

For the fiscal year ended March 31, 2007, our U.S. sales represented approximately 66.3% of our revenues, and we expect them to grow as a percentage of our total sales in the future. See Note 19 of Notes to Consolidated Financial Statements.

***Importation.*** While we own most of our brands or, by contract, have the exclusive right to act as U.S. importer of the brands of our strategic partners, we do not currently act as our own importer in the United States. We currently hold the federal importer and wholesaler license required by the Alcohol and Tobacco Tax and Trade Bureau, a division of the U.S. Department of the Treasury, and a wholesale liquor license issued by the State of New York, but we do not yet have the other state

licenses necessary to sell our products to the distributors in the individual states. Instead, we use the services of a licensed importer to act as importer of record on our behalf in the United States, both with respect to our proprietary brands and those of our strategic partners.

In 1998, we engaged MHW Ltd., a New York-based nationally recognized and licensed importer, to coordinate the importing and industry compliance required for the sales of our products across the United States. Through the utilization of MHW's national expertise and licenses, our inventory is strategically maintained in one of the largest bonded warehouses on both coasts (Western Carriers and Western Wine Services) and shipped nationally by an extensive network of licensed and bonded carriers. Pursuant to an agreement established on April 15, 1998, as amended on December 1, 2004, MHW also provides us with certain logistical services as well as accounting, inventory, insurance and disbursement services for our brands. In addition, MHW provides online tracking software, which provides daily reports on sales of our products to our distributors, receivables, inventory and cash receipts.

Under the terms of our agreement with MHW, we pay MHW a monthly service fee of \$4,900, plus \$1.00 per case on all cases sold during the month. Our agreement with MHW continues until terminated upon four months prior written notice by either party.

Until recently, it was much more cost effective for us to use MHW as our U.S. importer and to rely on its state licenses rather than expend the resources necessary to set up the required licensing infrastructure internally. At this stage of our growth, however, our revenue-based fees to MHW are reaching the point where it begins to be more economical for us to assume the role of importer ourselves. While we have commenced this process and expect to bring a number of the services provided by MHW in-house in the future, until we have obtained the requisite licenses in at least a majority of the states, we will continue to rely on MHW to perform the importing function for us.

***Wholesalers and distributors.*** In the United States, we are required by law to use state licensed distributors or, in the control states, state-owned agencies performing this function, to sell our brands to the various retail outlets. As a result, we are dependent on them not only for sales but also for product placement and retail store penetration. We have no distribution agreements or minimum sales requirements with any of our U.S. alcohol distributors and they are under no obligation to place our products or market our brands. In addition, all of them also distribute the products and brands of competitors of ours. As a result, the fostering and maintaining of our relationships with our distributors is of paramount importance to us. Through our internal sales team, we have established relationships for our brands with wholesale distributors in each state, and our products are currently sold in the United States by approximately 80 wholesale distributors, as well as by various state beverage alcohol control agencies.

#### ***International distribution***

Unlike the United States, the majority of the other countries in which we sell our brands allow for sales to be made directly from the brand owner to the various retail establishments, including liquor stores, chain stores, restaurants and pubs, without requiring that sales go through an importer or through a distributor or wholesaler tier. In our international markets, we do not use the services of an importer, although we use Terra Limited to handle the billing, inventory and shipping for us with respect to our non-U.S. markets, similar to that aspect of our arrangement with MHW in the United States. We do, however, rely primarily on established spirits distributors and wholesalers in most of our non-U.S. markets in much the same way as we do in the United States.

As in the United States, the spirits industry has undergone consolidation internationally, with considerable realignment of brands and brand ownership. The number of major spirits companies internationally has been reduced significantly due to mergers and brand ownership consolidation. While there are still a substantial number of companies owning one or more brands, most business is now done by six major companies each of whom owns and operates its own distribution company in the major international markets. These captive distribution companies focus primarily on the brands of the companies that own them.

Even though we do not utilize the direct route to market in our international operations, we do not believe that we are at a significant disadvantage, because typically the local wholesalers have

significant and established relationships with the retail accounts and are able to provide extensive customer service, in store merchandising and on premise promotions. In addition, even though we must compensate our wholesalers and distributors in each market in which we sell our brands, we are, as a result of using these distributors, still able to benefit from substantially lower infrastructure costs and centralized billing and collection.

Our primary international markets are the Republic of Ireland, the United Kingdom, Germany, France, Italy and Canada. In addition, we have sales in a number of other countries in Continental Europe and the Caribbean. For the fiscal year ended March 31, 2007, our non-U.S. sales represented 33.7% of our revenues. See Note 19 of Notes to Consolidated Financial Statements.

#### **Significant customers**

Sales to one customer, Southern Wine and Spirits (and its related entities), accounted for approximately 21.2% of our consolidated revenues for the fiscal year ended March 31, 2007.

#### **Our sales team**

While we currently expect more rapid growth in the United States, international markets hold considerable potential and are an important part of our global strategy. We are in the process of reevaluating our international strategy on a market-by-market basis to strengthen our distributor relationships, optimize our sales team and effectively focus our financial resources.

We currently have a total sales force of 30 people, including eight regional U.S. sales managers and two international sales managers, with an average of over 15 years of industry experience with premium spirits brands.

Our sales personnel are engaged in the day to day management of our distributors, which includes setting quotas, coordinating promotional plans for our brands, maintaining adequate levels of stock, brand education and training and sales calls with distributor personnel. In addition to distributor management, our sales team also maintains relationships with key retail customers through independent sales calls. They also schedule promotional events, create local brand promotion plans, host our in-store tastings in the jurisdictions where such promotions are legal and provide waitstaff and bartender training and education with respect to our brands.

#### **Advertising, marketing and promotion**

In order to build our brands, we must effectively communicate with three distinct audiences: our distributors, the retail trade and the end consumer. We place significant emphasis on advertising, marketing and promotional activities to establish and reinforce the image of our brands, with the objective of building substantial brand value. We also make a substantial investment in these activities. We are committed to continuing advertising and promotion activities to build our brands and their value and believe that our execution of disciplined and strategic branding and marketing campaigns will continue to drive our sales growth.

We employ full-time, in-house marketing, sales and customer service personnel who work together with third party design and advertising firms to maintain a high degree of focus on each of our product categories and build brand awareness through innovative marketing activities. We use a range of marketing strategies and tactics to build brand equity and increase sales, including consumer and trade advertising, price promotions, point-of-sale materials, event sponsorship, in-store and on-premise promotions and public relations, as well as a variety of other traditional and non-traditional marketing techniques to support the sales of our brands.

In addition to traditional advertising, we also employ four other marketing methods to support our brands: public relations, events, tastings and marketing to celebrities. We continue to have a significant public relations effort in the United States, which has helped gain important editorial coverage for our brands. Event sponsorship is an economical way for us to have our brands tasted by influential consumers, and we actively contribute product to trend-setting events where our brand has exclusivity in the brand category. We also conduct hundreds of in-store and on-premise promotions each year. In addition, we provide our products to celebrities appearing on various television programs.

We support our marketing efforts for our brands with a wide assortment of point-of-sale materials such as mirrors, banners, glassware, table tents, shelf talkers, case cards, napkins and apparel. The combination of trade and consumer programs, supported by attractive point-of-sale materials, also establishes greater credibility for us with our distributors and retailers.

We also place a significant emphasis on our bottle design, labeling and packaging to establish and reinforce the image of our brands. For instance, we recently introduced a significantly redesigned and upgraded Boru vodka bottle designed by the design firm of Claessens International.

### **Strategic brand-partner relationships**

A key component of our growth strategy and one of our competitive strengths is our ability to forge strategic relationships with owners of both emerging and established spirits brands seeking opportunities to increase their sales beyond their home markets and achieve global growth. Our original relationship with the Boru vodka brand was as its exclusive U.S. distributor. To date, we have also established strategic relationships with respect to Gosling's rum, the Pallini liqueurs and Celtic Crossing, all of which relationships are described below, and we will endeavor to continue expanding our brand portfolio through similar such arrangements in the future.

#### ***Gaelic Heritage Corporation Limited/Celtic Crossing***

In March 1998, we entered into an exclusive national distribution agreement with Gaelic Heritage Corporation Limited, an affiliate of Terra Limited, one of our suppliers, which was subsequently amended in April 2001, pursuant to which we acquired from Gaelic a 60% ownership interest, and our importer, MHW, acquired a 10% ownership interest, in the Celtic Crossing brand in the United States, Canada, Mexico, Puerto Rico and the islands between North and South America. We also have the right to acquire 70% of the ownership of the Celtic Crossing brand in the remainder of the world. We also acquired the exclusive right to distribute Celtic Crossing on a world-wide basis. Under the terms of the agreement with Gaelic, as amended, we have the right to purchase from Gaelic, based upon our forecasts, cases of Celtic Crossing at annually agreed costs and a royalty payment per case sold at various rates depending on the territory and type of case sold. During the term of the agreement, without the prior written consent of Gaelic, we may not distribute any other Irish liqueur unless it is bottled in Gaelic's (Terra's) facilities. Pursuant to the terms of the agreement, Gaelic provides us with €6.3 million (\$8.4 million) of product liability insurance. The agreement may be terminated, among other things, upon notification by either party that the other party has materially breached the agreement and such breach is not cured within 60 days of the date such notice is given.

#### ***I.L.A.R. S.p.A./Pallini liqueurs***

In August 2004, we entered into an exclusive marketing and distribution agreement with I.L.A.R. S.p.A., a family owned Italian spirits company founded in 1875, pursuant to which we obtained the long-term exclusive U.S. distribution rights with respect to its Pallini Limoncello liqueur and a right of first refusal on related brand extensions. We exercised such right with respect to its Pallini Raspicello and its Pallini Peachcello in May 2005 and commenced shipment of such products in September 2005.

During the period through December 31, 2007, we have the right to purchase Limoncello at a stipulated price subject to one adjustment in 2006 or 2007 to reflect the inflation rate in the Italian economy and subject to further adjustment for raw material increases of 5% or more during any quarter to the extent the increase is above the rate of inflation and only for the period the increase is maintained. After 2007, I.L.A.R. has the discretion to raise prices as long as the price increases do not exceed those of major competitors for comparable products. I.L.A.R. is required to maintain certain product standards, and we have input into adjustments of the product and packaging. We are required to prepare a preliminary annual strategy plan for advertising and distribution for review and are required to make certain advertising, marketing and promotional expenditures based on volume. The initial term of the agreement expires on December 31, 2009 and is automatically renewed for either three or five years, based on case sales in 2009. I.L.A.R. indemnifies us in the United States for claims arising out of compliance with U.S. laws or regulations or relating to the quality or fitness of products



and maintains \$5 million of insurance upon which we are named an additional insured. We indemnify I.L.A.R. for claims arising out of claims relating to the marketing, promotion, sale or distribution of the products and maintain \$5 million of standard product liability insurance upon which I.L.A.R. is the named insured. Additional agreements are pending regarding I.L.A.R.'s distribution of our products.

### ***Gosling-Castle Partners Inc./Gosling's rums***

Effective as of January 2005, we entered into a national distribution agreement with Gosling's Export (Bermuda) Limited, referred to as Gosling's Export, pursuant to which we obtained the exclusive right to distribute the Gosling's rum products, which have been produced by the Gosling family in Bermuda for over 150 years, and Gosling's rum-related gourmet food products in the United States. In February 2005, we expanded this relationship by purchasing a 60% controlling interest in a strategic export venture, now named Gosling-Castle Partners Inc., with the Gosling family. Gosling-Castle Partners was formed to enter into an export agreement with Gosling's Export that gives Gosling-Castle Partners the exclusive right to distribute Gosling's rum and related products on a world wide basis (other than in Bermuda) and assigns to Gosling-Castle Partners all of Gosling's Export's interest in our January 2005 U.S. distribution agreement with them. In exchange for the global distribution rights under the export agreement, Gosling-Castle Partners issued a note to Gosling's Export in the principal amount of \$2.5 million, which was paid in four equal installments of \$625,000 bi-annually through October 1, 2006. The export agreement has an initial term expiring in April 2020, subject to a 15 year extension if certain case sale targets are met. Under the terms of the export agreement, which commenced in April 2005, Gosling-Castle Partners is generally entitled to a stipulated share of the proceeds from the sale, if ever, of the ownership of any of the Gosling's brands to a third-party, through a sale of the stock of Gosling's Export or its parent, with the size of such share depending upon the number of case sales made during the twelve months preceding the sale. In addition, prior to selling the ownership of any of their brands that are subject to these agreements, Gosling's Export must first offer such brand to Gosling-Castle Partners and then to us. To obtain our interest in Gosling-Castle Partners, we contributed \$5.0 million to its capital, which amount consisted of \$100,000 in cash and a promissory note in the principal amount of \$4.9 million which was payable bi-annually through April 1, 2007. Pursuant to our arrangement with the Goslings, they have retained the right to act, through Gosling's Brothers Limited, as the sole supplier to Gosling-Castle Partners with respect to our Gosling's rum requirements.

### **Intellectual property**

Trademarks are an important aspect of our business. Our brands are protected by trademark registrations or are the subject of pending applications for trademark registration in the United States, the European Community and most other countries where we currently distribute the brand or have plans to distribute the brand. In some cases, the trademarks are registered in the names of our various subsidiaries and related companies. Generally, the term of a trademark registration varies from country to country, and, in the United States, trademark registrations need to be renewed every ten years. We will continue to register our trademarks in additional markets as we expand our distribution territories.

We have entered into distribution agreements for brands owned by third parties, such as the Pallini liqueurs and the Gosling's rums. The Pallini liqueurs and Gosling's rum brands are registered by their respective owners and we have the exclusive right to distribute the Gosling's rums on a worldwide basis (other than in Bermuda) and the Pallini liqueur brands in the United States. See "— Strategic brand-partner relationships."

Our unique "trinity" bottle is the subject of Irish and UK utility patents owned by The Roaring Water Bay (Research & Development) Company Limited and a U.S. Design patent owned by our subsidiary Castle Brands Spirits Company Limited. In December 2003, we entered into a license agreement with Roaring Water Bay (Research & Development) Company Limited whereby we obtained an exclusive license to use the patents for a five-year term ending in December 2008. The

license agreement provides for a royalty equal to 8% of the net invoice price of trinity bottle products covered by these patents sold or otherwise disposed of by us, subject to a maximum of €30,000 (\$40,005) per year. The license agreement also includes our right to acquire the patent registrations for the Trinity bottle for €90,000 (\$120,015).

### **Trademarks**

This annual report includes the names of our brands, which constitute trademarks or trade names which are proprietary to and/or registered in our name or in the name of one of our subsidiaries or related companies, including, but not limited to, Castle Brands<sup>™</sup>, Boru<sup>®</sup>, Crazzberry<sup>®</sup>, Brady's<sup>®</sup>, Knappogue Castle Whiskey<sup>®</sup>, Clontarf<sup>™</sup>, Jefferson's Bourbon<sup>™</sup>, Jefferson's Reserve<sup>®</sup>, Sam Houston Bourbon<sup>®</sup>, Sea Wynde<sup>®</sup>, Celtic Crossing<sup>®</sup> and British Royal Navy Imperial Rum<sup>™</sup>; and trademarks with respect to brands for which we have certain exclusive distribution rights and which are proprietary to and/or registered in the names of third parties, such as Pallini<sup>®</sup>, which is owned by I.L.A.R. S.p.A., and Gosling's<sup>™</sup>, Gosling's Black Seal<sup>®</sup>, Gosling's Gold Bermuda Rum<sup>™</sup> and Gosling's Old Rum<sup>™</sup> which are owned by Gosling Brothers Limited. This annual report also contains other brand names, trade names, trademarks or service marks of other companies and these brand names, trade names, trademarks or service marks are the property of those other companies.

### **Seasonality**

Our industry is subject to seasonality with peak sales in each major category generally occurring in the fourth calendar quarter, which is our third fiscal quarter. See "Risk Factors – Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future rendering quarter-to-quarter comparisons unreliable as indicators of performance."

### **Information systems**

We employ Microsoft Dynamics GP as our financial reporting system worldwide. This system is installed on our servers in New York and is accessible remotely by our personnel globally via secured Internet connection. We maintain local area networks, referred to as LANS, in our Houston, Dublin and New York offices. These LANS support email communication and Internet connectivity for these offices and, in addition, support such features as automatic data back-up and recovery in the event of a hardware failure at a local terminal. These LANS are maintained by professional third-party service providers at each location.

We have also entered into a 36-month contract in June 2005, with Dimensional Insight, Inc. for its InterReport service. Among other things, this service provides business intelligence regarding U.S. sales of our products held by our distributors, inventory levels at our distributors and shipments of our products from distributors to specific retailers, as well as reporting formats that compare this information against comparable prior year periods. We consider this to be an effective tool for our sales force and financial planners as it provides the feedback required to improve the accuracy of sales forecasting and inventory management, and the effectiveness of our sales and marketing promotions.

### **Competition**

We believe that we compete on the basis of quality, price, brand recognition and distribution strength. Our premium brands compete with other alcoholic and nonalcoholic beverages for consumer purchases, as well as for shelf space in retail stores, restaurant presence and wholesaler attention. In addition to the six major companies discussed below, we compete with numerous multinational producers and distributors of beverage alcohol products, many of which have greater resources than us.

Over the past ten years, the U.S. distilled spirits industry has undergone dramatic consolidation and realignment of brands and brand ownership. The number of major spirits importers in the United States has significantly declined due to mergers and brand ownership consolidation. While historically there were a substantial number of companies owning one or more major brands, today there are six major companies: Diageo, Pernod Ricard, Bacardi, Brown-Forman, Future Brands and Constellation Brands.

While these companies are the leading importers of spirits to the U.S. market, we believe that we are sometimes in a better position to partner with small to mid-size brands. Despite our relative capital position and resources with respect to our larger competitors, we have been able to compete with these larger companies in connection with entering into agency distribution agreements and acquiring brands by being more responsive to private and family-owned brands, utilizing flexibility in transaction structures and providing brand owners the option to retain local production and “home” market sales. Given our size relative to our major competitors, most of which have multi-billion dollar operations, we believe that we can generally provide greater focus on smaller brands and tailor structures based on individual preferences of brand owners.

By focusing on the premium segment of the market, in which products typically carry higher margins, and having an established, experienced sales force, we are often able to gain greater attention from our distributors than other companies of our size. Our U.S. regional sales managers, who average over 15 years of industry experience, provide long-standing relationships with distributor personnel and with their major customers. Finally, the continued consolidation among the major companies is expected to create an opportunity for small to mid-size spirits companies, such as ourselves, as distributors seek diversification among their suppliers.

### **Government regulation**

As holder of federal beverage alcohol permits, we are subject to the jurisdiction of the Federal Alcohol Administration Act (27 CFR Parts 19, 26, 27, 28, 29, 31, 71 and 252), U.S. Customs Laws (USC Title 19), Internal Revenue Code of 1986 (Subtitles E and F), and the Alcoholic Beverage Control Laws of all fifty states.

The Alcohol and Tobacco Tax and Trade Bureau of the United States Treasury Department regulates the spirits industry with respect to production, blending, bottling, sales and advertising and transportation of alcohol products. Also, each state regulates the advertising, promotion, transportation, sale and distribution of alcohol products within its jurisdiction. We are also required to conduct business in the United States only with holders of licenses to import, warehouse, transport, distribute and sell spirits.

In Europe, we are also subject to similar regulations related to the production of spirits, including, among others, the Food Hygiene Regulations 1950-1989 (Licensing Acts 1833-2004), European Communities (Hygiene of Foodstuffs) Regulations, 2000 (S.I. No. 165 of 2000), European Communities (Labeling, Presentation and Advertising of Food Stuffs) Regulations, 2002 (S.I. No. 483 of 2002), Irish Whiskey Act, 1980 (S.I. No. 33 of 1980), European Communities (Definitions, Description and Presentation of Spirit Drinks) Regulations, 1995 (S.I. No. 300 of 1995), Merchandise Marks Act 1970, Licensing Act 2003 and Licensing Act Northern Ireland Order 1996 covering the testing of raw materials used and the standards maintained in production processing, storage, labeling, distribution and taxation.

The advertising, marketing and sale of alcoholic beverages are subject to various restrictions in the United States and Europe. These range from a complete prohibition of the marketing of alcohol in some countries to restrictions on the advertising style, media and messages used.

Labeling of spirits is also regulated in many markets, varying from health warning labels to importer identification, alcohol strength and other consumer information. Specific warning statements related to risks of drinking beverage alcohol products are required to be included on all beverage alcohol products sold in the United States.

In the 18 U.S. control states, the state liquor commissions act in place of distributors and decide which products are to be purchased and offered for sale in their respective states. Products are selected for purchase and sale through listing procedures which are generally made available to new products only at periodically scheduled listing interviews. Products not selected for listings can only be purchased by consumers through special orders, if at all.

The distribution of alcohol-based beverages is also subject to extensive taxation both in the United States, at both the federal and state level, and internationally. Most foreign countries in which

we do business impose excise duties on distilled spirits, although the form of such taxation varies significantly from a simple application on units of alcohol by volume to intricate systems based on the imported or wholesale value of the product. Several countries impose additional import duty on distilled spirits, often discriminating between categories in the rate of such tariffs. Import and excise duties may have a significant effect on our sales, both through reducing the overall consumption of alcohol and through encouraging consumer switching into lower-taxed categories of alcohol.

We are also subject to regulations which limit or preclude certain persons with criminal records from serving as our officers or directors. In addition, certain regulations prohibit parties with consumer outlet ownership from becoming officers, directors or substantial shareholders.

We believe that we are in material compliance with all applicable federal, state and other regulations. However, we operate in a highly regulated industry which may be subject to more stringent interpretations of existing regulations. Future costs of compliance with changes in regulations could be significant.

Since we are importers of distilled spirits products produced primarily outside the United States, adverse effects of regulatory changes are more likely to materially affect earnings and our competitive market position rather than capital expenditures. Capital expenditures in our industry are normally associated with either production facilities or brand acquisition costs. Because we are not a U.S. producer, changes in regulations affecting production facility operations may indirectly affect the costs of the brands we purchase for resale, but we would not anticipate any resulting material adverse impact upon our capital expenditures.

Because it is our intent to expand our brand portfolio, any regulatory revisions that increase the asset value of brands could have a material negative impact upon our ability to purchase such brands. More typically in our industry, however, the introduction of new and more restrictive regulations would have the opposite effect of reducing, rather than increasing, the asset value of brands directly impacted by more restrictive regulations.

We are a company in an industry dominated by global conglomerates with international brands. Therefore, to the extent that new more restrictive marketing and sales regulations are promulgated, or excise taxes and customs duties are increased, our earnings and competitive industry position could be materially adversely affected. Large international conglomerates have far greater financial resources than we do and would be better able to absorb increased compliance costs.

## **Employees**

As of March 31, 2007, we had 62 employees, of which 30 were in sales and 32 were in management, finance, marketing and administration. Of our employees, 43 are located in the United States and 19 are employed outside of the United States in countries including Ireland and Great Britain. In April and May of this year, we terminated our two employees in the United Kingdom.

## **Geographic Information**

We operate in one business – premium branded spirits. Our product categories are vodka, rum, liqueurs, and whiskey. We report our operations in two geographical areas: International and United States. See Note 19 of Notes to Consolidated Financial Statements.

## **Item 1A. Risk Factors**

### **Our future success is highly uncertain and cannot be predicted based upon our limited operating history.**

Although our predecessor was formed in 1998, most of our brands, including Boru vodka, our leading brand, have only been acquired or introduced by us since our formation in July 2003. As a result, compared to most of our current and potential competitors, we have a relatively short operating history and our brands are early in their growth cycle. Additionally, we anticipate acquiring

brands in the future that are unlikely to have established global brand recognition. Accordingly, it is difficult to predict when or whether we will be financially and operationally successful, making our business and future prospects difficult to evaluate.

**We have a history of losses, we expect to experience continuing losses for the foreseeable future, and we may never achieve profitability.**

We have incurred losses since inception and had an accumulated loss of \$60.0 million as of March 31, 2007. We believe that we will continue to incur sizeable net losses for the foreseeable future as we expect to make continued and significant investment in product development, and sales and marketing and to incur significant administrative expenses as we seek to grow our current and future brands. We also anticipate that our cash allocations will exceed our income from sales for the foreseeable future. Despite our anticipated aggressive marketing expenditures, our products may never achieve widespread market acceptance and may not generate sales and profits to justify our investment. In addition, we may find that our expansion plans are more costly than we currently anticipate and that they do not ultimately result in commensurate increases in our sales, which would further increase our losses. If we continue to incur expenses at a greater rate than our revenues, we may never achieve profitability.

**We may require additional capital to finance the acquisition of additional brands and to grow existing brands, and our inability to raise such capital on beneficial terms or at all could harm our operations and restrict our growth.**

We may require additional capital in the future on an accelerated basis to fund potential acquisitions of new brands, expansion of our product lines, and increased sales, marketing and advertising costs with respect to our existing and any newly acquired brands. If, at such time, we have not generated sufficient cash from operations to finance those additional capital needs, we will need to raise additional funds through private or public equity and/or debt financing. We cannot assure you that, if and when needed, additional financing will be available to us on acceptable terms or at all. If additional capital is needed and either unavailable or cost prohibitive, our growth may be limited as we may need to change our business strategy to slow the rate of, or eliminate, our expansion or reduce or curtail our operations. In addition, any additional financing we undertake could impose covenants upon us that restrict our operating flexibility, and, if we issue equity securities to raise capital, our existing stockholders may experience dilution or the new securities may have rights senior to those of our common stock.

**We are dependent on a limited number of suppliers. Failure to obtain satisfactory performance from our suppliers or loss of our existing suppliers could cause us to lose sales, incur additional costs and lose credibility in the marketplace. We also have annual purchase obligations with certain suppliers.**

We depend on a limited number of third-party suppliers for the sourcing of all of our products, including both our own proprietary brands and those we distribute for others. These suppliers consist of third-party distillers, bottlers and producers in the United States, Bermuda, the Caribbean and Europe. We rely on the owners of Gosling's rum and the Pallini liqueurs to produce their brands for us. With respect to our proprietary products, we, in several instances, rely on a single supplier to fulfill one or all of the manufacturing functions for one or more of our brands. For instance, The Carbery Group is the sole producer for Boru vodka, our leading brand; Irish Distillers Limited is the sole provider of our single malt, blended and grain Irish whiskeys; Gaelic Heritage Corporation Limited is the sole producer of our Celtic Crossing Irish liqueur; and Terra Limited is not only the sole producer of our Brady's Irish cream liqueur but also the only bottler of both our Boru vodka and our Irish whiskeys. We do not have long-term written agreements with all of our suppliers. In addition, if we fail to complete purchases of products ordered annually, certain suppliers have the right to bill us for product not purchased during the period. The termination of our written or oral agreements or an adverse change in the terms of these agreements could have a negative impact on our business. If our suppliers increase their prices, we may not have alternative sources of supply and may not be able to raise the prices of our products to cover all or even a portion of the increased costs. In addition, our

suppliers' failure to perform satisfactorily or handle increased orders, delays in shipments of products from international suppliers or the loss of our existing suppliers, especially our key suppliers, could cause us to fail to meet orders for our products, lose sales, incur additional costs and/or expose us to product quality issues. In turn, this could cause us to lose credibility in the marketplace and damage our relationships with distributors, ultimately leading to a decline in our business and results of operations.

**We cannot yet act as our own importer of record in the United States and rely entirely on MHW Ltd. to perform this function for us. The loss of its services could thus significantly interrupt our U.S. sales and harm our reputation, our business and our results of operations.**

In the United States, there is a three-tier distribution system for imported spirits: the imported brand is sold to a licensed importer; the importer sells the imported brand to a wholesale distributor; and the distributor sells the imported brand to retail liquor stores, bars, restaurants and other outlets in the states in which it is licensed to sell alcohol. While we own most of our brands, we cannot yet act as our own importer as we do not currently have any of the state licenses necessary to sell our products to the distributors. We have, as a result, historically depended on MHW Ltd. to serve in this capacity for us. In addition to acting as importer of record for us, MHW also provides and supervises storage and transportation of our products to local wholesale distributors and provides several accounting and payment related services to us. Until we are licensed in a majority of the states and bring these services in-house, the loss of MHW's services or its poor performance, either nationally or at a state level, could significantly interrupt or decrease our U.S. sales and harm our reputation, our business and our results of operations. In addition, while MHW purchases product from us to fill wholesale orders, MHW is not liable to us for any unpaid balances due from the distributors on these orders. Accordingly, the inability or failure of MHW to collect accounts receivable from our distributors could also cause a decline in our results of operations.

In addition, until recently, it was much more cost effective for us to use MHW as our U.S. importer and to rely on its state licenses rather than expend the resources necessary to set up the required licensing infrastructure internally. At this stage of our growth, however, we believe that our fees to MHW, which are based in part on our case sale volumes, are now reaching the point where it may be more economical for us to assume the role of importer ourselves. While we have commenced this process, we currently hold only the federal importer and wholesaler license required by the Alcohol and Tobacco Tax and Trade Bureau and a wholesale liquor license from the state of New York. Until we have obtained the requisite licenses in a majority of the states, we must continue to rely on MHW to perform the importing function for us and, if we continue to grow, pay increasing fees to it for these services.

**We are substantially dependent upon our independent wholesale distributors. The failure or inability of even a few of our distributors to adequately distribute our products within their territories could harm our sales and result in a decline in our results of operations.**

We are required by law to use state licensed distributors or, in 18 states known as "control states," state-owned agencies performing this function, to sell our products to retail outlets, including liquor stores, bars, restaurants and national chains in the United States. We have established relationships for our brands with wholesale distributors in each state; however, failure to maintain those relationships could significantly and adversely affect our business, sales and growth. Over the past decade there has been increasing consolidation, both intrastate and interstate, among distributors. As a result, many states now have only two or three significant distributors. In addition, there are several distributors that now control distribution for not just one state but several states. As a result, if we fail to maintain good relations with a distributor, our products could in some instances be frozen out of one or more markets entirely. The ultimate success of our products also depends in large part on our distributors' ability and desire to distribute our products to the desired U.S. target markets, as we rely significantly on them for product placement and retail store penetration. We have no formal distribution agreements or minimum sales requirements with any of our distributors and they are under no obligation to place our products or market our brands. Moreover, all of them also distribute

competitive brands and product lines. We cannot assure you that our U.S. alcohol distributors will continue to purchase our products, commit sufficient time and resources to promote and market our brands and product lines or that they can or will sell them to our desired or targeted markets. If they do not, our sales will be harmed, resulting in a decline in our results of operations.

While most of our international markets do not require the use of independent distributors by law, we have chosen to conduct our sales through distributors in all of our markets and, accordingly, we face similar risks to those set forth above with respect to our international distribution. Some of these international markets may have only a limited number of viable distributors. In the Republic of Ireland, one of our larger international markets, we have relied on Comans Wholesale Limited as the exclusive distributor of our leading brand, Boru vodka. We have delivered notice to Comans terminating our agreement with them as of September 30, 2007.

**The sales of our products could decrease significantly if we cannot secure and maintain listings in the control states.**

In the control states, the state liquor commissions act in place of distributors and decide which products are to be purchased and offered for sale in their respective states. Products selected for listing must generally reach certain volumes and/or profit levels to maintain their listings. Products are selected for purchase and sale through listing procedures which are generally made available to new products only at periodically scheduled listing interviews. Products not selected for listings can only be purchased by consumers through special orders, if at all. If, in the future, we are unable to maintain our current listings in the 18 control states, or secure and maintain listings in those states for any additional products we may acquire, sales of our products could decrease significantly.

**If we are unable to identify and successfully acquire additional premium brands that are complementary to our existing portfolio, our growth will be limited, and, even if they are acquired, we may not realize planned benefits due to integration difficulties or other operating issues.**

A key component of our growth strategy is the acquisition of additional premium spirits brands that are complementary to our existing portfolio through acquisitions of such brands or their corporate owners, either directly or through mergers, joint ventures, long-term exclusive distribution arrangements and/or other strategic relationships. If we are unable to identify suitable brand candidates and successfully execute our acquisition strategy, our growth will be limited. In addition, even if we are successful in acquiring additional brands, we may not be able to achieve or maintain profitability levels that justify our investment in, or realize operating and economic efficiencies or other planned benefits with respect to, those additional brands. The addition of new products or businesses entails numerous risks with respect to integration and other operating issues, any of which could have a detrimental effect on our results of operations and/or the value of our equity. These risks include:

- difficulties in assimilating acquired operations or products;
- unanticipated costs that could materially adversely affect our results of operations;
- negative effects on reported results of operations from acquisition related charges and amortization of acquired intangibles;
- diversion of management's attention from other business concerns;
- adverse effects on existing business relationships with suppliers, distributors and retail customers;
- risks of entering new markets or markets in which we have limited prior experience; and
- the potential inability to retain and motivate key employees of acquired businesses.

In addition, there are special risks associated with the acquisition of additional brands through joint venture arrangements. While we own a controlling interest in our Gosling-Castle Partners Inc. strategic export venture, we may not have the majority interest in, or control of, future joint ventures

that we may enter into. There is, therefore, risk that our joint venture partners may at any time have economic, business or legal interests or goals that are inconsistent with our interests or goals or those of the joint venture. There is also risk that our current or future joint venture partners may be unable to meet their economic or other obligations and that we may be required to fulfill those obligations alone.

Our ability to grow through the acquisition of additional brands will also be dependent upon the availability of capital to complete the necessary acquisition arrangements. We intend to finance our brand acquisitions through a combination of our available cash resources, bank borrowings and, in appropriate circumstances, the further issuance of equity and/or debt securities. Acquiring additional brands could have a significant effect on our financial position, and could cause substantial fluctuations in our quarterly and yearly operating results. Also, acquisitions could result in the recording of significant goodwill and intangible assets on our financial statements, the amortization or impairment of which would reduce reported earnings in subsequent years.

**Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future rendering quarter-to-quarter comparisons unreliable as indicators of performance.**

Our quarterly revenues and operating results have varied in the past due to seasonality of our industry and the timing of our major marketing campaigns and brand additions. For instance, in our industry peak sales in each major category generally occur in the fourth calendar quarter, which is our third fiscal quarter. As a result, our third fiscal quarter revenues (those for the quarter ending December 31) are generally higher than other quarters and, for the fiscal year ended March 31, 2007, accounted for approximately 29.3% of our revenues for that year. Our quarterly operating results are likely to continue to vary significantly from quarter to quarter in the future for the same reasons. As a result, we believe that quarter-to-quarter comparisons of our revenues and operating results are not meaningful indicators of performance.

**Currency exchange rate fluctuations and devaluations could cause a significant adverse effect on our revenues, sales and overall financial results.**

For the fiscal year ended March 31, 2007, non-U.S. operations accounted for approximately 33.7% of our revenues. Therefore, gains and losses on the conversion of foreign payments into U.S. dollars could cause fluctuations in our results of operations, and fluctuating exchange rates could cause reduced revenues and/or gross margins from non-U.S. dollar-denominated international sales. Also, for the fiscal year ended March 31, 2007, euro denominated sales accounted for approximately 21.5% of our total revenue and British pound denominated sales accounted for approximately 8.3% of our total revenue, so a substantial change in the rate of exchange between the U.S. dollar and the euro or British pound could have a significant adverse effect on our financial results. Our ability to acquire spirits and produce and sell our products at favorable prices will also depend in part on the relative strength of the U.S. dollar. We may not be able to hedge against these risks.

**Adverse public opinion about alcohol could reduce demand for our products.**

Anti-alcohol groups have, in the past, successfully advocated more stringent labeling requirements, higher taxes and other regulations designed to discourage consumption of beverage alcohol. More restrictive regulations, negative publicity regarding alcohol consumption and/or changes in consumer perceptions of the relative healthfulness or safety of beverage alcohol could decrease sales and consumption of alcohol and thus the demand for our products. This could, in turn, significantly decrease both our revenues and our revenue growth, causing a decline in our results of operations.

**Class action or other litigation relating to alcohol abuse or the misuse of alcohol could deplete our cash and divert our personnel resources and, if successful, significantly harm our business.**

Our industry faces the possibility of class action or other similar litigation alleging that the continued excessive use or abuse of beverage alcohol has caused death or serious health problems. It



is also possible that federal, state or foreign governments could assert that the use of alcohol has significantly increased government funded health care costs. Litigation or assertions of this type have adversely affected companies in the tobacco industry, and it is possible that we, as well as our suppliers, could be named in litigation of this type.

In addition, lawsuits have been brought recently in nine states alleging that beer and spirits manufacturers have improperly targeted underage consumers in their advertising. The plaintiffs in these actions claim that the defendants' advertising "disproportionately" targeted underage consumers, by using youthful themes, humor and other subjects that are attractive to young persons. Plaintiffs in these cases allege that the defendants' advertisements, marketing and promotions violate the consumer protection or deceptive trade practices statutes in each of these states and seek repayment of the family funds expended by the underage consumers. While we have not been named in these lawsuits, it is possible we could be named in similar lawsuits in the future. Any class action or other litigation asserted against us could be expensive and time consuming to defend against, depleting our cash and diverting our personnel resources and, if the plaintiffs in such actions were to prevail, our business could be harmed significantly.

**Either our or our strategic partners' failure to protect our respective trademarks, service marks and trade secrets could compromise our competitive position and decrease the value of our brand portfolio.**

Our business and prospects depend in part on our, and with respect to our agency or joint venture brands, our strategic partners', ability to develop favorable consumer recognition of our brands and trademarks. Although both we and our strategic partners actively apply for registration of our brands and trademarks, they could be imitated in ways that we cannot prevent. In addition, we rely on trade secrets and proprietary know-how, concepts and formulas. Our methods of protecting this information may not be adequate. Moreover, we may face claims of misappropriation or infringement of third parties' rights that could interfere with our use of this information. Defending these claims may be costly and, if unsuccessful, may prevent us from continuing to use this proprietary information in the future and result in a judgment or monetary damages being levied against us. We do not maintain non-competition agreements with all of our executives and key personnel or with some of our key suppliers. If competitors independently develop or otherwise obtain access to our or our strategic partners' trade secrets, proprietary know-how or recipes, the appeal, and thus the value, of our brand portfolio could be reduced, negatively impacting our sales and growth potential.

**We depend on our key personnel. If we lose the services of any of these individuals or fail to hire and retain additional management personnel as we grow, we may not be able to implement our business strategy or operate our business effectively.**

We rely on a small number of key individuals to implement our plans and operations, including Mark Andrews, our chairman and chief executive officer, Keith A. Bellinger, our president and chief operating officer, and T. Kelley Spillane, our senior vice president – U.S. sales, as well as our other executive officers and our regional and foreign sales managers. While we currently maintain key person life insurance coverage on the lives of Messrs. Andrews, Bellinger and Spillane, that insurance may not be available to us in the future or the proceeds therefrom may not be adequate to replace the services of these managers. To the extent that the services of any of these individuals become unavailable, we will be required to hire other qualified personnel, and we may not be successful in finding or hiring adequate replacements. As a result, if we lose the services of any of these individuals, we may not be able to implement our business strategy or operate our business effectively. Further, our management of future growth and our successful integration of any acquired brands or companies will require substantial additional attention from our senior management team and require us to retain additional qualified management personnel and to attract and train new personnel. Failure to successfully retain and hire needed personnel to manage our growth and development would harm our ability to implement our business plan and grow our business.

In addition, in recent periods, we have experienced turnover at the Chief Financial Officer position, with two CFO departures within the last eight months. Keith A. Bellinger has resumed

responsibilities as our principal financial officer while a search for a new CFO is underway. While we have hired a consultant, Donald Marsh, to assist our management team in the management and execution of finance-related matters, the absence of a CFO may result in the Company being unable to maximize certain efficiencies within its finance department.

**Regulatory decisions and changes in the legal, regulatory and tax environment in the countries in which we operate could limit our business activities or increase our operating costs and reduce our margins.**

Our business is subject to extensive regulation regarding production, distribution, marketing, advertising and labeling of beverage alcohol products in all of the countries in which we operate. We are required to comply with these regulations and to maintain various permits and licenses. We are also required to conduct business only with holders of licenses to import, warehouse, transport, distribute and sell spirits. We cannot assure you that these and other governmental regulations applicable to our industry will not change or become more stringent. Moreover, because these laws and regulations are subject to interpretation, we may not be able to predict when and to what extent liability may arise. Additionally, due to increasing public concern over alcohol-related societal problems, including driving while intoxicated, underage drinking, alcoholism and health consequences from the abuse of alcohol, various levels of government may seek to impose additional restrictions or limits on advertising or other marketing activities promoting beverage alcohol products. Failure to comply with any of the current or future regulations and requirements relating to our industry and products could result in monetary penalties, suspension or even revocation of our licenses and permits, or those of MHW on whom we are currently dependent to import and distribute our products in the United States. Costs of compliance with changes in regulations could be significant and could harm our business, as we could find it necessary to raise our prices in order to maintain profit margins, which could lower the demand for our products and reduce our sales and profit potential.

In addition, the distribution of beverage alcohol products is subject to extensive taxation both in the United States and internationally (and, in the United States, at both the federal and state government levels), and beverage alcohol products themselves are the subject of national import and excise duties in most countries around the world. An increase in taxation or in import or excise duties could also significantly harm our sales revenue and margins, both through the reduction of overall consumption and by encouraging consumers to switch to lower-taxed categories of beverage alcohol.

**We could face product liability or other related liabilities that increase our costs of operations and harm our reputation.**

Although we maintain liability insurance and will attempt to limit contractually our liability for damages arising from our products, these measures may not be sufficient for us to successfully avoid or limit liability. Our product liability insurance coverage is limited to \$1.0 million per occurrence and \$2.0 million in the aggregate and our general liability umbrella policy is capped at \$10.0 million. Further, any contractual indemnification and insurance coverage we have from parties supplying our products is limited, as a practical matter, to the creditworthiness of the indemnifying party and the insured limits of any insurance provided by these suppliers. In any event, extensive product liability claims could be costly to defend and/or costly to resolve and could harm our reputation.

**Contamination of our products and/or counterfeit or confusingly similar products could harm the image and integrity of, or decrease customer support for, our brands and decrease our sales.**

The success of our brands depends upon the positive image that consumers have of them. Contamination, whether arising accidentally or through deliberate third-party action, or other events that harm the integrity or consumer support for our brands, could affect the demand for our products. Contaminants in raw materials purchased from third parties and used in the production of our products or defects in the distillation process could lead to low beverage quality as well as illness among, or injury to, consumers of our products and could result in reduced sales of the affected brand or all of our brands. Also, to the extent that third parties sell products that are either counterfeit

versions of our brands or brands that look like our brands, consumers of our brands could confuse our products with products that they consider inferior. This could cause them to refrain from purchasing our brands in the future and in turn could impair our brand equity and adversely affect our sales and operations.

**We must maintain a relatively large inventory of our products to support customer delivery requirements, and if this inventory is lost due to theft, fire or other damage or becomes obsolete, our results of operations would be negatively impacted.**

We must maintain relatively large inventories to meet customer delivery requirements for our products. We are always at risk of loss of that inventory due to theft, fire or other damage, and any such loss, whether insured against or not, could cause us to fail to meet our orders and harm our sales and operating results. In addition, our inventory may become obsolete as we introduce new products, cease to produce old products or modify the design of our products' packaging, which would increase our operating losses and negatively impact our results of operations.

**We have a material amount of goodwill and other intangible assets. If, as a result of newly adopted accounting standards, we are in the future required to write down a portion of this goodwill and other intangible assets, it would increase our net loss.**

As of March 31, 2007, goodwill represented approximately \$13.6 million, or 25.0%, of our total assets and other intangible assets represented approximately \$13.2 million, or 24.2%, of our total assets. Goodwill is the amount by which the costs of an acquisition accounted for using the purchase method exceed the fair value of the net assets acquired. Under Statement of Financial Accounting Standards No. 142 entitled "Goodwill and Other Intangible Assets," goodwill and indefinite lived intangible assets are no longer amortized, but instead are subject to a periodic impairment evaluation based on the fair value of the reporting unit. Any write-down of goodwill or intangible assets resulting from future periodic evaluations would increase our net loss and those increases could be material.

**Our existing and future debt obligations could impair our liquidity and financial condition.**

As of March 31, 2007, we had total consolidated indebtedness of approximately \$18.8 million. We may incur additional debt in the future to fund all or part of our capital requirements. Our outstanding debt and future debt obligations could impair our liquidity and could:

- make it more difficult for us to satisfy our other obligations;
- require us to dedicate a substantial portion of any cash flow we may generate to payments on our debt obligations, which would reduce the availability of our cash flow to fund working capital, capital expenditures and other corporate requirements;
- impede us from obtaining additional financing in the future for working capital, capital expenditures, acquisitions and general corporate purposes; and
- make us more vulnerable in the event of a downturn in our business prospects and limit our flexibility to plan for, or react to, changes in our industry.

If we were to fail in the future to make any required payment under agreements governing our indebtedness or fail to comply with the financial and operating covenants contained in those agreements, we would be in default as regards to that indebtedness. If the lenders were to require immediate payment, we might not have sufficient assets to satisfy our obligations under our credit facility, our subordinated notes or our other indebtedness. Our lenders would have the ability to require that we immediately pay all outstanding indebtedness, and we might not have sufficient assets to satisfy their demands. In such event, we could be forced to seek protection under bankruptcy laws, which could significantly harm our reputation and sales.

**We may not be able to maintain our listing on the American Stock Exchange, which may limit the ability of our stockholders to resell their common stock in the secondary market.**

Although we are currently listed on the American Stock Exchange, we might not meet the criteria for continued listing on the American Stock Exchange in the future. If we are unable to meet

the continued listing criteria of the American Stock Exchange and became delisted, trading of our common stock could be conducted in the Over-the-Counter Bulletin Board. In such case, an investor would likely find it more difficult to dispose of our common stock or to obtain accurate market quotations for it. If our common stock is delisted from the American Stock Exchange, it will become subject to the Securities and Exchange Commission's "penny stock rules," which impose sales practice requirements on broker-dealers that sell that common stock to persons other than established customers and "accredited investors." Application of this rule could make broker-dealers unable or unwilling to sell our common stock and limit the ability of purchasers in this offering to resell their common stock in the secondary market.

**Our executive officers, directors and principal stockholders own a substantial percentage of our voting stock, which likely allows them to control matters requiring stockholder approval. They could make business decisions for us that cause our stock price to decline.**

As of June 27, 2007, our executive officers, directors and principal stockholders beneficially owned approximately 40% of our common stock, including warrants, options and convertible notes that are exercisable for, or convertible into, shares of our common stock within 60 days of the date of this annual report. As a result, if they act in concert, they could control matters requiring approval by our stockholders, including the election of directors, and could have the ability to prevent or cause a corporate transaction, even if other stockholders, oppose such action. This concentration of voting power could also have the effect of delaying, deterring, or preventing a change of control or other business combination, which could cause our stock price to decline.

**Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our ability to produce accurate financial statements and on our stock price.**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, we will be required to furnish a report by our management on our internal control over financial reporting by March 31, 2008. We have not been subject to these requirements in the past. The internal control report must contain (a) a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, (b) a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of our internal control over financial reporting, (c) management's assessment of the effectiveness of our internal control over financial reporting as of the end of our most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective, and (d) for the fiscal year ending March 31, 2009, a statement that our independent registered public accounting firm has issued an attestation report on management's assessment of internal control over financial reporting.

To achieve compliance with Section 404 within the prescribed period, we are engaged in a process to document and evaluate our internal control over financial reporting, which is both costly and challenging. In this regard, we will continue to dedicate internal resources, engage outside consultants and adopt a detailed work plan to (a) assess and document the adequacy of internal control over financial reporting, (b) take steps to improve control processes where appropriate, (c) validate through testing that controls are functioning as documented, and (d) implement a continuous reporting and improvement process for internal control over financial reporting. Despite our efforts, we can provide no assurance as to our, or our independent registered public accounting firm's, conclusions with respect to the effectiveness of our internal control over financial reporting under Section 404. There is a risk that neither we nor our independent registered public accounting firm will be able to conclude within the prescribed timeframe that our internal controls over financial reporting are effective as required by Section 404. This could result in an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements.

**Provisions in our amended and restated certificate of incorporation, our amended and restated bylaws and Delaware law could make it more difficult for a third party to acquire us, discourage a takeover and adversely affect existing stockholders.**

Our amended and restated certificate of incorporation, our amended and restated bylaws and the Delaware General Corporation Law contain provisions that may have the effect of making more difficult, delaying, or deterring attempts by others to obtain control of our company, even when these attempts may be in the best interests of our stockholders. These include provisions limiting the stockholders' powers to remove directors or take action by written consent instead of at a stockholders' meeting. Our amended and restated certificate of incorporation also authorizes our board of directors, without stockholder approval, to issue one or more series of preferred stock, which could have voting and conversion rights that adversely affect or dilute the voting power of the holders of our common stock. Delaware law also imposes conditions on the voting of "control shares" and on certain business combination transactions with "interested stockholders."

These provisions and others that could be adopted in the future could deter unsolicited takeovers or delay or prevent changes in our control or management, including transactions in which stockholders might otherwise receive a premium for their shares over then current market prices. These provisions may also limit the ability of stockholders to approve transactions that they may deem to be in their best interests.

**We do not expect to pay any dividends for the foreseeable future. Our stockholders may never obtain a return on their investment.**

We do not anticipate that we will pay any dividends to holders of our common stock in the foreseeable future. Instead, we plan to retain any earnings to maintain and expand our existing operations, further develop our brands and finance the acquisition of additional brands. In addition, our ability to pay dividends is prohibited by the terms of our 6% convertible notes and we expect that any future credit facility will contain terms prohibiting or limiting the amount of dividends that may be declared or paid on our common stock. Accordingly, investors must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any return on their investment.

**Item 1B. Unresolved Staff Comments.**

Not applicable.

**Item 2. Properties**

Our executive offices are located in New York, New York, where we lease approximately 3,800 square feet of office space under a sublease that expires on March 30, 2008. We also lease approximately 7,500 square feet of office space in Dublin, Ireland under a lease that expires on February 28, 2009 and approximately 1,000 square feet of office space in Houston, Texas under a lease that expires on March 31, 2008.

**Item 3. Legal Proceedings**

Except as described below, we believe that neither we nor any of our wholly owned subsidiaries is currently subject to litigation which, in the opinion of our management, is likely to have a material adverse effect on us.

Our subsidiary, Castle Brands Spirits Company Limited, is the holder of a trademark registration for the mark "BORU" with the United States Patent and Trademark Office. On May 9, 2007, Distillerie Stock U.S.A. Ltd. filed a Petition for Cancellation with the United States Patent and Trademark Office for the cancellation of the trademark registration for BORU on several grounds, including potential confusion between BORU and its existing registered trademark "BORA". We have various defenses on the merits as well as procedural defenses which we expect to file in a timely

manner against Distillerie Stock's claims. We intend to vigorously pursue these defenses as appropriate. Currently, the matter is pending at the United States Patent and Trademark Office before the Trademark Trial and Appeal Board. While matters before the Trademark Trial and Appeal Board cannot result in monetary damages or directly affect the right to use a trademark, they can result in the cancellation of a trademark registration. Thus, it is possible this matter could result in the cancellation of our trademark registration for BORU in the United States. As a result, it is not feasible to predict the final outcome, and there can be no assurance that these claims might not be finally resolved adversely to us, resulting in material liability to our operations.

We may, however, become involved in litigation from time to time relating to claims arising in the ordinary course of our business. These claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

## PART II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

#### *Price range of common stock*

The following table describes the per share range of high and low sales prices for our common stock, as reported by the American Stock Exchange. On April 6, 2006, our common stock began trading on the American Stock Exchange under the symbol "ROX."

<u>Fiscal Quarter</u>	<u>High</u>	<u>Low</u>
First Quarter (April 6 – June 30, 2006).....	\$9.15	\$5.95
Second Quarter (July 1 – September 30, 2006) .....	\$7.90	\$5.50
Third Quarter (October 1 – December 31, 2006) .....	\$7.55	\$5.56
Fourth Quarter (January 1 – March 31, 2007) .....	\$7.48	\$5.03

As of June 28, 2007, there were 187 stockholders of record of our common stock. This does not include the number of persons whose stock is in nominee or "street name" accounts through brokers.

#### *Dividend policy*

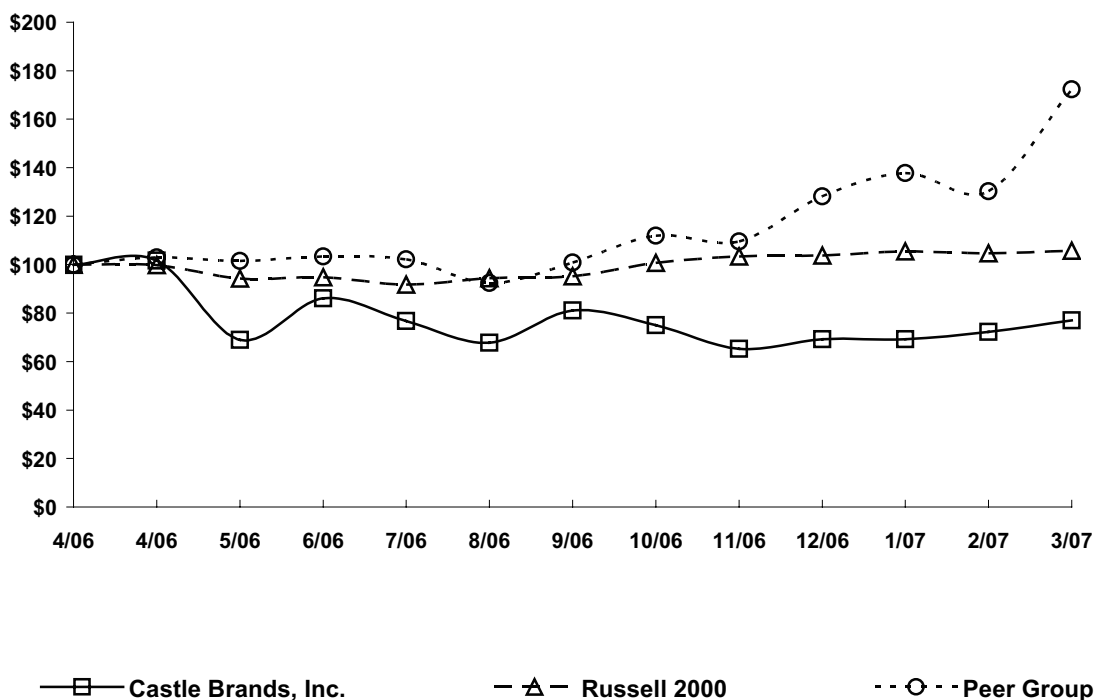
We have never declared or paid any cash dividends on our capital stock other than \$1,389,765 dividends we paid in shares of our common stock to our preferred stockholders upon the consummation of our initial public offering. We do not intend to pay any cash dividends with respect to our common stock in the foreseeable future. We currently intend to retain any earnings for use in the operation of our business and to fund future growth. In addition, our ability to pay dividends is subject to the consent of the holders of our 6% convertible notes and we expect that any future credit facility will contain terms prohibiting or limiting the amount of dividends that may be declared or paid on our common stock. Any future determination to pay cash dividends will be at the discretion of our board of directors and will depend upon our financial condition, operating results, capital requirements and such other factors as the board of directors deems relevant.

## COMPARISON OF CUMULATIVE TOTAL RETURN

The following graph compares the cumulative total stockholder return on our common stock from April 6, 2006 (the date trading of our common stock began on the American Stock Exchange) through March 31, 2007 to the cumulative total return for (i) the Russell 2000 Index (the “Russell 2000 Index”) and (ii) a peer group that we selected that consists of alcoholic and non-alcoholic beverage companies. The peer group is comprised of Wilamette Valley Vineyards, Inc., Scheid Vineyards Inc., Drinks Americas Holdings, Ltd., Lifeway Foods Inc. and Jones Soda Co. (the “Peer Index”). Total return values were calculated based on cumulative total return assuming the investment, at the closing price on April 6, 2006, of \$100 in each of our common stock, the Russell 2000 Index, and the Peer Index. In calculating total annual stockholder return, reinvestment of dividends, if any, is assumed. The indices are included for comparative purpose only. They do not necessarily reflect management’s opinion that such indices are an appropriate measure of the relative performance of our common stock. This graph is not “soliciting material,” is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference in any of our filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

### COMPARISON OF 1 YEAR CUMULATIVE TOTAL RETURN\*

Among Castle Brands Inc., the Peer Index  
And the Russell 2000 Index



\* \$100 invested on 4/6/06 in stock or index-including reinvestment of dividends. Fiscal year ending March 31.

### Item 6. Selected Consolidated Financial Data

The following tables set forth selected consolidated financial data and other data for the periods ended and as of the dates indicated. The selected consolidated financial data for the fiscal years ended March 31, 2007, 2006, 2005, 2004 and 2003 has been derived from our historical audited consolidated financial statements. You should read the following selected consolidated financial data and other data in conjunction with our consolidated financial statements, including the related notes, and the section entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included elsewhere in this Annual Report on Form 10-K.



The “other data” presented below relates to our case sales, which are measured based on the industry standard of nine-liter equivalent cases, an important measure in our industry that we use to evaluate the effectiveness of our operational strategies and overall financial performance. We believe that by providing this information investors can better assess trends in our business. Net sales per case is total net sales for the applicable period presented, divided by the total number of cases sold during the period. Gross profit per case and selling expense per case are derived by dividing our gross profit and selling expense, respectively, for the applicable period presented by the number of cases sold for such period.

	<b>Years ended March 31,</b>				
	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Consolidated statement of operations data</b>					
(in thousands, except per share data):					
Sales, net . . . . .	\$ 25,164	\$ 21,150	\$ 12,618	\$ 4,827	\$ 2,419
Cost of sales . . . . .	16,780	13,656	8,745	3,285	1,427
Gross profit . . . . .	8,384	7,494	3,873	1,542	992
Selling expense . . . . .	16,766	13,048	11,569	5,398	3,348
General and administrative expense . . . . .	8,646	5,493	3,637	1,960	818
Depreciation and amortization . . . . .	1,001	907	323	226	73
Operating loss . . . . .	(18,029)	(11,954)	(11,656)	(6,042)	(3,247)
Other income . . . . .	5	4	124	2	0
Other expense . . . . .	(47)	(37)	(46)	(82)	(3)
Foreign exchange gain/(loss) . . . . .	1,360	(338)	120	(85)	(8)
Interest expense, net . . . . .	(1,085)	(1,579)	(998)	(304)	(182)
Write-off of deferred financing costs in connection with conversion of 6% subordinated convertible notes . . . . .	(295)	—	—	—	—
Current credit/(charge) on derivative financial instrument . . . . .	118	16	(77)	26	9
Income tax benefit . . . . .	148	148	—	—	—
Minority interests . . . . .	1,267	656	5	35	—
Net loss . . . . .	\$(16,558)	\$(13,084)	\$(12,528)	\$(6,450)	\$(3,431)
Less: Preferred stock and preferred membership unit dividends . . . . .	48	1,596	1,252	761	15
Net loss attributable to common stockholders . . . . .	\$(16,606)	\$(14,680)	\$(13,780)	\$(7,211)	\$(3,446)
Net loss per common share basic and diluted (1) . . . . .	\$ (1.40)	\$ (4.73)	\$ (4.44)	\$ (3.22)	\$ (1.87)
Weighted average shares outstanding basic and diluted (1) . . . . .	11,898	3,107	3,107	2,237	1,841
<b>Other data (unaudited):</b>					
Number of case sales . . . . .	314,644	267,052	170,060	64,013	21,708
Net sales per case . . . . .	\$ 79.98	\$ 79.20	\$ 74.20	\$ 75.41	\$111.44
Gross profit per case . . . . .	\$ 26.65	\$ 28.06	\$ 22.77	\$ 24.08	\$ 45.68
Selling expense per case . . . . .	\$ 53.29	\$ 48.86	\$ 68.03	\$ 84.33	\$154.24

(1) Net loss per common share basic and diluted was positively affected by the increase in shares outstanding resulting from the shares issued and converted in our initial public offering.

**Selected balance sheet data (in thousands):**

	<b>As of March 31,</b>				
	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Cash equivalents and short-term investments. . . . .	\$ 6,917	\$ 1,392	\$ 5,676	\$ 3,461	\$ 236
Working capital (deficit) . . . . .	17,084	(799)	5,665	4,541	(229)
Total assets . . . . .	54,526	43,644	42,926	27,707	4,528
Total debt . . . . .	18,779	25,431	16,362	4,095	2,158
Total liabilities . . . . .	29,566	38,546	26,511	8,506	3,947
Total stockholders' equity (deficiency) . . . . .	23,553	(26,024)	(12,125)	928	(1,436)

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. This discussion and analysis contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of many factors, including, but not limited to, those described under "Risk Factors" and elsewhere in this Annual Report on Form 10-K.

### **Overview**

We develop and market premium branded spirits in several growing market categories, including vodka, rum, whiskey and liqueurs, and we distribute these spirits in all 50 U.S. states and the District of Columbia, in six key international markets, including Ireland, Great Britain, Northern Ireland, Germany, Canada and the Duty Free markets, and in a number of other countries in continental Europe. The brands we market include, among others, Boru vodka, Gosling's rum, Clontarf Irish Whiskey, Knappogue Castle Whiskey, Jefferson's, Jefferson's Reserve and Sam Houston bourbons and the Pallini liqueurs.

Our current growth strategy focuses on: (a) aggressive brand development to encourage case sale and revenue growth of our existing portfolio of brands through significant investment in sales and marketing activities, including advertising, promotion and direct sales personnel expense; and (b) the selective addition of complementary premium brands through a combination of strategic initiatives, including acquisitions, joint ventures and long-term exclusive distribution arrangements.

### ***Corporate structure***

Castle Brands Inc. is the successor to Great Spirits Company, LLC, a Delaware limited liability company.

Great Spirits Company, LLC was formed in February 1998. In December 2002, Great Spirits Company formed a wholly owned subsidiary, Great Spirits (Ireland) Limited, to market its products internationally. Shortly thereafter, Great Spirits Company determined to convert from a limited liability company to a C Corporation and to acquire two Irish operating companies, The Roaring Water Bay Spirits Company Limited and The Roaring Water Bay Spirits Company (GB) Limited.

In order to effect these changes, in July 2003, Castle Brands Inc. was formed as a holding company (initially called GSRWB, Inc.) and along with its wholly owned subsidiary, Castle Brands (USA) Corp. (initially called Great Spirits Corp.), under the laws of Delaware. In December 2003, we then merged Great Spirits Company into Castle Brands (USA) Corp., referred to as CB-USA, and CB-USA became our U.S. operating subsidiary.

Simultaneously with the foregoing merger, Castle Brands Inc. acquired:

- (a) The Roaring Water Bay Spirits Group Limited, the shell holding company that owned the stock of The Roaring Water Bay Spirits Company Limited, and changed the names of this shell holding company and its operating entity to Castle Brands Spirits Group Limited, referred to as CB-Ireland, and Castle Brands Spirits Company Limited, respectively. In connection with this acquisition, Castle Brands Spirits Company Limited became our Irish operating subsidiary; and
- (b) The Roaring Water Bay Spirits Marketing and Sales Company Limited, the shell holding company that owned the stock of The Roaring Water Bay Spirits Company (GB) Limited, and changed the names of this shell holding company and its operating entity to Castle Brands Spirits Marketing and Sales Company Limited, referred to as CB-UK, and Castle Brands Spirits Company (GB) Limited, respectively. In connection with this acquisition, Castle Brands Spirits Company (GB) Limited became our UK operating subsidiary.

In February 2005, Castle Brands Inc. acquired 60% of the shares of Gosling-Castle Partners Inc., which holds the worldwide distribution rights (excluding Bermuda) to the Gosling's rums and related products.

In October 2006, Castle Brands Inc. acquired all of the outstanding shares of McLain & Kyne, Ltd. (“McLain & Kyne”) pursuant to Stock Purchase Agreement. McLain & Kyne is a Louisville, Kentucky based developer and marketer of three premium small batch bourbons: Jefferson’s Reserve, Jefferson’s and Sam Houston.

### ***Strategic transactions***

A review and understanding of our historical growth during the past three fiscal years should consider the timing of our strategic transactions. These transactions for our company and our predecessor companies are outlined below. In addition to the impact of these transactions, we have had significant growth in our own brands and will continue to focus on developing those brands.

*Roaring Water Bay acquisition.* On December 1, 2003, in connection with our acquisition of The Roaring Water Bay Spirits Group Limited and The Roaring Water Bay Spirits Company (GB) Limited and their related entities, referred to collectively as Roaring Water Bay, described above, we added the Boru vodka, Clontarf Irish whiskey and Brady’s Irish cream brands to our portfolio. While we were already selling Boru vodka in the United States pursuant to the 2002 distribution agreement, the acquisition added significant Boru vodka sales internationally, principally in the Republic of Ireland and the United Kingdom. This acquisition is reflected in our financial results for the last four months of our fiscal year ended March 31, 2004 and in all subsequent periods.

*Pallini liqueur distribution agreement.* On August 17, 2004, we signed an exclusive U.S. marketing and distribution agreement for the Pallini liqueurs. Sales of those products are reflected in our results for the fiscal year ended March 31, 2005, commencing as of August 2004, and in all subsequent periods.

*Gosling’s rum distribution agreement.* On January 1, 2005, we signed an exclusive U.S. distribution agreement for the Gosling’s rums. Gosling’s rum sales are reflected in our financial results for the last three months of the fiscal year ended March 31, 2005 and in all subsequent periods.

*Gosling-Castle Partners export venture.* On February 18, 2005, we reached agreement to expand our Gosling’s relationship by acquiring a 60% interest in a newly formed global export venture with the Gosling family, now named Gosling-Castle Partners, Inc., that had been formed to acquire, through an export agreement, the exclusive distribution rights for Gosling’s rums worldwide, except for the Gosling’s home market of Bermuda, including an assignment to such venture of the Gosling’s rights under our January 2005 distribution agreement. This export agreement became effective on April 1, 2005. The financial results of Gosling- Castle Partners are included in our consolidated financial statements commencing as of our February 2005 purchase of such interest, with adjustments for minority interest; however, it had no meaningful operations prior to the April 1, 2005 commencement of the export agreement.

*McLain & Kyne acquisition.* On October 12, 2006, as a result of our acquisition of all of the outstanding stock of McLain & Kyne, Ltd (f/k/a McLain & Kyne Distillery, Ltd.), we added McLain & Kyne’s premium small batch bourbons to our portfolio: Jefferson’s, Jefferson’s Reserve and Sam Houston. The financial results of this acquisition are included in our financial statements commencing October 13, 2006 and in all subsequent periods.

### ***Operations overview***

We generate revenue through the sale of our premium spirits to our network of wholesale distributors or, in control states, state-owned agencies, which, in turn, distribute our premium brands to retail outlets. A number of factors affect our overall level of sales, including the number of cases sold, revenue per case, relative contribution by brand and geographic mix. Changes in any of these factors may have a material impact on overall sales. We introduced the new Boru vodka bottle design in April 2007 in the U.S., and will introduce it in the international markets starting in September 2007. During fiscal 2007 we are launching an advertising campaign that will feature our new bottle design for Boru vodka. This represents a significant upgrade in packaging and brings the product more in line with its brand positioning. In the United States, our sales price per case includes excise tax and import

duties, which are also reflected in a corresponding increase in our cost of sales. Most of our international sales are sold “in bond,” with the excise taxes paid by our customers upon shipment, thereby resulting in lower relative revenue as well as a lower relative cost of sales, although some of our United Kingdom sales are sold “tax paid,” as in the United States. Our sales typically peak during the months of October through December in anticipation of, and during, the holiday season. See “Risk Factors – Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future rendering quarter-to-quarter comparisons unreliable as indicators of performance.” The difference between sales and net sales principally reflects adjustments for various distributor incentives.

Our gross profit is determined by the prices at which we are able to sell our products, our ability to control our cost of sales, the relative mix of our case sales by brand and geography and the impact of foreign currency fluctuations. Our cost of sales is principally driven by our cost of procurement, bottling and packaging, which differ by brand, as well as freight and warehousing costs. We purchase certain of our products, such as the Gosling’s rums and Pallini liqueurs, as finished goods. For other products, we purchase the components of our products, including the distilled spirits, bottles and packaging materials, and have arrangements with third parties for bottling and packaging. Our U.S. sales typically have a higher absolute gross margin than in other markets, as sales prices per case are generally higher in the United States than elsewhere.

Selling expense principally includes advertising and marketing expenditures and compensation paid to our marketing and sales personnel. Our selling expense, as a percentage of sales and per case, is currently high compared to our competitors because of our brand development, level of marketing spend and our established sales force versus our relatively small base of case sales and sales volumes. However, we believe that our strategy of building an infrastructure capable of supporting our anticipated future growth is the correct long-term approach for us. In anticipation of continuing growth, we have added the following components that are included in selling costs:

- hiring of a highly qualified and experienced sales force;
- continuous improvement of our product distribution network and forging of strong distributor relationships – beyond those a company of our size might be expected to maintain; and
- implementation of a products depletion tracking system, by both brand and SKU (enabling us to more effectively target our selling efforts).

While we expect the absolute level of selling expense to continue to increase in the coming years, we also expect selling expense as a percentage of revenues and on a per case basis to continue to decline, as our volumes expand and we employ our direct sales team over a larger number of brands.

General and administrative expenses include all corporate and administrative functions that support our operations. These expenses consist primarily of administrative payroll, occupancy and related expenses and professional services. While we expect these expenses to increase on an absolute basis as our sales volumes continue to increase and we add additional personnel, we also expect our general and administrative expenses as a percentage of sales to continue to decline due to economies of scale.

We expect to significantly increase our case sales in the U.S. and internationally over the next several years through organic growth, and through the extension of our product line via acquisitions and distribution agreements. We will seek to maintain strong liquidity and manage our working capital and overall capital resources during this period of anticipated growth to be able to take advantage of these opportunities and to achieve our long-term objectives, although there is no assurance that we will be able to do so.

We believe continued investment in marketing and advertising to broaden customer awareness and the hiring of salespeople to provide greater coverage of key geographic regions is important to the improvement of operations. These efforts will lead to sizable increases in our absolute level of selling expense and it is uncertain as to whether the investment will translate into increased customer brand recognition for our spirits and therefore greater case sales. Given the competitive nature of the

spirits industry and the existence of well-established brands in each spirits category, we expect to incur increased competition from existing and new competitors as we achieve greater case sales and market share.

We believe a number of industry dynamics and trends will create growth opportunities for us to broaden our spirits portfolio and increase our case sales, including:

- the continued consolidation of brands among the major spirits companies is expected to result in their divestiture of non-core brands, which may create an opportunity for us as we focus on smaller and emerging brands;
- the ongoing industry consolidation is expected to make it more difficult for spirits companies and new entrants to secure an attractive route to market, particularly in the United States, while we already have established extensive U.S. and international distribution;
- owners of small private and family-owned spirits brands will seek to partner with or be acquired by a larger company with global distribution. We expect to be an attractive alternative for these brand owners as one of the few modestly-sized publicly traded spirits companies; and
- particular opportunities in the premium end of the spirits market in which we participate, given positive changes in customer preferences, demographics and expected growth rates in the imported spirits segments.

Our growth strategy is based upon acquiring smaller and emerging brands and growing existing brands. To identify potential acquisition candidates we plan to rely on our management's industry experience and our extensive network of contacts in the industry. We also plan to maintain and grow our U.S. and international distribution channels so that we are more attractive to smaller spirits companies who are looking for a route to market for their products. With respect to small private and family-owned spirits brands, we will continue to be flexible and creative in our acquisition proposals and present an alternative to the larger spirits companies.

We also believe there will be growth opportunities for us as a result of the expected growth rates in the imported spirits segments in which we compete. Given the historical and projected growth rates for the imported spirits industry, and the imported vodka and imported rum segments in particular, we are expecting growth in case sales for all of our products, with the most significant increases in Boru vodka and Gosling's rum. We plan to increase our marketing and advertising initiatives to take full advantage of this anticipated growth, including the launch of a consumer-oriented Boru advertising campaign which was initiated in the first quarter of 2007.

The pursuit of acquisitions and other new business relationships will require significant management attention and time commitment. There is uncertainty concerning our ability to successfully identify attractive acquisition candidates, our ability to obtain financing on favorable terms and whether we will complete these types of transactions in a timely manner and on terms acceptable to us, if at all.

To address the uncertainty regarding potential acquisition candidates, we plan to rely on, and continue to grow, our extensive network of industry contacts to help us identify and evaluate spirits products with growth potential. We plan to rely on our management team's extensive experience in the spirits industry to successfully integrate any products we acquire and, when appropriate, hire additional personal.

## Financial performance overview

The following table sets forth certain information regarding our case sales for the fiscal years ending March 31, 2007, 2006 and 2005. The data in the following table is based on nine-liter equivalent cases, which is a standard spirits industry metric.

<u>Case Sales</u>	<u>Year ended March 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Cases</b>			
United States .....	188,997	149,898	74,190
International .....	125,647	117,154	95,870
Total .....	<u>314,644</u>	<u>267,052</u>	<u>170,060</u>
Vodka .....	160,069	127,894	107,122
Rum .....	78,552	65,060	9,038
Liqueurs .....	53,404	56,156	38,153
Whiskey .....	22,619	17,942	15,747
Total .....	<u>314,644</u>	<u>267,052</u>	<u>170,060</u>
<b>Percentage of Cases</b>			
United States .....	60.1%	56.1%	43.6%
International .....	39.9	43.9	56.4
Total .....	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Vodka .....	50.9%	47.9%	63.0%
Rum .....	25.0	24.4	5.3
Liqueurs .....	16.9	21.0	22.4
Whiskey .....	7.2	6.7	9.3
Total .....	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

## Critical accounting policies and estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires us to make a number of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Such estimates and assumptions affect the reported amounts of sales and expenses during the reporting period. On an ongoing basis, we evaluate these estimates and assumptions based upon historical experience and various other factors and circumstances. We believe our estimates and assumptions are reasonable under the circumstances; however, actual results may differ from these estimates under different future conditions.

We believe that the estimates and assumptions discussed below are most important to the portrayal of our financial condition and results of operations in that they require our most difficult, subjective or complex judgments and form the basis for the accounting policies deemed to be most critical to our operations.

### *Revenue recognition*

We recognize revenue from product sales when the product is shipped to a customer (generally upon shipment to a distributor or to a control state entity), title and risk of loss has passed to the customer in accordance with the terms of sale (FOB shipping point or FOB destination) and collection is reasonably assured. We do not offer a right of return but will accept returns if we shipped the wrong product or wrong quantity.

### *Accounts receivable*

We record trade accounts receivable at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts to reflect any loss anticipated on the trade accounts

receivable balances and charged to the provision for doubtful accounts. We calculate this allowance based on our history of write-offs, level of past due accounts based on contractual terms of the receivables and our relationships with, and economic status of, our customers.

### ***Inventory***

Our inventory, which consists of distilled spirits, packaging and finished goods, is valued at the lower of cost or market, using the weighted average cost method. We assess the valuation of our inventories and reduce the carrying value of those inventories that are obsolete or in excess of our forecasted usage to their estimated realizable value. We estimate the net realizable value of such inventories based on analyses and assumptions including, but not limited to, historical usage, future demand and market requirements. Reduction to the carrying value of inventories is recorded in cost of goods sold.

### ***Goodwill and other intangible assets***

Goodwill represents the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. As of March 31, 2007 and 2006 goodwill and other indefinite lived intangible assets that arose from acquisitions were \$13.6 and \$11.6 million, respectively. In accordance with SFAS 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), goodwill and other intangible assets with indefinite lives are not amortized, but instead are tested for impairment annually, or, more frequently if circumstances indicate a possible impairment may exist.

We evaluate the recoverability of goodwill and indefinite lived intangible assets using a two-step impairment test approach at the reporting unit level. In the first step the fair value for the reporting unit is compared to its book value including goodwill. In the case that the fair value of the reporting unit is less than the book value, a second step is performed which compares the implied fair value of the reporting unit's goodwill to the book value of the goodwill. The fair value for the goodwill is determined based on the difference between the fair values of the reporting units and the net fair values of the identifiable assets and liabilities of such reporting units. If the fair value of the goodwill is less than the book value, the difference is recognized as an impairment.

SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to the estimated residual values and reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets."

### ***Stock-based awards***

Effective April 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), applying the modified prospective method. Prior to April 1, 2006, we accounted for stock options according to the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations, and therefore no related compensation expense was recorded for awards granted with no intrinsic value.

Under the modified prospective transition method, compensation cost associated with stock options recognized in the year ended March 31, 2007 includes: 1) amortization related to the remaining unvested portion of all stock option awards granted prior to April 1, 2006 over the requisite service period based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, *Accounting for Stock-Based Compensation*; and 2) amortization related to all stock option awards granted on or subsequent to April 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. A compensation charge is recorded when it is probable that performance or service conditions will be satisfied. The probability of vesting is updated annually and compensation is adjusted via a cumulative catch-up adjustment or prospectively depending upon the nature of the change. Under the modified prospective transition method, prior period results have not been restated.



Stock based compensation for the year ended March 31, 2007 was \$1.4 million. We used the Black-Sholes option-pricing model to estimate the fair value of options granted. The assumptions used in valuing the options granted during the years ended March 31, 2007, 2006 and 2005 are included in Note 14 to the consolidated financial statements.

***Fair value of financial instruments***

SFAS No. 107, “Disclosures About Fair Value of Financial Instruments,” defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties and requires disclosure of the fair value of certain financial instruments. We believe that there is no material difference between the fair value and the reported amounts of financial instruments in the balance sheets due to the short-term maturity of these instruments, or with respect to the debt, as compared to the current borrowing rates available to us.

***Results of operations***

The following table sets forth, for the periods indicated, the percentage of net sales of certain items in our financial statements.

	<b>Years ended March 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Sales, net . . . . .	100.0%	100.0%	100.0%
Cost of sales . . . . .	<u>66.7%</u>	<u>64.6%</u>	<u>69.3%</u>
Gross profit . . . . .	<u>33.3%</u>	<u>35.4%</u>	<u>30.7%</u>
Selling expense . . . . .	66.6%	61.7%	91.7%
General and administrative expense . . . . .	34.4%	26.0%	28.8%
Depreciation and amortization . . . . .	<u>4.0%</u>	<u>4.3%</u>	<u>2.6%</u>
Loss from continuing operations . . . . .	<u>(71.7)%</u>	<u>(56.6)%</u>	<u>(92.4)%</u>
Other income . . . . .	0.0%	(0.0)%	1.0%
Other expense . . . . .	(0.2)%	(0.2)%	(0.4)%
Foreign exchange gain/(loss) . . . . .	5.4%	(1.6)%	1.0%
Interest expense, net . . . . .	(5.4)%	(7.5)%	(7.9)%
Current credit/(charge) on derivative financial instrument . . . . .	0.5%	0.1%	(0.6)%
Income tax benefit . . . . .	0.6%	0.7%	0.0%
Minority interests . . . . .	<u>5.0%</u>	<u>3.0%</u>	<u>0.0%</u>
Net loss . . . . .	<u>(65.8)%</u>	<u>(62.1)%</u>	<u>(99.3)%</u>
Less:			
Preferred stock and preferred membership unit dividends . . . . .	<u>0.2%</u>	<u>7.5%</u>	<u>9.9%</u>
Net loss attributable to common stockholders . . . . .	<u>(66.0)%</u>	<u>(69.6)%</u>	<u>(109.2)%</u>

***Fiscal year ended March 31, 2007 compared with fiscal year ended March 31, 2006***

*Net sales.* Net sales increased \$4.1 million, or 19.0%, to \$25.2 million in the fiscal year ended March 31, 2007 from \$21.1 million in the comparable prior period. There was no material change in the selling prices of our existing products. Our increase in net sales reflects an increase in overall case sales, primarily from existing brands. The weakening dollar vis-à-vis the euro and the British pound also positively impacted our net sales as our international sales which are denominated in euros and British pounds translated to U.S. dollars at a higher rate. However, some of these net sales gains were offset by reduced net sales from direct imports into the U.S., whereby federal excise taxes are paid directly by the distributor, resulting in lower revenue per case. In addition vodka case sales, which have a lower revenue per case than most of our other brands, were a larger percentage of overall case sales in the fiscal year ended March 31, 2007 than the comparable prior period, also resulting in a lower net sales growth.

Our case sales, measured in nine-liter case equivalents, increased 47,592 cases, or 17.8%, to 314,644 cases versus the comparable prior period, resulting in our largest year of sales to date. Our U.S. case sales as a percentage of total case sales increased to 60.1% during the fiscal year ended March 31, 2007 from 56.1% in the prior fiscal year. This increase reflects the momentum of our portfolio in the U.S., particularly for Boru vodka, Gosling's rums and the Pallini liqueurs.

The table below presents the increase or decrease, as applicable, in our case sales by product category for the fiscal year ended March 31, 2007 as compared to the prior fiscal year. Current period Whiskey case sales include sales of bourbon products following our acquisition of McLain & Kyne on October 12, 2006. In fiscal 2007, we elected to discontinue sales of a low-margin Irish cream, which resulted in a decrease in the sales of liqueurs. A decrease in the liqueur sales in the fiscal year ended March 31, 2007 as compared to the prior fiscal year was offset by increases in case sales of our other brands, particularly Boru vodka, which sales increased 53.7% in the U.S. and 25.2% overall from the prior fiscal year, primarily attributable to the launch of the new packaging in the U.S, resulting in increased sales orders to fill distributor inventories, and by sales of newly-acquired premium single batch bourbon brands following our acquisition of McLain & Kyne on October 12, 2006.

	<u>Increase/(decrease) in case sales</u>		<u>Percentage Increase/(decrease)</u>	
	<u>Overall</u>	<u>U.S.</u>	<u>Overall</u>	<u>U.S.</u>
Vodka . . . . .	32,175	25,257	25.2%	53.7%
Rum . . . . .	13,492	8,971	20.7%	17.4%
Whiskey . . . . .	4,677	3,320	26.1%	85.4%
Liqueurs . . . . .	<u>(2,752)</u>	<u>1,551</u>	(4.9%)	3.3%
Total . . . . .	<u>47,592</u>	<u>39,099</u>	17.8%	26.1%

*Gross profit.* Gross profit increased 11.9% to \$8.4 million during the fiscal year ended March 31, 2007 from \$7.5 million in the comparable prior period, while our gross margin decreased to 33.5% during the fiscal year ended March 31, 2007 compared to 35.4% for the prior fiscal year.

The absolute increase in gross profit reflected our increased level of sales. The decrease in gross margin percentage reflects a shift in product mix and increased growth of some of the lower margin products, including shifts in both brands and sizes. Our margins are lower on vodka, which was a greater portion of overall case sales in the fiscal year ended March 31, 2007 than in the comparable prior period. In addition, since the majority of our production is billed in euros, we were adversely affected by the weakening dollar vis-à-vis the euro.

*Selling expense.* Selling expense increased 28.5% to \$16.8 million in the fiscal year ended March 31, 2007 from \$13.0 million in the comparable prior period. This increase in selling expense was attributable to the expansion, growth and continued support of our brands and increased case sales, including increases in distributor incentives and sales support costs and increased expenses in connection with the Gosling's rum advertising campaign. In order to strengthen our sales and marketing team, we added new personnel, which resulted in an increase in consultancy and compensation expense. We adopted SFAS 123(R), Share-Based Payment on April 1, 2006, which resulted in stock-based compensation expense attributable to sales and marketing personnel of \$0.4 million in the fiscal year ended March 31, 2007. As a result of the foregoing, selling expense as a percentage of net sales increased to 66.6% in the fiscal year ended March 31, 2007 as compared to 61.7% for the comparable prior year period.

*General and administrative expense.* General and administrative expense increased 57.4% to \$8.6 million in the fiscal year ended March 31, 2007 from \$5.5 million in the comparable prior period. This increase in general and administrative expense was in part attributable to the increased costs of being a public company. These public company costs include increases in professional fees and public company directors and officers' liability insurance of \$1.0 million, as compared to the prior fiscal year. In addition to increased compensation for existing personnel, we hired several new employees, resulting in an increase in compensation expense of \$0.9 million. We also adopted SFAS 123(R), Share-Based Payment on April 1, 2006, which resulted in stock-based compensation expense

attributable to personnel other than those in sales and marketing of \$1.0 million in the fiscal year ended March 31, 2007. As a result of the foregoing, general and administrative expense as a percentage of net sales increased to 34.4% in the fiscal year ended March 31, 2007 compared to 26.0% for the comparable prior year period.

*Depreciation and amortization.* Depreciation and amortization increased 10.3% to \$1.0 million in the fiscal year ended March 31, 2007 from \$0.9 million in the comparable prior year period. This increase was primarily attributable to our acquisition of additional fixed and intangible assets and the accelerated amortization expense resulting from our termination of the Comans distribution agreement, such termination to be effective in September 2007.

*Other Income/(Expense), Net.* Other income/(expense), net, increased 30.2% to \$1.5 million during the fiscal year ended March 31, 2007 from \$1.1 million in the comparable prior period. The major components of this category include a change in foreign exchange, net interest income/(expense) and minority interest.

Foreign exchange gain during the fiscal year ended March 31, 2007 was \$1.4 million as compared to a loss of (\$0.3) million in the comparable prior period. The current period gain is attributable to the effects of the strengthening of the euro and the British pound against the dollar on our intercompany loans to our foreign subsidiaries.

Interest income during the fiscal year ended March 31, 2007 was \$1.0 million as compared to zero in the comparable prior period. The source of this income is the investment of the proceeds of our initial public offering in April 2006. Interest expense during the fiscal year ended March 31, 2007 was \$2.4 million versus \$1.6 million in the comparable prior period. The increase in interest expense is primarily attributable to the write off of deferred financing costs in connection with the conversion of 40% of our convertible notes upon completion of our initial public offering in April 2006 of \$0.3 million, the vesting of certain warrants treated as interest expense of \$0.3 million, as well as the expansion of our senior notes to \$10.0 million from \$4.6 million in November 2006, resulting in \$0.3 million of additional interest expense.

Minority interest during the fiscal year ended March 31, 2007 amounted to a credit of \$1.3 million as compared to a credit of \$0.7 million in the comparable prior period as a result of a larger loss recorded by our 60%-owned subsidiary, Gosling-Castle Partners, Inc.

*Net loss attributable to common stockholders.* The net loss attributable to common stockholders for the fiscal year ended March 31, 2007 increased 13.1% to \$16.6 million from \$14.7 million in the comparable prior period. Net loss per common share basic and diluted was positively affected by the increase in shares outstanding resulting from the shares issued and converted in our initial public offering. As previously discussed, we adopted SFAS 123(R), Share-Based Payment on April 1, 2006, which resulted in total stock-based compensation expense of \$1.4 million in the fiscal year ended March 31, 2007 as compared to none in the comparable prior period. The net loss per common share included \$0.1 million of preferred stock dividends accrued during the fiscal year ended March 31, 2007 as compared to \$1.6 million in the comparable prior period.

*EBITDA.* EBITDA decreased 20.4% to negative \$12.9 million for the year ended March 31, 2007 versus negative \$10.7 million the comparable prior period. EBITDA represents net income before deducting interest expense (including expensing of deferred financing costs), income taxes, depreciation and amortization and the impact of the non-cash charge for stock-based compensation reported under SFAS 123(R). We use EBITDA as the primary internal management measure for evaluating performance on a period over period analysis, when comparing actual results to budgeted performance and when allocating additional resources. This non-GAAP financial measure is presented in order to assist industry analysts and investors in assessing our liquidity, our ability to incur and service debt, make capital expenditures and meet working capital requirements. EBITDA should not be considered as an alternative to operating income as an indicator of our performance, as an alternative to cash flows from operating activities as a measure of liquidity, or as an alternative to any other measure determined in accordance with GAAP. Unlike net income, EBITDA does not include depreciation or interest expense and therefore does not reflect current or future capital expenditures

or the cost of capital. We compensate for these limitations by using EBITDA as only one of several comparative tools, together with GAAP measurements, to assist in the evaluation of operating performance. Such GAAP measurements include operating income (loss), net income (loss), cash flows from operations and cash flow data. We have significant uses of cash flows, including interest payments, debt principal repayments, and other non-recurring charges, which are not reflected in EBITDA. Because EBITDA as determined by us excludes some, but not all, items that affect net income, it may not be comparable to EBITDA or similarly titled measures used by other companies.

The following table sets forth our reconciliation of EBITDA to net loss (the most directly comparable financial measure):

(Dollars in thousands)	Years ended March 31,	
	2007	2006
Net loss .....	(16,557)	(13,084)
Add (subtract):		
Income tax benefit .....	(148)	(148)
Interest expense, net, including expensing of deferred financing costs .....	1,380	1,579
Depreciation and amortization .....	1,001	907
Stock based compensation .....	<u>1,388</u>	<u>—</u>
EBITDA .....	<u>(12,936)</u>	<u>(10,746)</u>

***Fiscal year ended March 31, 2006 compared with fiscal year ended March 31, 2005***

*Net sales.* Net sales increased \$8.5 million, or 67.6%, to \$21.1 million in the fiscal year ended March 31, 2006 from \$12.7 million in the comparable prior period. Approximately \$3.3 million, or 38.8%, and \$5.2 million, or 61.2%, of this increase reflected an increase in case sales of new and existing brands, respectively. There was no material change in the selling prices of our existing products. Our case sales, measured in nine-liter case equivalents, increased 96,992 cases, or 57.0%, to 267,052 cases versus the comparable prior period, with the increase comprised of:

- 55,523 cases related to our Gosling-Castle Partners global export venture which commenced in April 2005 and 9,084 cases related to our Pallini agency agreement which commenced in August 2004; and
- 32,385 incremental case sales of our other existing brands, particularly Boru vodka.

Our U.S. case sales as a percentage of total case sales increased to 56.1% during the fiscal year ended March 31, 2006 from 43.2% in the prior fiscal year. This increase reflects the addition of the Gosling's rums and Pallini liqueurs, as well as increased U.S. sales of our other brands, particularly Boru vodka.

The table below presents the increase in case sales by product category for the fiscal year ended March 31, 2006 compared to the prior fiscal year.

	Increase in case sales		Percentage increase	
	Overall	U.S.	Overall	U.S.
Vodka .....	20,770	17,754	19.4%	60.7%
Rum .....	55,464	42,410	578.0%	462.0%
Liqueurs/cordials .....	19,068	14,605	51.4%	44.5%
Irish Whiskey .....	<u>1,690</u>	<u>1,609</u>	53.8%	—
Total .....	<u>96,992</u>	<u>76,377</u>	57.0%	103.9%

*Gross profit.* Gross profit increased 93.5% to \$7.5 million during the fiscal year ended March 31, 2006 from \$3.9 million in the prior fiscal year, and our gross margin increased to 35.4% during the fiscal year ended March 31, 2006 compared to 30.7% for the prior fiscal year. The absolute increase in gross profit reflected our increased level of sales and the increase in gross margin reflected higher

margins attributable to Gosling's rums and Pallini liqueurs as well as to a shift in our product mix to products which are produced by others. Although gross margins are less on our vodka sales, the increase in case sales has offset the lower margin achieved.

*Selling expense.* Selling expense increased 12.8% to \$13.0 million in the fiscal year ended March 31, 2006 from \$11.6 million in the prior fiscal year. The change in selling expense was primarily attributable to an increase of \$1.1 million in compensation expense due to the hiring of additional sales personnel, including sales personnel hired by the new Gosling-Castle Partners global export venture in which the company has a 60% interest, to an increase in distributor incentives and sales support costs of \$0.2 million and to increases in selling related shipping costs and sales commissions of \$0.1 million and \$0.2 million, respectively. As a percentage of net sales, selling expense decreased to 61.7% compared to 91.7% for the comparable prior year period. This decrease is principally due to leveraging our sales force and marketing expenditures across increased sales volumes.

*General and administrative expense.* General and administrative expense increased 51.9% to \$5.5 million for the fiscal year ended March 31, 2005 from \$3.6 million in the prior fiscal year. Major components of this increase included an increase of \$1.0 million in compensation expense due to the hiring of additional corporate personnel, including several accounting personnel and our president and chief operating officer, increased professional and recruiting fees of \$0.5 million, increased occupancy, insurance and other office expenses of \$0.1 million and an increase in our provision for doubtful accounts of \$0.3 million. As a percentage of net sales, general and administrative expense decreased to 26.0% for the fiscal year ended March 31, 2006 compared to 28.8% for the comparable prior year period, due to economies of scale with higher sales volumes.

*Depreciation and amortization.* Depreciation and amortization increased 181% to \$0.9 million in the fiscal year ended March 31, 2005 from \$0.3 million in the comparable prior year period. This increase was primarily attributable to amortization of the Gosling worldwide (except Bermuda) distribution agreement which became effective during February 2005.

*Net loss attributable to common stockholders.* The net loss attributable to common stockholders for the fiscal year ended March 31, 2006 increased 6.5% to \$14.7 million from \$13.8 million in the prior fiscal year. These net losses included \$1.6 million and \$1.3 million in preferred stock dividends accrued during the fiscal years ended March 31, 2006 and 2005, respectively.

### **Potential fluctuations in quarterly results and seasonality**

Our industry is subject to seasonality with peak sales in each major category generally occurring in the fourth calendar quarter, which is our third fiscal quarter. See "Risk Factors – Our quarterly operating results have fluctuated in the past and may fluctuate significantly in the future rendering quarter-to-quarter comparisons unreliable as indicators of performance."

## Quarterly results of operations

The following table presents unaudited consolidated statements of operations data for each of the eight quarters concluding with the quarter ended March 31, 2007. We believe that all necessary adjustments have been included to present fairly the quarterly information when read in conjunction with our annual financial statements and related notes. The operating results for any quarter are not necessarily indicative of the results for any subsequent quarter.

	<u>March 31, 2007</u>	<u>December 31, 2006</u>	<u>September 30, 2006</u>	<u>June 30, 2006</u>
<b>Consolidated statement of operations data</b>				
(in thousands, except per share amounts):				
Sales, net .....	\$ 6,071	\$ 7,381	\$ 6,252	\$ 5,460
Cost of sales .....	<u>4,046</u>	<u>4,938</u>	<u>4,231</u>	<u>3,564</u>
Gross profit .....	<u>2,025</u>	<u>2,443</u>	<u>2,021</u>	<u>1,896</u>
Selling expense .....	3,930	4,600	4,694	3,543
General and administrative expense .....	2,410	2,101	1,899	2,236
Depreciation and amortization .....	<u>258</u>	<u>263</u>	<u>246</u>	<u>234</u>
Loss from continuing operations .....	<u>(4,573)</u>	<u>(4,521)</u>	<u>(4,818)</u>	<u>(4,117)</u>
Other income .....	(0)	1	3	1
Other expense .....	(10)	(21)	(10)	(6)
Foreign currency gain/(loss) .....	217	484	262	397
Current credit/(charge) on derivative financial instrument .....	(3)	132	(9)	(2)
Income tax benefit .....	37	37	37	37
Interest expense, net .....	(378)	(208)	(76)	(718)
Minority interests .....	<u>166</u>	<u>366</u>	<u>392</u>	<u>343</u>
Net loss .....	<u>(4,544)</u>	<u>(3,730)</u>	<u>(4,219)</u>	<u>(4,065)</u>
Less: preferred stock and preferred membership unit dividends .....	<u>0</u>	<u>0</u>	<u>0</u>	<u>48</u>
Net loss attributable to common stockholders .....	<u>\$ (4,544)</u>	<u>\$ (3,730)</u>	<u>\$ (4,219)</u>	<u>\$ (4,113)</u>
Net loss per common share:				
Basic .....	<u>\$ (0.38)</u>	<u>\$ (0.31)</u>	<u>\$ (0.35)</u>	<u>\$ (0.36)</u>
Diluted .....	<u>\$ (0.38)</u>	<u>\$ (0.31)</u>	<u>\$ (0.35)</u>	<u>\$ (0.36)</u>
Weighted average shares used in computation:				
Basic .....	<u>12,109,741</u>	<u>12,051,045</u>	<u>12,009,741</u>	<u>11,422,725</u>
Diluted .....	<u>12,109,741</u>	<u>12,051,045</u>	<u>12,009,741</u>	<u>11,422,725</u>

	<u>March 31,</u> <u>2006</u>	<u>December 31,</u> <u>2005</u>	<u>September 30,</u> <u>2005</u>	<u>June 30,</u> <u>2005<sup>(1)</sup></u>
<b>Consolidated statement of operations data</b>				
(in thousands, except per share amounts):				
Sales, net .....	\$ 3,699	\$ 7,360	\$ 5,175	\$ 4,916
Cost of sales .....	<u>2,343</u>	<u>4,998</u>	<u>3,162</u>	<u>3,153</u>
Gross profit .....	<u>1,356</u>	<u>2,362</u>	<u>2,013</u>	<u>1,763</u>
Selling expense .....	3,082	3,616	3,213	3,137
General and administrative expense .....	1,461	1,659	1,236	1,137
Depreciation and amortization .....	<u>232</u>	<u>233</u>	<u>220</u>	<u>222</u>
Loss from continuing operations .....	<u>(3,419)</u>	<u>(3,146)</u>	<u>(2,656)</u>	<u>(2,733)</u>
Other income .....	—	(30)	34	—
Other expense .....	(9)	(10)	(9)	(9)
Foreign currency gain/(loss) .....	219	(259)	15	(313)
Current credit/(charge) on derivative financial instrument .....	(3)	4	(2)	17
Income tax benefit .....	37	37	37	37
Interest expense, net .....	(541)	(415)	(364)	(259)
Minority interests .....	<u>228</u>	<u>204</u>	<u>95</u>	<u>129</u>
Net loss .....	<u>(3,488)</u>	<u>(3,615)</u>	<u>(2,850)</u>	<u>(3,131)</u>
Less: preferred stock and preferred membership unit dividends .....	<u>482</u>	<u>422</u>	<u>387</u>	<u>305</u>
Net loss attributable to common stockholders .....	<u><u>\$(3,970)</u></u>	<u><u>\$(4,037)</u></u>	<u><u>\$(3,237)</u></u>	<u><u>\$(3,436)</u></u>
Net loss per common share: (2)				
Basic .....	<u><u>\$ (1.28)</u></u>	<u><u>\$ (1.30)</u></u>	<u><u>\$ (1.04)</u></u>	<u><u>\$ (1.11)</u></u>
Diluted .....	<u><u>\$ (1.28)</u></u>	<u><u>\$ (1.30)</u></u>	<u><u>\$ (1.04)</u></u>	<u><u>\$ (1.11)</u></u>
Weighted average shares used in computation: (2)				
Basic .....	<u><u>3,107</u></u>	<u><u>3,107</u></u>	<u><u>3,107</u></u>	<u><u>3,107</u></u>
Diluted .....	<u><u>3,107</u></u>	<u><u>3,107</u></u>	<u><u>3,107</u></u>	<u><u>3,107</u></u>

(1) Our quarterly results of operations include the results of operations of Gosling-Castle Partners, our 60%-owned strategic venture, commencing as of the February 18, 2005 closing date of our investment in such entity, with adjustments for minority interest; however, Gosling-Castle Partners had no meaningful operations prior to April 1, 2005.

(2) Net loss per common share basic and diluted was positively affected by the increase in shares outstanding resulting from the shares issued and converted in our initial public offering.

### Liquidity and capital resources

Our primary uses of cash have been for selling and marketing expense, employee compensation, new product development and working capital. Our main sources of cash have been from the sale of common and preferred stock, the sale of convertible and senior notes and borrowings under bank credit facilities.

Our balance of cash equivalents and short-term investments was \$6.9 million at March 31, 2007 as compared to \$1.4 million at March 31, 2006. This increase is attributable to the receipt of net proceeds of approximately \$26.3 million upon our initial public offering in April 2006. Our balance of cash equivalents and short-term investments increased to \$25.0 million in May 2007 as a result of the

closing of a \$21.0 million private placement of common stock and warrants sold to certain institutional investors. The net proceeds of the private placement are \$19.9 million, after giving effect to the placement fee of \$1.1 million.

The following trends are reasonably likely to result in a material decrease in our liquidity over the near-to-mid term:

- an increase in working capital requirements to finance higher levels of inventories and accounts receivable;
- addition of administrative and sales personnel as our business expands;
- increases in advertising, public relations and sales promotions for existing and new brands and as we expand within existing markets or enter new markets;
- acquisition of additional spirits brands;
- financing the operations of our 60%-owned Gosling-Castle Partners strategic export venture;
- the continued cost of being a public company and Sarbanes-Oxley compliant; and
- expansion into new markets and within existing markets in the United States and internationally.

We expect that we will require increasing amounts of working capital to finance our inventory levels in the United States. Except for Gosling’s rums, which are bottled in the United States, all of our products are imported from Europe. In the case of our wholly-owned brands, there is a three-to-four month production and shipping lead time between the time of order placement and the time the product is available for sale. This lead time has required us to ensure that we maintain sufficient inventories to properly service our customers.

We expect to experience a lengthening of the revenue collection cycle due to the need to extend payment terms as an incentive to encourage customers to make container-sized purchases of our products on which title passes to the customer at the shipping point in Ireland. A lengthening of the revenue collection cycle will require a significant amount of working capital.

**Cash flows**

The following table summarizes our primary sources and uses of cash during the periods presented (in thousands):

	<u>Year ended March 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
<b>Net cash provided by (used in):</b>			
Operating activities .....	\$(21,628)	\$(14,269)	\$(13,331)
Investing activities .....	(7,688)	(406)	(598)
Financing activities.....	<u>28,929</u>	<u>10,392</u>	<u>16,142</u>
Net increase (decrease) in cash and cash equivalents ..	<u>\$ (387)</u>	<u>\$ (4,283)</u>	<u>\$ 2,213</u>

**Operating activities.** A substantial portion of our available cash has been used to fund our operating activities. In general, these cash funding requirements are based on operating losses, driven chiefly by our sizable investment in selling and marketing. With increases in our overall sales volumes, we have also utilized cash to fund our receivables and inventories. In general, these increases are only partially offset by increases in our accounts payable to our suppliers and accrued expenses. Our business has incurred significant losses since inception.

On average, the production cycle for our owned brands can take as long as three months from the time we obtain the distilled spirits and other materials needed to bottle and package our products to the time we receive products available for sale, which is impacted by the international nature of our business. With respect to Gosling’s rums and Pallini liqueurs, we do not produce the finished product and, instead, receive the finished product directly from the owners of such brands. From the time we



have products available for sale, an additional three to four months may be required before we sell our inventory and collect payment from our customers.

In the fiscal year ended March 31, 2007, net cash used in operating activities was \$21.6 million, consisting primarily of losses from our operations of \$16.6 million, increases in inventory of \$3.8 million, increases in accounts receivable of \$2.8 million and the effects of changes in foreign exchange of \$1.1 million, and decreases in due to related parties of \$1.1 million and minority interest in the net loss of our 60%-owned subsidiary Gosling-Castle Partners of \$1.3 million. These uses of cash were offset, in part, by a decrease in debt due from related parties of \$0.9 million, amortization of deferred financing cost of \$0.4 million, a write-off of deferred financing costs in connection with the conversion of 6% subordinated convertible notes of \$0.3 million, as well as depreciation and amortization expense of \$1.0 million, non-cash interest charges and stock-based compensation expense \$0.3 million and stock based compensation expense of \$1.4 million.

In the fiscal year ended March 31, 2006, net cash used in operating activities was \$14.3 million, consisting primarily of losses from our operations of \$13.1 million, increases in inventory, amounts due from affiliates, prepaid expense, deferred financing costs in connection with our initial public offering, and other assets, and minority interest in the net loss of our 60%-owned subsidiary Gosling-Castle Partners. These uses of cash were offset, in part, by an increase in accounts payable and accrued expenses, a decrease in accounts receivable and depreciation expense and non-cash interest charges.

In the fiscal year ended March 31, 2005, net cash used in operating activities was \$13.3 million, consisting primarily of losses from our operations of \$12.5 million, increases in trade accounts receivable, inventory and other assets, offset, in part, by an increase in accounts payable and accrued expenses.

**Investing Activities.** We fund certain acquisitions and operating activities primarily with cash and short-term investments. Net cash used for investing activities was \$7.7 million during 2007, reflecting initial investments of \$25.0 from the proceeds of our initial public offering against acquisitions of property and equipment \$0.4 million and intangible assets of \$0.1 million. In addition, in October 2006, Castle Brands Inc. acquired 100% of the outstanding shares of McLain & Kyne, Ltd. Cash used in investing activities for this business acquisition was \$1.3 million, net of cash acquired. Investing activities during 2007 also include proceeds of \$19.0 million from the sale of investments to fund certain acquisitions and operating activities.

**Financing activities.** During the three years ending March 31, 2007, in order to fund the above operating and investing activities, our total net cash from financing activities was approximately \$55.5 million, which came primarily from our issuances of common stock, convertible preferred stock, senior notes and convertible subordinated debt.

Net cash provided by financing activities during the year ended March 31, 2007 was \$28.9 million, consisting primarily of funds raised from our initial public offering on April 6, 2006. Net cash received from the issuance of common stock in our initial public offering was \$26.4 million, after making the following payments:

- repayment of €133,323 (\$159,961, calculated at the conversion rate at the time of repayment), of the principal amount of non-interest bearing indebtedness owed by us to former stockholders of Roaring Water Bay;
- repayment of €290,328 (\$357,454, calculated at the conversion rate at the time of repayment) of the principal amount of indebtedness and accrued interest owed by us to former stockholders of Roaring Water Bay;
- repayment of the \$2.0 million principal amount of indebtedness outstanding under the February 2006 credit facility provided to us by Frost Nevada Investments Trust, an entity controlled by one of our directors;
- payment of interest of \$5,000 accrued from April 1, 2006 through the closing date of the initial public offering for the February 2006 credit facility; and
- payment of \$204,952 in dividends accrued on preferred membership units in our predecessor company, Great Spirits Company, LLC, through December 1, 2003.

Net cash provided by financing activities during the fiscal year ended March 31, 2006 was \$10.4 million and consisted primarily of funds raised from the second and third tranches of our 6% convertible note financing, netted against the following: payments of deferred registration costs in connection with the company's prospective initial public offering of \$1.3 million, repayment of notes payable of \$3.0 million and payments made in connection with the issuance cost of our 6% convertible note financing of \$0.2 million. A portion of these funds was used during that period to fund our capital investments in Gosling-Castle Partners of \$2.2 million.

We believe that we will be able to fund our operations from the proceeds of our recent private placement, our projected cash flow from operations, and current cash and cash equivalents for at least twelve months following the closing of our private placement, which occurred on May 10, 2007. Beyond that, additional financing may be needed to fund working capital and other requirements. Changes in our operating plans, acquisitions or other additions of brands, lower than anticipated sales, increased expenses, or other events, including those described in "Risk Factors," may require us to seek additional debt or equity financing on an accelerated basis. Financing may not be available on acceptable terms, or at all, and our failure to raise capital when needed could impact negatively our growth plans, financial condition and results of operations. Additional equity financing may be dilutive to the holders of our common stock, and debt financing, if available, may involve significant cash payment obligations or financial covenants and ratios that restrict our ability to operate our business.

#### ***Obligations and commitments***

***Irish bank facilities.*** We have credit facilities with availability aggregating approximately €1.4 million (\$1.9 million) with two affiliated Irish banks, including overdraft, customs and excise guaranty, forward currency dealing, revolving credit and accounts receivable facilities. These facilities, which are payable on demand and continue until terminated by either party on not less than three months prior written notice, have interest rates ranging from prime plus 3% to 7.85%. We also have revolving credit facilities aggregating approximately £242,000 (\$474,992) with one of these lenders for working capital purposes. These other banking facilities, which are also payable on demand and renew annually subject to certain provisions, have interest rates ranging from prime plus 2% to prime plus 2.25%. We also secured a €190,000 (\$253,365) term note with one of these lenders. We have deposited €375,000 (\$502,643) with the banks to secure these borrowings and both we and our subsidiaries, CB-UK and CB-Ireland, have agreed to provide an intercompany guarantee of these facilities up to an amount of €860,000 (\$1,146,810). The term note carries an interest rate of 5.2% and calls for monthly payments of principal and interest of €6,377 through July 2007.

We believe we are in compliance with the financial covenants of our Irish bank facilities and that the completion of this offering will not cause us to fail to be in compliance with any of the financial covenants with respect to the Irish bank facilities.

***February 2006 credit facility.*** On February 17, 2006, we entered into a credit facility with Frost Nevada Investments Trust, an entity controlled by Phillip Frost, M.D., one of our directors, which enabled us to borrow up to \$5.0 million. We borrowed \$2.0 million under this facility at an interest rate of 9% per annum payable quarterly, plus a facility fee of \$100,000 paid at the time of the drawdown. Interest under this facility was payable quarterly. We repaid all outstanding principal and accrued interest under this note in the amount of \$2,026,000 in April 2006.

***February 2007 credit facility.*** On February 12, 2007, we entered into a credit agreement with Frost Nevada Investments Trust, which is controlled by Dr. Phillip Frost, one of our directors, which enabled us to borrow up to \$5.0 million. We paid a facility fee of \$150,000 upon entering into the credit agreement. We never made any borrowings under this facility. The facility was terminated pursuant to its terms following the closing of our May 2007 private placement of common stock..

***9% senior notes.*** On June 9, September 28 and October 13, 2004, our wholly owned subsidiary Castle Brands (USA), issued to 27 individuals \$4.6 million of senior notes secured by accounts receivable and inventories of Castle Brands (USA). As issued, these senior notes bore an interest rate of 8%, payable semi-annually on November 30th and May 31st, and were to mature on May 31, 2007. The senior notes are guaranteed as to payment by us. In addition, these notes were accompanied by

warrants to purchase 25 shares of our common stock at \$8.00 a share for every \$1,000 principal amount of such notes for an aggregate of 116,500 shares. Effective August 15, 2005, the terms of these notes were modified with the consent of the note holders to mature on May 31, 2009 in exchange for an interest rate adjustment to 9%.

On November 10, 2006, we issued an aggregate of \$5.4 million of additional senior notes secured by accounts receivable and inventories of Castle Brands (USA). These notes also mature on May 31, 2009 and bear interest at 9% payable semi-annually. In addition, each holder of senior notes received warrants to purchase 40 shares of common stock at \$8.00 per share for each \$1,000 of additional principal purchased by such holder. There were 213,600 warrants issued in conjunction with the issuance of the additional senior notes. These warrants have been fair valued at \$706,944 in the aggregate and have been treated as a discount to the notes payable based upon their relative fair value.

The senior notes are subject to customary restrictive covenants. In addition, the consent of holders of a requisite majority of the aggregate principal amount of these notes is required for Castle Brands (USA) to take any of the following actions: merge or consolidate or sell all or substantially all of its assets other than with an entity formed in the United States or to a person or entity that assumes all of our obligations under the senior notes, engage in a transaction with an affiliate unless the transaction is on fair and reasonable terms, or change our jurisdiction of incorporation without giving 60 days prior notice.

If we or Castle Brands (USA) were to default on the payment of principal or interest on our senior notes and the default continues for 20 business days, breach any representation, warranty or certification made in the senior note documents, default in the performance of the material obligations under the senior note documents, which default is unremedied for a period of 60 days after we receive notice of such default, enter into any arrangement for the benefit of creditors or otherwise wind-up or dissolve, then the holders of our senior notes could declare all principal and interest to be immediately payable.

We believe that we are in compliance with the financial covenants related to our senior notes and will continue to be in compliance upon completion of this offering.

**6% subordinated convertible notes.** On March 1, 2005, we entered into a convertible note purchase agreement for up to \$10.0 million, with the principal amount convertible, at the option of the holder, at a conversion price of \$8.00 per share. The convertible note agreement was amended on August 16, 2005 to (a) increase the amount of loans under such agreement to \$15.0 million and (b) provide for 40% of the outstanding principal amount of the notes to convert automatically into common stock upon an initial public offering of our common stock at a conversion price of \$7.00 per share. As of March 31, 2006, there were three 6% convertible promissory notes outstanding for \$5.0 million each. These notes were issued on March 1, 2005, June 27, 2005 and August 16, 2005 and mature on March 1, 2010. They bear interest at the rate of 6% per annum, payable quarterly, at our option for a period of two years from the date of the note, in cash or in additional notes bearing an interest rate of 7.5% per annum. We may not prepay our 6% convertible notes without the consent of the holders.

In accordance with the amended terms, \$6.0 million of our 6% convertible notes automatically converted into 857,143 shares of our common stock at a price of \$7.00 per share upon the closing of the initial public offering of our common stock on April 10, 2006. The outstanding balance of our 6% convertible notes may be converted into common stock at any time at the option of the holders at a conversion rate of \$8.00 per share and will automatically convert at such time as the closing price of our common stock is \$20.00 per share or more for thirty consecutive days at any time after March 1, 2008. The 6% convertible notes are unsecured.

These 6% convertible notes are subject to a number of customary restrictive covenants and certain potential limits on future indebtedness, excluding qualified brand acquisition indebtedness, and which are impacted by our aggregate equity market capitalization. As long as there is at least \$1.5 million aggregate principal amount outstanding under these notes: (a) the approval of holders of

at least a majority of the aggregate principal amount of the 6% convertible notes outstanding is required before we may pay dividends or make a distribution or payment on our equity securities or redeem or repurchase our equity securities (other than repurchases from employees upon termination of their employment) and (b) the approval of holders of at least 70% of the aggregate principal amount of the 6% convertible notes outstanding is required before we may engage in a transaction with an affiliate or incur indebtedness in excess of \$30.0 million; provided, however, that the indebtedness covenant will no longer be applicable if the product of our fully diluted securities multiplied by the average of the highest bid and lowest asked prices on the exchange or over-the-counter quotation system on which our common stock is listed is at least \$100.0 million for a period of at least 90 days. The limit on indebtedness does not include indebtedness that is incurred in connection with the acquisition of a brand related to, or an entity doing business in or related to, the beverage alcohol market, to the extent such indebtedness (including costs and fees associated with incurring such debt) does not exceed an amount equal to three times the target's earnings before interest, taxes, depreciation and amortization.

If we were to default on the payment of principal or interest on our 6% convertible notes, fail to pay any other debt for borrowed money in excess of \$250,000 when it is due and payable, fail to perform the affirmative covenants contained in the convertible note purchase agreement, and fail to cure such failure within 10 business days or fail to perform, keep or observe any material term, provision, covenant or agreement contained in the convertible note purchase agreement or any of the notes issued under the agreement and fail to cure within 20 days, then the holders of our 6% convertible notes could declare all principal and interest to be immediately payable.

We believe that we are currently in compliance with all of the financial covenants related to our 6% convertible notes.

***Gosling's export venture.*** On February 18, 2005, in connection with our investment in the Gosling-Castle Partners Inc. strategic export venture with the Gosling's family, we issued a promissory note to Gosling-Castle Partners (now our 60% owned subsidiary) in the amount of \$4.9 million. This promissory note, which bore interest at the rate of 4% per annum beginning October 1, 2005, had no restrictive covenants and was due in installments as follows, and has now been fully paid:

- \$1,025,000 was due April 1, 2005 and was paid;
- \$1,125,000 was due October 1, 2005 and was paid;
- \$1,000,000 was due April 1, 2006 and was paid;
- \$1,000,000 was due October 1, 2006 and was paid; and
- \$750,000 was due April 1, 2007 and was paid.

Under Gosling-Castle Partners' exclusive export agreement with Gosling's Export (Bermuda) Limited, Gosling-Castle Partners was required to pay \$2.5 million to Gosling's Export (Bermuda) Limited in exchange for the distribution rights set forth in such agreement in four equal installments on April 1, 2005, October 1, 2005, April 1, 2006 and October 1, 2006. As of March 31, 2007, Gosling-Castle Partners has no payments remaining.

***5% Euro denominated convertible subordinated notes.*** In connection with the acquisition of Roaring Water Bay on December 1, 2003, we issued an aggregate principal amount of €1,374,750 (recorded as \$1,660,148 in our consolidated financial statements as of March 31, 2006) of our 5% euro denominated convertible subordinated notes due December 1, 2006.

Upon the closing of the initial public offering in April 2006, all of our 5% euro denominated convertible subordinated notes automatically converted into 263,362 shares of our common stock, and all of the interest accrued on these notes (except for \$2,500 of accrued interest, which will be paid on June 30, 2006) was paid out of the proceeds of the initial public offering.

***The Roaring Water Bay related notes.*** In December 2003, in connection with our acquisition of Roaring Water Bay, we issued to the stockholders of Roaring Water Bay subordinated non-interest bearing notes in the principal amount of €444,389 (\$576,372, calculated at the conversion rate at such

time). In connection with the acquisition, we also issued 5.7% subordinated notes due July 11, 2007, in the principal amount of €255,000 (\$302,022, calculated at the conversion rate at such time) in exchange for the elimination of certain common share rights of the Roaring Water Bay stockholders.

We used \$517,395 from the proceeds of the initial public offering to prepay all of the remaining principal balance outstanding under both the non-interest bearing notes and the 5.7% subordinated notes. We also paid from such proceeds all accrued and unpaid interest on the 5.7% subordinated notes through the closing date of the initial public offering.

**Office equipment leases.** We financed the purchase of certain office equipment totaling \$17,872. The equipment leases call for monthly payments of principal and interest at the rate of 5% per annum, to be paid through July 2009. As of March 31, 2007, we owed \$8,891 under this lease.

**Future commitments – notes and capital lease.** Principal payments due over the next five years for the above listed notes payable and capital lease are due as follows (as translated at the exchange rate in effect on March 31, 2007):

<u>For the years ending March 31,</u>	<u>Amount</u> <u>(in thousands)</u>
2008 .....	\$ 419
2009 .....	4
2011 .....	<u>18,356</u>
Total .....	18,779
Less current portion .....	<u>419</u>
Non-current portion .....	<u>\$18,360</u>

**Convertible preferred stock.** All of our Series A preferred stock, Series B preferred stock and Series C preferred stock automatically converted into an aggregate of 4,089,463 shares of our common stock, and all of the dividends accrued on our preferred stock through April 9, 2006 were converted into 193,107 shares of our common stock.

### Contractual obligations

The following table sets forth our contractual commitments as of March 31, 2007 for each of the following quarters:

	<u>Payments due during quarter ending March 31,</u>						<u>Total</u>
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>Thereafter</u>	
	(in thousands)						
Long-term notes payable, including current portion and estimated interest							
Ulster Bank facilities .....	\$416	\$—	\$ —	\$—	\$ —	\$ —	\$ 416
9% senior notes .....	—	—	10,000	—	—	—	10,000
6% convertible subordinated notes .	—	—	9,000	—	—	—	9,000
Capital leases .....	4	4	1	—	—	—	9
Operating leases .....	<u>322</u>	<u>5</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>327</u>
Total .....	<u>\$742</u>	<u>\$ 9</u>	<u>\$19,001</u>	<u>\$—</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$19,752</u>

### Impact of inflation

We believe that our results of operations are not materially impacted by moderate changes in the inflation rate. Inflation and changing prices did not have a material impact on our operations during fiscal 2005, 2006 or 2007. Severe increases in inflation, however, could affect the global and U.S. economies and could have an adverse impact on our business, financial condition and results of operations.

## **Recent accounting pronouncements**

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109" ("FIN 48"), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation will apply to our fiscal year beginning April 1, 2007. We do not expect the interpretation will have a material impact on its results from operations or financial position.

In September 2006, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin 108, "Considering the Effects on Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," ("SAB 108"). SAB 108 requires registrants to quantify errors using both the income statement method (i.e. iron curtain method) and the rollover method and requires adjustment if either method indicates a material error. If a correction in the current year relating to prior year errors is material to the current year, then the prior year financial information needs to be corrected. A correction to the prior year results that are not material to those years would not require a "restatement process" where prior financials would be amended. SAB 108 is effective for fiscal years ending after November 15, 2006. We determined that SAB 108 did not have a material effect on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements," to define fair value, establish a framework for measuring fair value in accordance with generally accepted accounting principles, and expand disclosures about fair value measurements. SFAS No. 157 will be effective for fiscal years beginning after November 15, 2007, our fiscal year beginning April 1, 2008. We are assessing the impact the adoption of SFAS No. 157 will have on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159), which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 further establishes certain additional disclosure requirements. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. Management is currently evaluating the impact and timing of the adoption of SFAS 159 on our consolidated financial statements.

## **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

As of March 31, 2007, we did not participate in any derivative financial instruments, or other financial or commodity instruments for which fair value disclosure would be required under SFAS No. 107, "Disclosure About Fair Value of Financial Investments." We hold no investment securities that would require disclosure of market risk.

We do participate in certain foreign exchange currency future contracts programs to limit our risk and the potential impact of currency fluctuations on our product costs. When placing a product order, we attempt to lock in its cost by buying forward contracts on euros coinciding with the projected payment dates for such purchases. Individual forward contracts rarely extend for more than six months or exceed €300,000 (\$400,500). At March 31, 2007 total forward contracts outstanding amounted to €600,000 (\$723,700, calculated at the weighted average conversion rate in such contracts). Depending upon the term of the contract, the cost of these transactions can vary between approximately 50 to 150 basis points.

## Item 8. Financial Statements and Supplementary Data

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders  
Castle Brands Inc.

We have audited the accompanying consolidated balance sheets of Castle Brands Inc. and subsidiaries as of March 31, 2007 and 2006, and the related consolidated statements of operations, changes in stockholders' equity (deficiency) and cash flows for each of the years in the three-year period ended March 31, 2007. 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 consolidated financial position of Castle Brands Inc. and subsidiaries as of March 31, 2007 and 2006, and the consolidated results of their operations and their consolidated cash flows for each of the years in the three-year period ended March 31, 2007 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related consolidated financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 1[R] to the consolidated financial statements, effective April 1, 2006, the Company changed its method of accounting for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment".

/s/ EISNER LLP

Eisner LLP

New York, New York  
June 27, 2007



**CASTLE BRANDS INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash equivalents . . . . .	\$ 1,004,957	\$ 1,392,016
Short-term investments . . . . .	5,912,464	—
Accounts receivable – net of allowance for doubtful accounts of \$352,458 and \$395,207 . . . . .	6,503,449	3,511,215
Due from affiliates . . . . .	10,328	953,616
Inventories . . . . .	10,716,983	6,673,235
Prepaid expenses and other current assets . . . . .	1,585,901	1,021,369
<b>TOTAL CURRENT ASSETS</b> . . . . .	<b>25,734,082</b>	<b>13,551,451</b>
<b>EQUIPMENT</b> – net . . . . .	643,753	407,983
<b>OTHER ASSETS</b>		
Intangible assets – net of accumulated amortization of \$2,233,808 and \$1,379,389 . . . . .	13,813,596	13,936,427
Goodwill . . . . .	13,036,650	11,649,430
Deferred registration costs . . . . .	—	2,823,594
Restricted cash . . . . .	502,643	362,293
Other assets . . . . .	795,237	913,032
<b>TOTAL ASSETS</b> . . . . .	<b>\$ 54,525,961</b>	<b>\$ 43,644,210</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)</b>		
<b>CURRENT LIABILITIES</b>		
Current maturities of notes payable and capital leases . . . . .	\$ 419,308	\$ 3,678,547
Accounts payable . . . . .	5,150,535	3,757,515
Accrued expenses, put warrant payable and derivative instrument . . . . .	1,987,669	2,986,188
Due to stockholders and affiliates . . . . .	1,092,755	2,121,334
Convertible stockholder notes payable . . . . .	—	1,660,148
Stockholder notes payable . . . . .	—	147,113
<b>TOTAL CURRENT LIABILITIES</b> . . . . .	<b>8,650,267</b>	<b>14,350,845</b>
<b>LONG TERM LIABILITIES</b>		
Senior notes payable . . . . .	9,354,861	4,594,791
Notes payable and capital leases, less current maturities . . . . .	9,005,207	15,350,640
Preferred stock and preferred membership units dividends payable . . . . .	—	1,546,480
Deferred tax liability . . . . .	2,555,368	2,703,515
	<b>29,565,703</b>	<b>38,546,271</b>
<b>REDEEMABLE CONVERTIBLE PREFERRED STOCK</b>		
Redeemable convertible preferred stock Series A, B, C; 4,103,750 shares designated; issued and outstanding 0 and 4,089,463 shares at March 31, 2007 and 2006, respectively, liquidation preference of \$33,326,484 . . . . .	—	28,447,683
<b>COMMITMENTS AND CONTINGENCIES (Note 16)</b>		
<b>MINORITY INTERESTS</b> . . . . .	<b>1,407,645</b>	<b>2,674,731</b>
<b>STOCKHOLDERS' EQUITY (DEFICIENCY)</b>		
Preferred stock, \$.01 par value, 5,000,000 shares authorized, none outstanding		
Common stock, \$.01 par value, 45,000,000 shares authorized, 12,109,741 and 3,106,666 shares issued and outstanding at March 31, 2007 and 2006, respectively . . . . .	121,098	31,067
Additional paid in capital . . . . .	84,086,710	17,182,405
Accumulated deficiency . . . . .	(59,962,237)	(43,404,887)
Accumulated other comprehensive (loss)/income . . . . .	(692,958)	166,940
<b>TOTAL STOCKHOLDERS' EQUITY (DEFICIENCY)</b> . . . . .	<b>23,552,613</b>	<b>(26,024,475)</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)</b> . .	<b>\$ 54,525,961</b>	<b>\$ 43,644,210</b>

See accompanying notes to the consolidated financial statements.

**CASTLE BRANDS INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Years Ended March 31,		
	2007	2006	2005
Sales, net . . . . .	\$ 25,164,038	\$ 21,149,635	\$ 12,617,863
Cost of sales . . . . .	16,779,694	13,655,772	8,744,859
Gross profit . . . . .	8,384,344	7,493,863	3,873,004
Selling expense . . . . .	16,766,119	13,047,580	11,568,997
General and administrative expense . . . . .	8,646,147	5,492,925	3,636,626
Depreciation and amortization . . . . .	1,000,888	907,409	323,485
Operating loss . . . . .	(18,028,810)	(11,954,051)	(11,656,104)
Other income . . . . .	5,040	4,279	123,601
Other expense . . . . .	(46,831)	(37,099)	(45,346)
Foreign exchange gain/(loss) . . . . .	1,360,500	(337,990)	120,500
Interest expense, net . . . . .	(1,085,035)	(1,579,283)	(998,096)
Write-off of deferred financing costs in connection with conversion of 6% subordinated convertible notes . . . . .	(295,368)	—	—
Current credit/(charge) on derivative financial instrument . . . . .	117,921	15,828	(76,825)
Income tax benefit . . . . .	148,147	148,151	—
Minority interests . . . . .	1,267,086	655,946	4,721
Net loss . . . . .	(16,557,350)	(13,084,219)	(12,527,549)
Preferred stock and preferred membership unit dividends . . . . .	48,238	1,596,027	1,252,118
Net loss attributable to common stockholders . . . . .	\$(16,605,588)	\$(14,680,246)	\$(13,779,667)
Net loss attributable to common stockholders per common share			
Basic . . . . .	\$ (1.40)	\$ (4.73)	\$ (4.44)
Diluted . . . . .	\$ (1.40)	\$ (4.73)	\$ (4.44)
Weighted average shares used in computation			
Basic . . . . .	11,898,313	3,106,666	3,106,666
Diluted . . . . .	11,898,313	3,106,666	3,106,666

See accompanying notes to the consolidated financial statements.

**CASTLE BRANDS INC. AND SUBSIDIARIES**  
**Consolidated Statements of Changes in Stockholders' Equity (Deficiency)**

	<u>Common Stock</u>		<u>Additional Paid in Capital</u>	<u>Accumulated Deficiency</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Total Stockholders' Equity (Deficiency)</u>
	<u>Shares</u>	<u>Amount</u>				
<b>BALANCE, MARCH 31, 2004</b> . . . . .	3,106,666	31,067	\$18,732,301	\$(17,793,119)	\$ (41,946)	\$ 928,303
Comprehensive loss						
Net loss . . . . .				(12,527,549)		(12,527,549)
Foreign currency translation adjustment . . . . .					(152,627)	(152,627)
Total comprehensive loss. . . . .						(12,680,176)
Warrants issued in connection with senior notes . . . . .			129,195			129,195
Imputed interest on note payable in connection with acquisition of intangible assets. . . . .			126,152			126,152
Estimated fair value ascribed to warrants issued in connection with redeemable preferred stock. . . . .			164,144			164,144
Acquisition of minority interests . . . . .			(2,065)			(2,065)
Increasing rate dividend on Series C preferred stock . . . . .			297,264			297,264
Accrued preferred stock dividends . . . . .			(1,087,974)			(1,087,974)
<b>BALANCE, MARCH 31, 2005</b> . . . . .	3,106,666	31,067	18,359,017	(30,320,668)	(194,573)	(12,125,157)
Comprehensive loss						
Net loss . . . . .				(13,084,219)		(13,084,219)
Foreign currency translation adjustment . . . . .					361,513	361,513
Total comprehensive loss. . . . .						(12,722,706)
Vesting of stock options as consultancy expense. . . . .			53,440			53,440
Estimated fair value ascribed to warrants issued in connection with distribution agreement . . . . .			220,000			220,000
Estimated fair value ascribed to warrants issued in connection with redeemable preferred stock. . . . .			43,815			43,815
Increasing rate dividend on Series C preferred Stock . . . . .			38,344			38,344
Accrued preferred stock dividends . . . . .			(1,532,211)			(1,532,211)
<b>BALANCE, MARCH 31, 2006</b> . . . . .	3,106,666	\$31,067	\$17,182,405	\$(43,404,887)	\$ 166,940	\$(26,024,475)
Comprehensive loss						
Net loss . . . . .				(16,557,350)		(16,557,350)
Foreign currency translation adjustment . . . . .					(859,898)	(859,898)
Total comprehensive loss. . . . .						(17,417,248)
Accrued preferred stock dividends . . . . .			(48,238)			(48,238)
Issuance of common stock in initial public offering, net of issuance costs . . . . .	3,500,000	35,000	26,393,889			26,428,889
Conversion of redeemable convertible preferred stock, net of fractional shares . . . . .	4,089,463	40,895	28,406,772			28,447,667
Issuance of common stock in payment of accrued dividends . . . . .	193,107	1,931	1,387,834			1,389,765
Conversion of 5% euro denominated convertible subordinated notes . . . . .	263,362	2,634	1,660,539			1,663,173
Conversion of 40% of 6% convertible subordinated notes . . . . .	857,143	8,571	5,991,429			6,000,000
Issuance of common stock in connection with acquisition of McLain & Kyne, Ltd. . . . .	100,000	1,000	704,200			705,200
Vesting of stock options as consultancy expense. . . . .			29,032			29,032
Estimated fair value ascribed to warrants issued to financial consultant . . . . .			283,727			283,727
Estimated fair value ascribed to warrants issued in connection with issuance of senior notes . . . . .			706,944			706,944
Stock-based compensation. . . . .			1,388,177			1,388,177
<b>BALANCE, MARCH 31, 2007</b> . . . . .	12,109,741	\$121,098	\$84,086,710	\$(59,962,237)	\$(692,958)	\$ 23,552,613

See accompanying notes to the consolidated financial statements.

**CASTLE BRANDS INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended March 31,		
	2007	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
<b>Net loss</b> .....	\$(16,557,350)	\$(13,084,219)	\$(12,527,549)
Adjustments to reconcile net loss to net cash used in operating activities			
Depreciation and amortization .....	1,000,888	907,409	323,485
Minority interest in net loss of consolidated subsidiary ..	(1,267,086)	(655,946)	(4,721)
Loss on disposal of fixed assets .....	—	1,184	8,316
Amortization of deferred financing costs .....	390,756	470,848	387,698
Current (credit)/charge on derivative financial instrument .....	(117,921)	(15,828)	76,825
Deferred tax benefit .....	(148,147)	(148,151)	—
Effect of changes in foreign exchange .....	(1,115,522)	290,435	118,476
Stock-based compensation expense .....	1,388,178	—	—
Non-cash interest charge .....	283,727	—	—
Write-off of deferred financing costs in connection with conversion of 6% subordinated convertible notes .....	295,368	—	—
Changes in operations, assets and liabilities			
Increase in accounts receivable .....	(2,792,260)	(24,046)	(1,775,404)
(Decrease)/increase in due from affiliates .....	944,254	(599,400)	(355,161)
Increase in inventory .....	(3,764,136)	(1,459,956)	(1,569,612)
Increase in prepaid expenses and supplies .....	(550,933)	(704,739)	51,615
Increase in other assets .....	(359,051)	(355,744)	(878,568)
Increase in accounts payable and accrued expenses ..	1,823,622	572,970	1,572,920
(Decrease)/increase in due to related parties .....	(1,082,907)	536,249	1,241,179
<b>Total adjustments</b> .....	<u>(5,071,170)</u>	<u>(1,184,715)</u>	<u>(802,952)</u>
<b>NET CASH USED IN OPERATING ACTIVITIES</b> .....	<u>(21,628,520)</u>	<u>(14,268,934)</u>	<u>(13,330,501)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Acquisition of property and equipment .....	(359,432)	(197,315)	(165,725)
Acquisition of intangible assets .....	(133,816)	(194,874)	(25,988)
Business acquisitions – net of cash acquired .....	(1,282,021)	(13,379)	(406,116)
Short-term investments purchased .....	(25,000,000)	—	—
Short-term investments – sales .....	19,087,536	—	—
<b>NET CASH USED IN INVESTING ACTIVITIES</b> .....	<u>(7,687,733)</u>	<u>(405,568)</u>	<u>(597,829)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Repayment of notes payable .....	(25,421,773)	(24,256,571)	(6,694,880)
Proceeds from notes payable and warrants .....	26,909,459	33,318,866	16,421,697
Payments of obligations under capital leases .....	(3,504)	(3,603)	(1,823)
Increase in restricted cash .....	(98,548)	—	(377,828)
Issuance of redeemable convertible preferred stock and warrants .....	—	2,900,000	7,500,000
Payments for costs of stock issuances .....	—	(247,466)	(705,522)
Dividends paid on preferred membership shares .....	(204,952)	—	—
Issuance of common stock .....	31,500,000	—	—
Payments for costs of stock issuance .....	<u>(3,751,537)</u>	<u>(1,319,574)</u>	<u>—</u>

	Years Ended March 31,		
	2007	2006	2005
<b>NET CASH PROVIDED BY FINANCING</b>			
<b>ACTIVITIES</b> .....	28,929,145	10,391,652	16,141,644
<b>EFFECTS OF FOREIGN CURRENCY</b>			
<b>TRANSLATION</b> .....	49	(1,532)	1,643
<b>NET INCREASE/(DECREASE) IN CASH AND CASH</b>			
<b>EQUIVALENTS</b> .....	(387,059)	(4,282,850)	2,213,314
<b>CASH AND CASH EQUIVALENTS – BEGINNING</b> ...	1,392,016	5,676,398	3,461,441
<b>CASH AND CASH EQUIVALENTS – ENDING</b> .....	<u>\$ 1,004,957</u>	<u>\$ 1,392,016</u>	<u>\$ 5,676,398</u>
<b>SUPPLEMENTAL DISCLOSURES</b>			
Schedule of non-cash investing and financing activities			
Acquisition of intangible assets .....	\$ —	\$ —	\$ (8,051,555)
Note payable – intangible assets .....	\$ —	\$ —	\$ 2,500,000
Value ascribed to minority interests .....	\$ —	\$ —	\$ 3,329,333
Value ascribed to deferred tax liability on intangible assets .....	\$ —	\$ —	\$ 2,222,222
Acquisition of property and equipment .....	\$ —	\$ —	\$ (17,821)
Increase in capital leases payable .....	\$ —	\$ —	\$ 17,821
Reduction in cost of business acquisition .....	\$ —	\$ —	\$ (120,000)
Surrender of redeemable convertible preferred .....	\$ —	\$ —	\$ 120,000
Senior notes .....	\$ (706,944)	\$ —	\$ (129,194)
Fair value of put warrants issued in connection with senior notes – net .....	\$ 706,944	\$ —	\$ 129,194
Conversion of redeemable convertible preferred stock, net of fractional shares, by issuance of common stock .....	\$28,447,667	\$ —	\$ —
Issuance of common stock in payment of accrued dividends .....	\$ 1,389,765	\$ —	\$ —
Conversion of 5% euro denominated convertible subordinated notes by issuance of common stock ....	\$ 1,663,173	\$ —	\$ —
Conversion of 40% of 6% convertible subordinated notes by issuance of common stock .....	\$ 6,000,000	\$ —	\$ —
McLain & Kyne acquisition-net of cash acquired, by issuance of common stock .....	\$ 705,200	\$ —	\$ —
Increase in deferred registration costs .....	\$ —	\$ (1,047,477)	\$ —
Increase in accounts payable, accrued expenses, put warrant payable and derivative instrument .....	\$ —	\$ 1,047,477	\$ —
Increase in intangible assets .....	\$ —	\$ (220,000)	\$ —
Estimated fair value ascribed to warrants issued in connection with distribution agreement .....	\$ —	\$ 220,000	\$ —
Interest paid .....	\$ 1,090,962	\$ 1,178,166	\$ 343,236

See accompanying notes to the consolidated financial statements.

**CASTLE BRANDS INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements March 31, 2007**

**NOTE 1 — ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

- A. Description of business and business combination – Castle Brands Inc. is the successor to Great Spirits Company, LLC, a Delaware limited liability company (“GSC”). GSC was formed in February 1998. In May 2003, Great Spirits (Ireland) Limited (“GSI”), a wholly owned subsidiary of GSC, began operations in Ireland to market GSC’s products internationally. GSI has been an inactive entity since December 2003 and was dissolved as of September 30, 2006. In July 2003, GSRWB, Inc. (renamed Castle Brands Inc.) and its wholly owned subsidiary, Great Spirits Corp. (renamed Castle Brands (USA) Corp.) (“CB-USA”), were formed under the laws of Delaware in contemplation of a pending acquisition. On December 1, 2003, Castle Brands Inc. acquired The Roaring Water Bay Spirits Group Limited and The Roaring Water Bay Spirits Marketing and Sales Company Limited and their related entities (collectively, “Roaring Water Bay”). The acquisition has been accounted for under purchase accounting. Simultaneously, GSC was merged into CB-USA, and Castle Brands Inc. issued stock to GSC’s members in exchange for their membership interests in GSC. Subsequent to the acquisition, The Roaring Water Bay Spirits Group Limited was renamed Castle Brands Spirits Group Limited (“CB Ireland”) and The Roaring Water Bay Spirits Marketing and Sales Company Limited was renamed Castle Brands Spirits Marketing and Sales Company Limited (“CB-UK”).

In February 2005, Castle Brands Inc. acquired 60% of the shares of Gosling-Castle Partners Inc. (“GCP”), which holds the worldwide distribution rights (excluding Bermuda) to Gosling’s rum and related products.

In October 2006, Castle Brands Inc. acquired all of the outstanding capital stock of McLain & Kyne, Ltd. (“McLain & Kyne”), pursuant to a Stock Purchase Agreement. McLain & Kyne is a Louisville, Kentucky based developer and marketer of three premium small batch bourbons: Jefferson’s Reserve, Jefferson’s and Sam Houston.

As used herein, the “Company” refers to Castle Brands Inc. and, where appropriate, it also refers collectively to Castle Brands Inc. and its direct and indirect subsidiaries, including its majority owned GCP subsidiary.

- B. Organization and Operations – The Company is principally engaged in the manufacture, marketing and sale of fine spirit brands of vodka, Irish whiskey, rums and liqueurs (the “products”) in the United States, Canada, Europe, and the Caribbean.
- C. Brands – Vodka – Boru vodka, is an ultra-pure, quadruple distilled and specially filtered premium vodka. Boru is produced in Ireland and has three flavor extensions (citrus, orange and Crazzberry).

Rum – Gosling’s rums, a family of premium rums with a 150-year history, for which the Company is, through its export venture GCP, the exclusive marketer outside of Bermuda, including the award-winning Gosling’s Black Seal rum; and Sea Wynde, a premium rum developed and introduced by the Company in 2001.

Whiskey – Knappogue Castle Whiskey, a vintage-dated premium single-malt Irish whiskey; Knappogue Castle 1951, a pure pot-still whiskey that has been aged for 36 years; and the Clontarf Irish whiskeys, a family of premium Irish whiskeys, available in single malt, reserve and classic pure grain versions; three premium small batch bourbons: Jefferson’s Reserve, Jefferson’s and Sam Houston.

Liqueurs – Brady’s Irish cream, a premium Irish cream liqueur; Celtic Crossing, a premium Irish liqueur; and, pursuant to an exclusive U.S. marketing arrangement, Pallini Limoncello, Raspicello and Peachello premium Italian liqueurs.

- D. Basis of presentation – The consolidated financial statements include the accounts of Castle Brands Inc., its wholly-owned subsidiaries, CB-USA and McLain and Kyne, and its wholly-owned foreign subsidiaries, CB Ireland and CB-UK, and its majority owned Gosling-Castle Partners, Inc. with adjustments for income or loss allocated based upon percentage of ownership. The accounts of the subsidiaries have been included as of the date of acquisition. All significant intercompany transactions and balances have been eliminated.
- E. Cash equivalents – The Company considers all highly liquid instruments with a maturity at date at acquisition of three-months or less to be cash equivalents.
- F. Investments – The Company follows Statement of Financial Accounting Standards (“SFAS”) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, classifying its investments based on the intended holding period. The Company currently classifies its investments as available-for-sale. Available-for-sale securities are carried at estimated fair value, based on available market information, with unrealized gains and losses, if any, reported as a component of stockholders’ equity. Investments consist primarily of auction rate corporate debt, auction rate municipal securities, government bonds, mutual funds and corporate securities that are highly liquid in nature and represent the investment of cash that is available for current operations. Although original maturities of the Companies auction rate securities are generally longer than one year, the Company has the right to sell these securities each auction date subject to the availability of buyers. Interest rates on these securities reset at every auction date, generally every twenty eight days.
- G. Trade accounts receivable – The Company records trade accounts receivable at net realizable value. This value includes an appropriate allowance for estimated uncollectible accounts to reflect anticipated losses on the trade accounts receivable balances. The Company calculates this allowance based on its history of write-offs, level of past due accounts based on contractual terms of the receivables and its relationships with and economic status of the Company’s customers.
- H. Revenue recognition – Revenue from product sales is recognized when the product is shipped to a customer (generally a distributor), title and risk of loss has passed to the customer in accordance with the terms of sale (FOB shipping point or FOB destination), and collection is reasonably assured. Revenue is not recognized on shipments to control states in the United States until such time as product is sold through to the retail channel.
- I. Inventories – Inventories, which comprise distilled spirits, raw materials (bulk spirits, bottles, labels and caps), packaging and finished goods, are valued at the lower of cost or market, using the weighted average cost method. The Company assesses the valuation of its inventories and reduces the carrying value of those inventories that are obsolete or in excess of the Company’s forecasted usage to their estimated net realizable value. The Company estimates the net realizable value of such inventories based on analyses and assumptions including, but not limited to, historical usage, expected future demand and market requirements. Reductions to the carrying value of inventories are recorded in cost of goods sold.
- J. Equipment – Equipment consists of office equipment, computers and software and furniture and fixtures. When assets are retired or otherwise disposed of, the cost and related depreciation is removed from the accounts, and any resulting gain or loss is recognized in the statement of operations. Equipment is depreciated using the straight-line method over the estimated useful lives of the assets ranging from three to five years.
- K. Goodwill and other intangible assets – Goodwill represents the excess of purchase price including related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. As of March 31, 2007 and 2006, goodwill and other indefinite lived intangible assets that arose from acquisitions were \$13.6 million and \$11.6 million, respectively. Goodwill and other intangible assets with indefinite lives are not amortized, but instead are tested for impairment annually, or more frequently if circumstances indicate a

possible impairment may exist. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to the estimated residual values and reviewed for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The Company performed its annual impairment assessment on long-lived assets, including intangible assets and goodwill. The Company concluded that there was no impairment during the years ended March 31, 2007, 2006 and 2005.

- L. Shipping and handling – The Company reflects as inventory costs freight-in and related external handling charges relating to the purchase of raw materials and finished goods. These costs are charged to cost of sales at the time the underlying product is sold. The Company also incurs shipping costs in connection with its various marketing activities, including the shipment of point of sale materials to the Company’s regional sales managers and customers, and the costs of shipping product in connection with its various marketing programs and promotions. These shipping charges are included in selling expense. Shipping charges included in selling expense amounted to \$210,256, \$398,202 and \$280,000 for the years ended March 31, 2007, 2006 and 2005, respectively.
- M. Excise taxes and duty – Excise taxes and duty are computed at standard rates based on alcohol proof per gallon/liter and are paid after finished goods are imported into the United States and Great Britain and then transferred out of “bond.” Excise taxes and duty are recorded to inventory as a component of the cost of the underlying finished goods. When the underlying products are sold “ex warehouse” the sales price reflects the taxes paid and the inventoried excise taxes and duties are charged to cost of sales. During the years ended March 31, 2007, 2006 and 2005, the line items for the Company’s revenues and cost of sales included the amounts of excise tax and duties presented in the table below:

	<u>Year ended March 31,</u>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Sales, net . . . . .	\$6,095,939	\$3,776,049	\$1,913,450
Cost of Sales . . . . .	\$6,095,939	\$3,776,049	\$1,913,450

- N. Distributor charges and promotional goods – The Company incurs charges from its distributors for a variety of transactions and services rendered by the distributor, including product depletions, product samples for various promotional purposes, in-store tastings and training where legal, and local advertising where legal. Such charges are reflected as selling expense as incurred. In addition, for certain of its distributors, the Company has entered into arrangements whereby the purchase of a particular product or products by a distributor is accompanied by a percentage of the sale being composed of promotional goods or as a predetermined discount percentage of dollars off invoice. In such cases, the cost of the promotional goods is charged to cost of sales and dollars off invoice are a reduction to revenue.
- O. Foreign currency translation – The functional currency for the Company’s foreign operations is the euro in Europe, excluding the United Kingdom, the British pound in the United Kingdom, and the Canadian dollar in Canada. The translation from the applicable foreign currencies to U.S. dollars is performed for balance sheet accounts using current exchange rates in effect at the balance sheet date and for revenue and expense accounts using a weighted average exchange rate during the period. The resulting translation adjustments are recorded as a component of other comprehensive income. Gains or losses resulting from foreign currency transactions are shown as a separate line item in accompanying consolidated statements of operations.
- P. Fair Value of Financial Instruments – SFAS No. 107, “Disclosures About Fair Value of Financial Instruments,” defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties and



requires disclosure of the fair value of certain financial instruments. The Company believes that there is no material difference between the fair value and the reported amounts of financial instruments in the balance sheets due to the short term maturity of these instruments, or with respect to the debt, as compared to the current borrowing rates available to the Company.

- Q. Income Taxes – Under the asset and liability method of SFAS No. 109 “Accounting for Income Taxes,” deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. A valuation allowance is provided to the extent a deferred tax asset is not considered recoverable.
- R. Stock-based compensation – Effective April 1, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), as interpreted by SEC Staff Accounting Bulletin No. 107. See Note 14.
- S. Research and Development Costs – The costs of research, development and product improvement are charged to expense as incurred and are included in selling expense.
- T. Advertising – Advertising costs are expensed when the advertising first appears in its respective medium. Advertising expense, which is included in selling expense, was \$4,187,542, \$3,281,348 and \$4,032,061 for the years ended March 31, 2007, 2006 and 2005, respectively.
- U. Impairment of Long-Lived Assets – The Company periodically reviews whether changes have occurred that would require revisions to the carrying amounts of its long-lived assets. When the sum of the expected future cash flows is less than the carrying amount of the asset, an impairment loss is recognized based on the fair value of the asset. The Company concluded that there was no impairment during the years ended March 31, 2007, 2006 and 2005.
- V. Use of estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates include the accounting for items such as evaluating annual impairment tests, fair value of put warrants, derivative instruments and other equity issuances, allowance for doubtful accounts, depreciation, amortization and expense accruals.
- W. Recent accounting pronouncements – In March 2006, the FASB issued SFAS No. 156, “Accounting for Servicing of Financial Assets”. This standard is required to be adopted as of the first fiscal year beginning after September 15, 2006. The Company determined that SFAS No. 156 did not have a material impact on its financial position or results of operations.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109” (“FIN 48”), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation will apply to the Company’s fiscal year beginning April 1, 2007. The Company does not expect the interpretation will have a material impact on its results from operations or financial position.

In September 2006, the Securities and Exchange Commission (“SEC”) issued Staff Accounting Bulletin 108, “Considering the Effects on Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements,” (“SAB 108”). SAB 108 requires registrants to quantify errors using both the income statement method (i.e. iron curtain method) and the rollover method and requires adjustment if either method indicates

a material error. If a correction in the current year relating to prior year errors is material to the current year, then the prior year financial information needs to be corrected. A correction to the prior year results that are not material to those years would not require a “restatement process” where prior financials would be amended. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company determined that SAB 108 did not have a material effect on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements,” to define fair value, establish a framework for measuring fair value in accordance with generally accepted accounting principles, and expand disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, the beginning of the Company’s 2008 fiscal year. The Company is assessing the impact the adoption of SFAS No. 157 will have on the Company’s financial position and results of operations.

In February 2007, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS 159), which allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. Subsequent changes in fair value of these financial assets and liabilities would be recognized in earnings when they occur. SFAS 159 further establishes certain additional disclosure requirements. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. Management is currently evaluating the impact and timing of the adoption of SFAS 159 on the Company’s consolidated financial statements.

- X. Reclassifications – Certain prior year balances have been reclassified to conform to the current year presentation.

**NOTE 2 — BASIC AND DILUTED NET LOSS PER COMMON SHARE**

Basic net loss per common share is computed by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted net loss per common share is computed giving effect to all dilutive potential common shares that were outstanding during the period. Diluted potential common shares consist of incremental shares issuable upon exercise of stock options and warrants, contingent conversion of debentures and convertible preferred stock outstanding. In computing diluted net loss per share for the years ended March 31, 2007, 2006 and 2005, no adjustment has been made to the weighted average outstanding common shares as the assumed exercise of outstanding options and warrants and the assumed conversion of preferred stock and convertible debentures is anti-dilutive.

Potential common shares not included in calculating diluted net loss per share are as follows:

	<b>March 31,</b>		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
Stock options . . . . .	1,294,125	888,500	745,500
Stock warrants . . . . .	812,218	598,618	390,493
Convertible debentures . . . . .	1,125,000	2,245,505	888,375
Convertible preferred stock . . . . .	—	4,089,463	3,741,965
Total . . . . .	<u>3,231,343</u>	<u>7,822,086</u>	<u>5,766,333</u>

**NOTE 3 — INVESTMENTS**

The following is a summary of available-for-sale securities:

	<u>Adjusted Cost</u>	<u>Gross Unrealized Gain/(Loss)</u>	<u>Estimated Fair Value</u>
<b>March 31, 2006</b>			
Mutual funds . . . . .	1,912,464	—	1,912,464
Auction rate municipal securities . . . .	2,000,000	—	2,000,000
Auction rate corporate debt . . . . .	1,000,000	—	1,000,000
Corporate securities . . . . .	<u>1,000,000</u>	<u>—</u>	<u>1,000,000</u>
Total . . . . .	<u>5,912,464</u>	<u>—</u>	<u>5,912,464</u>

**NOTE 4 — INVENTORIES**

	<u>March 31,</u>	
	<u>2007</u>	<u>2006</u>
Raw materials . . . . .	\$ 1,501,455	\$1,339,697
Finished goods . . . . .	<u>9,215,528</u>	<u>5,333,538</u>
Total . . . . .	<u>\$10,716,983</u>	<u>\$6,673,235</u>

As of March 31, 2007 and 2006, 99% and 100%, respectively of the raw materials and 13.0% and 23.5%, respectively, of finished goods were located outside of the United States.

Inventories are stated at the lower of weighted average cost or market.

**NOTE 5 — INVESTMENTS AND ACQUISITIONS**Acquisition of McLain & Kyne, Ltd.

On October 12, 2006, the Company acquired all of the outstanding capital stock of McLain & Kyne, Ltd., pursuant to a Stock Purchase Agreement (the “Agreement”). McLain & Kyne is a Louisville, Kentucky-based developer and marketer of three premium small batch bourbons: Jefferson’s Reserve, Jefferson’s and Sam Houston. As consideration for the acquisition, the Company has paid \$2,000,000, consisting of \$1,294,800 in cash and issued 100,000 shares of its common stock, valued at \$705,200. The Company will also pay an earn-out to the sellers based on the financial performance of the acquired business. The aggregate amount of such earn-out payments, which shall not exceed \$4,000,000, will be determined by a calculation based on the gross margin (as defined in the Agreement) recognized by the Company from the sales of McLain & Kyne’s bourbons through March 31, 2011. As a result of the initial purchase price allocation, the Company recorded goodwill of \$1,387,220. The purchase price allocation for this acquisition is preliminary since the Company is in the process of determining the fair value of the assets acquired and liabilities assumed and may be revised as additional information becomes available. The preliminary fair values allocated to McLain & Kyne’s net tangible and intangible assets are as follows: current assets of \$100,021, inventory of \$53,866, intangible assets of \$600,000 and current liabilities of \$32,692. Any change in the fair value of the net assets acquired will change the amount of the purchase price allocable to goodwill. The operating results of the McLain & Kyne business are reflected in the accompanying consolidated financial statements from the date of acquisition and were not material.

The Agreement also provides for, among other things, representations, warranties, indemnities and “piggyback” registration rights for the shares issued.

The following table presents unaudited pro forma information about sales and net loss had the operations of the above described acquisition been combined with the Company’s business as of the first day of the period shown. This information has not been adjusted to reflect any changes in

the operations of McLain & Kyne subsequent to its acquisition by the Company. Changes in operations of the acquired business includes, but are not limited to, discontinuation of products changes in trade practices, application of the Company's credit policies, changes in manufacturing processes or locations, changes in marketing and advertising programs and integration of systems and personnel. Had any of these changes been implemented by the former management of the business acquired prior to acquisition by the Company, the sales and net income information might have been materially different than the actual results achieved and from the pro forma information provided below.

	<b>For the Years Ended March 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
Net sales .....	<u>\$ 25,621,644</u>	<u>\$ 21,510,515</u>	<u>\$ 13,040,270</u>
Operating loss.....	<u>\$(17,970,822)</u>	<u>\$(11,952,586)</u>	<u>\$(11,690,367)</u>
Net loss attributable to common stock holders .....	<u>\$(16,547,600)</u>	<u>\$(14,678,781)</u>	<u>\$(13,813,930)</u>
Net loss attributable to common stock holders per common share			
Basic.....	<u>\$ (1.39)</u>	<u>\$ (1.23)</u>	<u>\$ (1.16)</u>
Diluted.....	<u>\$ (1.39)</u>	<u>\$ (1.23)</u>	<u>\$ (1.16)</u>
Weighted average shares:			
Basic.....	<u>11,898,313</u>	<u>11,898,313</u>	<u>11,898,313</u>
Diluted.....	<u>11,898,313</u>	<u>11,898,313</u>	<u>11,898,313</u>

In management's opinion, the unaudited pro forma results of operations are not indicative of the actual results that would have occurred had the above acquisitions been consummated at the beginning of the periods presented or of future operations of the combined companies under our management.

#### Investment in Gosling-Castle Partners Inc.

In February 2005, the Company entered into a stock subscription agreement for 60% of the stock of Gosling Partners, Inc., whose name was subsequently changed to Gosling-Castle Partners Inc.

The Company agreed to pay GCP \$5,000,000 for its 60% interest: \$100,000 in cash and issuance of a promissory note of \$4,900,000 to GCP for the balance owed. The promissory note was payable in five installments with one remaining payment of \$750,000 due April 1, 2007.

Effective with the payment of the second installment on October 1, 2005, this promissory note began accruing interest on the unpaid principal amount at the rate of 4% per annum until the note is repaid in full. As of March 31, 2007 and 2006, \$105,000 and \$55,000, respectively, in interest on this note has been accrued and remains unpaid.

The global distribution agreement commenced on April 1, 2005 and has a 15 year term. It is renewable for additional 15 year terms as long as GCP meets certain case sale targets during the initial term as set forth in the agreement. (See Note 18 – Gosling-Castle Partners Inc. Export Agreement with Gosling's Export (Bermuda) Limited). The Company ascribed the entire purchase of \$5,000,000 to the Gosling global distribution agreement described above. In conjunction with this transaction the Company recorded a deferred tax liability of \$2,222,222 to reflect the difference between the adjusted book value and tax basis. This deferred tax liability was recorded as an increase to the value of the distribution agreement and is included in intangible assets.

Castle Brands Inc. has agreed to fund certain operating losses of GCP. The balance funded at March 31, 2007 is approximately \$2,800,000.

**NOTE 6 — EQUIPMENT**

Equipment consists of the following:

	<b>March 31,</b>	
	<u>2007</u>	<u>2006</u>
Equipment and software .....	\$1,248,871	\$827,628
Furniture and fixtures .....	45,898	32,478
Leasehold improvements .....	<u>—</u>	<u>4,733</u>
	1,294,769	864,839
Less: accumulated depreciation .....	<u>651,016</u>	<u>456,856</u>
	<u>\$ 643,753</u>	<u>\$407,983</u>

Depreciation expense for the years ended March 31, 2007, 2006 and 2005 totaled \$162,625, \$125,014, and \$81,724 respectively.

**NOTE 7 — GOODWILL AND INTANGIBLE ASSETS**

The changes in the carrying amount of goodwill for the years ended March 31, 2007, 2006 and 2005 were as follows:

	<u>Amount</u>
Balance as of March 31, 2005 .....	\$11,636,051
Acquisition of minority interests .....	<u>13,379</u>
Balance as of March 31, 2006 .....	11,649,430
Acquisition of McLain & Kyne, Ltd .....	<u>1,387,220</u>
Balance as of March 31, 2007 .....	<u>\$13,036,650</u>

Intangible assets consist of the following:

	<b>March 31,</b>	
	<u>2007</u>	<u>2006</u>
Definite life brands .....	\$ 308,909	\$ 194,159
Trademarks .....	408,222	341,604
Rights .....	9,036,793	9,036,793
Patents .....	825,000	825,000
Distribution relationship .....	416,000	416,000
Supply relationship .....	732,000	732,000
Other .....	<u>28,480</u>	<u>78,260</u>
	11,755,404	11,623,816
Less: accumulated amortization .....	<u>2,233,808</u>	<u>1,379,389</u>
Net .....	9,521,596	10,244,427
Other identifiable intangible assets – indefinite life		
Trade names and formulations .....	<u>4,292,000</u>	<u>3,692,000</u>
	<u>\$13,813,596</u>	<u>\$13,936,427</u>

Accumulated amortization consists of the following:

	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Brands.....	\$ 230,992	\$ 101,902
Trademarks.....	25,790	116,071
Rights.....	1,220,093	668,150
Patents.....	183,333	128,333
Distribution relationship.....	329,600	194,133
Supply relationship.....	244,000	170,800
Accumulated amortization.....	<u>\$2,233,808</u>	<u>\$1,379,389</u>

Amortization expense for the years ended March 31, 2007, 2006 and 2005 totaled \$838,263, \$782,395 and \$241,761, respectively.

On September 1, 2006, the Company delivered notice to Comans Wholesale Limited that it was terminating its distribution agreement. As a result of the delivery of the notice, the distribution agreement will terminate, as provided for by its terms, as of September 15, 2007. The Company has adjusted the estimated useful life of the underlying intangible asset to agree to the termination date. The change in estimated useful life resulted in an additional \$52,300 in amortization expense for the year ended March 31, 2007.

Estimated aggregate amortization expense for each of the five succeeding fiscal years is as follows:

<b><u>For the years ending March 31,</u></b>	<b><u>Amount</u></b>
2008.....	\$ 789,326
2009.....	760,106
2010.....	704,639
2011.....	704,639
2012.....	704,639
Total.....	<u>\$3,663,349</u>

#### **NOTE 8 — RESTRICTED CASH**

In connection with the credit facilities as described in Note 10, personal guarantees of the two former managing directors of CB Ireland and CB-UK in the amount of €158,717 were cancelled and replaced with a deposit of cash collateral of €300,000, or \$400,050 (as translated at the exchange rate in effect on March 31, 2007). For purposes of increasing the Company's creditors insurance in Ireland, this deposit of cash collateral has subsequently been increased to €376,935, or \$502,643 (as translated at the exchange rate in effect on March 31, 2007).

#### **NOTE 9 — OVERDRAFT ACCOUNTS**

CB Ireland and CB-UK maintain overdraft coverage with a financial institution in Ireland of up to €400,000 (\$533,400) and £20,000 (\$39,250), respectively. Overdraft balances included in notes payable totaled \$380,334 and \$98,327 at March 31, 2007 and 2006, respectively.

**NOTE 10 — SENIOR NOTES PAYABLE, NOTES PAYABLE AND CAPITAL LEASE**

	March 31,	
	2007	2006
Notes payable consist of the following:		
Revolving credit facilities <sup>(A)</sup> .....	\$ 407,261	\$ 332,409
Revolving credit facilities <sup>(B)</sup> .....	8,363	166,283
Subordinated notes <sup>(C)</sup> .....	—	307,938
Senior notes <sup>(D)</sup> .....	9,354,861	4,594,791
Subordinated convertible notes <sup>(E)</sup> .....	9,000,000	15,000,000
Non-interest bearing notes <sup>(F)</sup> .....	—	1,210,162
9% Promissory note <sup>(G)</sup> .....	—	2,000,000
	<u>18,770,485</u>	<u>23,611,583</u>
Capital leases .....	<u>8,891</u>	<u>12,395</u>
Total .....	<u>\$18,779,376</u>	<u>\$23,623,978</u>

(A) The Company has arranged revolving credit facilities aggregating approximately €1,412,303 (\$1,883,306) with a lender for working capital purposes. These facilities are payable on demand, continue until terminated by either party on not less than three months prior written notice, and call for interest at rates ranging from prime plus 3% to prime plus 7.85%. The Company also maintains a €190,000 (\$253,365) term note with the same lender. The note carries an interest rate of 5.2%, is payable on demand and subject to annual review and renewal by the lender, and calls for monthly payments of principal and interest of €6,377 through 2007.

(B) The Company has arranged revolving credit facilities aggregating approximately £242,000 (\$474,992). The facilities, which are payable on demand and subject to annual review and renewal by the lender, call for interest at rates ranging from prime plus 2% to prime plus 2.25%.

(C) In connection with the Company's acquisition of CB Ireland, the Company issued to the former minority shareholders of CB Ireland €255,000 (\$307,937) of subordinated notes, which were set to mature on July 11, 2007. The notes accrued interest at the rate of 5.7% per annum with the aggregate interest payable being limited to €51,000 (\$61,588). All outstanding principal and accrued interest on these notes in the amount of €290,328 (\$350,600) were paid in April 2006.

(D) On June 9, September 28 and October 13, 2004, the Company issued \$3,555,000, \$1,005,000 and \$100,000, respectively, of senior notes secured by accounts receivable and inventories of CB-USA. As issued, these senior notes bore an interest rate of 8%, payable semi-annually on November 30 and May 31, with an original maturity date of May 31, 2007. In addition, each holder of \$1,000 of senior notes received warrants to purchase 25 shares of the Company's common shares at \$8.00 per share, expiring May 31, 2009. There were 116,500 warrants issued in conjunction with the issuance of the senior notes. These warrants have been valued at \$129,195 in the aggregate and have been treated as a discount to the notes payable. Effective August 15, 2005, the terms of these notes were modified with the consent of the note holders to mature on May 31, 2009 in exchange for an interest rate adjustment to 9%. Interest expense pertaining to the discount to the notes payable is recognized, and the notes payable accreted, over the adjusted term of the notes.

On November 10, 2006, CB-USA issued to 11 individuals an aggregate of \$5,340,000 of additional senior notes secured by accounts receivable and inventories of CB-USA. These notes mature on May 31, 2009 and bear interest at 9% payable semi-annually. In addition, each holder of senior notes received warrants to purchase 40 shares of the Company's common stock at \$8.00 per share, expiring May 31, 2009, for each \$1,000 of principal purchased by such holder. There were 213,600 warrants issued in conjunction with the issuance of the additional senior notes. These warrants have been valued at \$706,944 in the aggregate and have been treated as a discount to the notes

payable. Interest expense pertaining to this discount is recognized, and the notes payable accreted, over the term of the notes. The total assets securing these notes aggregated \$12,108,958 at March 31, 2007.

- (E) On March 1, 2005, the Company entered into an agreement to issue up to \$10,000,000 of subordinated convertible notes to a single investor. As of March 31, 2005, \$5,000,000 of convertible notes were issued. In June 2005, the Company issued the remaining \$5,000,000 of convertible notes. The notes, which mature on March 1, 2010, bear interest at the rate of 6% per annum which is payable quarterly. The Company has the option for the first two years from the date of issuance to pay interest in kind at the rate of 7.5% per annum. Through March 31, 2007, the Company has accrued and paid all interest in cash at the 6% percent rate pursuant to the terms of the note and has the means and intent to continue to do so. The notes may be converted into common stock at \$8 per share at any time, and shall be converted at the option of the holder or automatically after the third year from the date of issuance and upon the 30th consecutive trading day on which the closing price of the common stock is no less than \$20 per share. Upon the completion of our initial public offering on April 10, 2006, 40% of the notes converted automatically into common stock at a price of \$7.00 per share.

In July 2005, the Company entered into an agreement with an investor to issue \$5,000,000 of subordinated convertible notes. The closing was completed in August 2005. The notes, which mature on March 1, 2010, bear interest at the rate of 6% per annum. The Company has the option for the first two years from the date of issuance to pay interest in kind at the rate of 7.5% per annum. Through March 31, 2007, the Company has accrued and paid all interest in cash at the 6% percent rate pursuant to the terms of the note and has the means and intent to continue to do so. The notes may be converted into common stock at \$8 per share at any time, and shall be converted automatically after the third year from the date of issuance and upon the 30th consecutive trading day on which the closing price of the common stock is no less than \$20 per share. 40% of the notes converted automatically into common stock upon the completion of our initial public offering on April 10, 2006, at a price of \$7.00 per share.

In July 2005, the original \$10,000,000 of convertible notes were amended to be equivalent in terms to those of the new \$5,000,000 investor. The automatic conversion of 40% of the combined \$15,000,000 of convertible notes at the \$7.00 conversion price upon the closing of the initial public offering resulted in the issuance of 107,143 more shares than would have been issued at the \$8.00 conversion price.

- (F) On February 14, 2005, the Company, through its interest in GCP, entered into an agreement with Gosling's Export (Bermuda) Limited ("GXB") to acquire the global distribution rights (excluding Bermuda) to GXB's portfolio of products in exchange for \$2,500,000 in non-interest bearing notes due in four equal semi-annual installments. These notes have been paid in full as of March 31, 2007.
- (G) On February 17, 2006, the Company entered into a \$5 million credit agreement with an investment trust which is a stockholder and controlled by one of the Company's directors. On February 17, 2006, the Company borrowed \$2.0 million under this credit agreement and issued a promissory note bearing interest at the rate of 9% per annum, payable at maturity. In addition, the Company paid a \$100,000 facility fee upon receipt of these funds. The Company repaid all outstanding principal and accrued interest under this note in the amount of \$2,026,000 in April 2006.

The Company financed the purchase of certain office equipment totaling \$17,821 included in equipment. The lease calls for monthly payments of \$337 in principal and interest at the rate of 5% per annum, to be paid through July 2009. As of March 31, 2007 and 2006, the Company owed \$8,891 and \$12,395, respectively, under this lease. Future minimum lease payments equal \$9,442 including interest.



Principal payments due over the next five years for the above listed notes payable and capital lease are due as follows (as translated at the exchange rate in effect on March 31, 2007):

<u>For the years ending March 31,</u>	
2008 .....	\$ 419,308
2009 .....	3,873
2010 .....	<u>18,356,195</u>
Total.....	18,779,376
Less current portion .....	<u>419,308</u>
Non current portion.....	<u>\$18,360,068</u>

**NOTE 11 — COMMON STOCK**

On April 10, 2006, the Company completed its initial public offering by issuing 3,500,000 shares of common stock at \$9.00 per share.

Net proceeds to the Company after payment of issuance costs not already paid as of April 10, 2006 were \$26,428,889, determined as follows:

Aggregate offering proceeds to the Company ..	<u>\$31,500,000</u>
Underwriting discounts and commissions .....	2,205,000
Other fees and expenses .....	<u>2,866,111</u>
Total expenses .....	<u>5,071,111</u>
Net proceeds to the company .....	<u>\$26,428,889</u>

Concurrently with the initial public offering, the following transactions occurred:

- The conversion of all of the Company's outstanding Series A convertible preferred stock into 535,715 shares of common stock;
- The conversion of all of the Company's outstanding Series B convertible preferred stock into 200,000 shares of common stock;
- The conversion of all of the Company's outstanding Series C convertible preferred stock into 3,353,748 shares of common stock;
- 193,107 shares of common stock were issued in payment of all of the dividends accrued on preferred stock through April 9, 2006;
- All of the €1,374,750 (\$1,660,148) principal amount of the Company's 5% euro denominated convertible subordinated notes was converted into 263,362 shares of common stock;
- \$6.0 million (40%) of the \$15.0 million principal amount of the Company's 6% convertible notes was converted into 857,143 shares of common stock;

On November 24, 2006, the Company issued 100,000 shares of common stock in connection with the acquisition of all of the outstanding capital stock of McLain & Kyne, Ltd.

**NOTE 12 — FOREIGN CURRENCY FORWARD CONTRACTS**

The Company enters into forward contracts to attempt to limit its exposure to foreign currency fluctuations. The Company recognizes in the balance sheet derivative contracts at fair value, and reflects any net gains and losses currently in earnings. At March 31, 2006, the Company held outstanding forward exchange positions for the purchase of euros, expiring through July 2006, in the amount of \$723,700 with a weighted average conversion rate of €1 = \$1.2062 as compared to the spot rate at March 31, 2006 of €1 = \$1.2076. At March 31, 2007, the Company held outstanding forward exchange positions for the purchase of euros, expiring through June 2007, in the amount of \$1,137,824 with a weighted average conversion rate of €1 = \$1.3292 as compared to the spot rate at March 31, 2007 of €1 = \$1.3335. Gain or loss on foreign transactions, which was de minimus, is included in other income and expense.

### NOTE 13 — PROVISION FOR INCOME TAXES

The Company's income taxes benefit (expense) for the years ended March 31, 2007, 2006 and 2005 consists of federal and state and local taxes attributable to GCP, which does not file a consolidated income tax return with the Company, and foreign taxes. As of March 31, 2007, the Company had federal net operating loss carry forwards of approximately \$31,760,000 for U.S. tax purposes, which expire through 2027 and foreign net operating loss carry forwards of approximately \$13,290,000 which carry forward without limit of time.

The pre-tax loss, on a financial statement basis, from foreign sources totaled (\$4,111,657), (\$2,255,627), and (\$4,026,096) for the years ended March 31, 2007, 2006, and 2005, respectively.

The Company does not have any undistributed earnings from foreign subsidiaries at March 31, 2007, 2006 and 2005.

The following table reconciles the income tax (benefit) expense and the federal statutory rate of 34%.

	For the years ended March 31,		
	2007	2006	2005
	%	%	%
Computed expected tax benefit, at 34%.....	34.00	34.00	34.00
Increase in valuation allowance.....	(41.41)	(30.47)	(28.34)
Effect of foreign rate differential.....	(5.96)	(4.11)	(8.22)
Stock based compensation.....	8.38%	—	—
Other.....	(1.91)	(6.54)	(3.44)
State and local taxes, net of federal benefit.....	<u>6.00</u>	<u>6.00</u>	<u>6.00</u>
Income tax benefit.....	<u>(0.90)</u>	<u>(1.12)</u>	<u>—</u>

In connection with the investment in GCP, the Company recorded a deferred tax liability on the ascribed value of the acquired intangible assets of \$2,222,222, increasing the value of the asset. The deferred tax liability is being reversed and a deferred tax benefit is being recognized over the amortization period of the intangible asset (15 years). For the years ended March 31, 2007, 2006 and 2005, the Company recognized \$148,147, \$148,151 and \$0, respectively.

On December 1, 2003, the Company recorded a deferred tax liability of \$629,444 as the amount ascribed to the difference between the book and tax basis of the tangible and intangible assets acquired as additional goodwill.

The tax effects of temporary differences that give rise to deferred tax assets and deferred tax liabilities are presented below.

	<b>March 31,</b>	
	<b>2007</b>	<b>2006</b>
Deferred income tax asset		
Foreign currency transactions .....	\$ 50,000	\$ 66,000
Accounts receivable .....	35,000	—
Stock based compensation .....	555,000	—
Amortization of intangibles .....	312,000	—
Net operating loss carryforwards – U.S. ....	12,705,000	8,117,000
Net operating loss carryforwards – foreign .....	1,328,000	917,000
Other .....	2,000	—
Total gross assets .....	14,987,000	9,100,000
Less: Valuation allowance .....	<u>(14,987,000)</u>	<u>(9,100,000)</u>
Net deferred asset .....	<u>\$ —</u>	<u>\$ —</u>
Deferred income tax liability		
Intangible assets acquired in acquisition of subsidiary .....	\$ (629,444)	\$ (629,444)
Intangible assets acquired in investment in strategic-venture .....	<u>(1,925,924)</u>	<u>(2,074,071)</u>
Net deferred income tax liability .....	<u>\$ (2,555,368)</u>	<u>\$ (2,703,515)</u>

The Company has recorded a full valuation allowance against its deferred tax assets as it believes it is more likely that such deferred tax assets will not be realized. The valuation allowance for deferred tax assets as of March 31, 2007, 2006 and 2005 was approximately \$14,987,000, \$9,100,000 and \$5,000,000 respectively. The net change in the total valuation allowance for the years ended March 31, 2007, 2006 and 2005 was \$5,887,000, \$4,100,000 and \$3,550,000, respectively. The Company does not offset its deferred tax assets and liabilities because its deferred tax assets and liabilities are in different taxable entities which do not file consolidated returns.

**NOTE 14 — STOCK OPTIONS AND WARRANTS**

- A. **Stock Options** – In July 2003, the Company implemented the 2003 Stock Incentive Plan (“the Plan”) which provides for awards of incentive and non-qualified stock options, restricted stock and stock appreciation rights for its officers, employees, consultants and directors in order to attract and retain such individuals who contribute to the Company’s success by their ability, ingenuity and industry knowledge, and to enable such individuals to participate in the long-term success and growth of the Company by giving them an equity interest in the Company. There are 2,000,000 common shares reserved and available for distribution under the Plan, of which 705,875 remain available. Stock options granted under the Plan are granted with an exercise price at or above the fair market value of the underlying common stock at the date of grant, generally vest over a four or five year period and expire ten years after the grant date.

Prior to April 1, 2006, the Company accounted for stock options according to the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations, and therefore no related compensation expense was recorded for awards granted with no intrinsic value. The Company adopted the modified prospective transition method provided for under SFAS 123R, and consequently, had not retroactively adjusted results from prior periods. Under this transition method, compensation cost associated with stock options recognized in the year ended March 31, 2007 includes: 1) amortization related to the remaining unvested portion of all stock option awards granted prior to April 1, 2006 over the requisite service period based on the grant-date fair value

estimated in accordance with the original provisions of SFAS 123, *Accounting for Stock-Based Compensation* ; and 2) amortization related to all stock option awards granted on or subsequent to April 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. A compensation charge is recorded when it is probable that performance or service conditions will be satisfied. The probability of vesting is updated annually and compensation is adjusted via a cumulative catch-up adjustment or prospectively depending upon the nature of the change.

For stock options granted prior to the adoption of SFAS 123R, if compensation expense for the Company's stock option plan had been determined based upon estimated fair values at the grant dates in accordance with SFAS No. 123R, the Company's pro forma net loss and pro forma basic and diluted net loss per common share would have been as follows:

	<u>For the years ended March 31,</u>	
	<u>2006</u>	<u>2005</u>
Net loss attributable to common stockholders, as reported .....	\$(14,680,246)	\$(13,779,667)
Stock-based compensation expense determined under fair value method .....	<u>(354,556)</u>	<u>(370,068)</u>
Pro forma net loss attributable to common stockholders .....	<u>\$(15,034,802)</u>	<u>\$(14,149,735)</u>
Loss per share: Basic and diluted – as reported .....	<u>\$ (4.73)</u>	<u>\$ (4.44)</u>
Basic and diluted – pro forma .....	<u>\$ (4.84)</u>	<u>\$ (4.55)</u>

As a result of the adoption of SFAS 123R, incremental compensation expense for the year ended March 31, 2007 amounted to \$1,388,178, of which \$390,931 is included in selling expense and \$997,247 is included in general and administrative expense in the accompanying consolidated statements of operations. At March 31, 2007 total unrecognized compensation cost amounted to approximately \$2,677,765, representing 720,500 unvested options. There were no options exercised under the share-based payment arrangements for the year ended March 31, 2007.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model and is affected by assumptions regarding a number of highly complex and subjective variables. The use of an option pricing model also requires the use of a number of complex assumptions including expected volatility, risk-free interest rate, expected dividends, and expected term. Expected volatility is based on the historical volatility of a peer group of companies over the expected life of the option as the Company does not have enough history trading as a public company to calculate its own stock price volatility. The expected term and vesting 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 U.S. Treasury yield curve in effect at the time of grant for the expected term of the option. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future. SFAS 123R also requires the Company to estimate forfeitures at the time of grant and revise these estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company estimates forfeitures based on its expectation of future experience while considering its historical experience.

A summary of the options outstanding under the stock option plan is as follows:

	Year ended March 31,					
	2007		2006		2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year . . . . .	888,500	\$6.82	745,500	\$6.47	563,000	\$6.00
Granted . . . . .	713,125	7.44	190,000	8.00	279,500	7.26
Forfeited . . . . .	(307,500)	6.70	(47,000)	6.00	(97,000)	6.00
Outstanding at end of period . . . . .	<u>1,294,125</u>	<u>7.19</u>	<u>888,500</u>	<u>6.82</u>	<u>745,500</u>	<u>6.47</u>
Options exercisable at period end . . . . .	<u>573,625</u>	<u>\$7.07</u>	<u>301,767</u>	<u>\$6.40</u>	<u>174,533</u>	<u>\$6.36</u>
Weighted average fair value of options granted during the period . . . . .		\$5.02		\$3.05		\$2.69

The following table represents information relating to stock options outstanding at March 31, 2007:

Range of Exercise Prices	Options Outstanding		Options Exercisable		
	Shares	Weighted Average Remaining Life in Years	Shares	Weighted Average Exercise Price	Aggregate Intrinsic value
\$5.00 – \$6.00 . . . . .	465,500	7.01	296,500	\$5.98	\$275,745
\$6.01 – \$7.00 . . . . .	81,000	9.85	—	6.07	—
\$7.01 – \$8.00 . . . . .	547,000	8.47	181,500	7.73	—
\$8.01 – \$9.00 . . . . .	<u>200,625</u>	<u>9.29</u>	<u>95,625</u>	<u>9.00</u>	<u>—</u>
	<u>1,294,125</u>		<u>573,625</u>		<u>\$275,745</u>

As of March 31, 2007, the total stock options outstanding were 1,294,125. The weighted average exercise price of these options was \$7.19. Total stock options exercisable as of March 31, 2007 were 573,625. The weighted average remaining life of the options outstanding and exercisable was 8.15 and 7.78, respectively. The weighted average exercise price of these options was \$7.07.

The fair value of options at date of grant was estimated using the Black-Scholes option-pricing model utilizing the following weighted average assumptions:

	March 31, 2007	March 31, 2006	March 31, 2005
Risk-free interest rate . . . . .	4.61%	4.41%	4.42%
Expected options life in years . . . . .	7.00	7.00	6.79
Expected stock price volatility . . . . .	66%	25%	25%
Expected dividend yield . . . . .	0%	0%	0%

The following summarizes the activity of the Company's stock options that have not vested for the years ended March 31, 2007, 2006 and 2005:

	<u>Shares</u>	<u>Weighted Average Exercise Price</u>
Nonvested at April 1, 2004 . . . . .	563,000	\$6.00
Granted . . . . .	279,500	7.26
Canceled or expired . . . . .	(97,000)	6.00
Vested . . . . .	<u>(174,533)</u>	6.36
Nonvested at March 31, 2005 . . . . .	570,967	6.50
Granted . . . . .	190,000	8.00
Canceled or expired . . . . .	(47,000)	6.00
Vested . . . . .	<u>(127,234)</u>	6.45
Nonvested at March 31, 2006 . . . . .	586,733	7.04
Granted . . . . .	713,125	7.44
Canceled or expired . . . . .	(307,500)	6.70
Vested . . . . .	<u>(271,858)</u>	7.81
Nonvested at March 31, 2007 . . . . .	<u>720,500</u>	<u>\$7.21</u>

As of March 31, 2007, there was \$2,677,765 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under existing stock option plans. This cost is expected to be recognized over a weighted-average period of 4.20 years. The total fair value of shares vested during the years ended March 31, 2007, 2006 and 2005 was \$1,154,377, \$354,556 and \$370,068, respectively.

Since no options were exercised, the Company did not recognize any tax benefit for the years ended March 31, 2007, 2006 and 2005.

B. Stock Warrants – The Company has entered into various warrant agreements.

Common Stock Warrant Issued to the Financing Agent

On August 29, 2002, in connection with a revolving credit facility, the Company granted to the lender, Keltic Financial Partners, LP (“Keltic”), a warrant to acquire 100,000 shares of the Company’s common stock at an exercise price of \$6.00. The warrant is subject to anti-dilution provisions, upon the occurrence of certain events such as stock splits and stock dividends, vests immediately and is exercisable through September 1, 2014. The warrant is exercisable at any time and includes a cashless exercise provision. The Company was not obligated to register the warrant or the underlying shares, except to the extent that, if the Company elected to file a registration statement, Keltic could have the shares underlying its warrant included in that registration statement and the Company would assume all registration costs and other expenses in connection with such registration. The Company filed such registration statement on May 31, 2007, and Keltic elected to have the shares underlying its warrant included in such registration statement.

From the date of issuance through September 27, 2005, when the warrant was amended, the warrant contained a put option right based on the intrinsic value of the warrants exercised that could be exercised by the holder at any time commencing as of September 2006 and ending on the warrant expiration date.

The \$282,295 fair value assigned to the warrant was recorded as a financing cost reduction in the value assigned to the loan’s credit facility (debt discount amount). Such amount was to be recognized over the three-year life of the credit facility as additional interest expense. The Company has recorded interest expense for the year ended March 31, 2005 of \$133,307. The credit facility was closed in June 2004 and the unaccreted balance recognized as additional interest expense at that time.

The Company accounted for the warrant and the put option rights as a compound financial instrument in the consolidated financial statements at fair value following the guidelines of EITF 00-19, paragraphs 44 and 45, and paragraphs 11 and 24 of SFAS 150. Changes in the fair value of the compound instrument are recognized in earnings for each reporting period. For the years ended March 31, 2007, 2006 and 2005, the Company recorded a (credit)/charge for the change in the value of the compound financial instrument of (\$117,921), (\$15,828) and \$76,825, respectively. The Company recorded a (credit) of (\$18,752) as of September 30, 2005 to reflect the change in fair value of the compound instrument as a result of the amendment discussed below.

On September 27, 2005, the warrant was amended to eliminate the cash put feature and replace it with certain penalties (up to \$200,000) if the shares underlying the warrant have not been registered by June 1, 2007 and June 1, 2008. The Company agreed that if on either June 1, 2007 or June 1, 2008 (a) there are shares of common stock received or issuable upon the exercise of the warrant that have not been registered, and (b) it has not filed a registration statement with respect to which Keltic had the opportunity to register the unregistered shares, the Company would pay Keltic \$100,000 within ten (10) days of such dates.

The Company accounted for the warrant and the registration rights penalty as a derivative following the guidance of EITF 00-19. The Company has concluded that the amendment to the warrant agreement obligating the Company to issue registered shares by the stated dates is dependent both on the Commission's acceptance of the Company's registration and on the underwriters' ability to successfully market the shares. Since these factors are beyond the control of the Company, it has accounted for the instrument as if it would be required to be net-cash settled.

The Company applied EITF 05-04, View A, concluding that the registration rights are inseparable from the underlying warrant and should be accounted for together as a unit (the delivery of unregistered shares, plus the cash penalty, in exchange for the exercise price) and recorded as a liability at fair value at each reporting date with changes in fair value reported in earnings.

The Company has reflected the fair value of the combined instrument at March 31, 2007 and 2006 included in the balance sheet caption accrued expenses, put warrants payable and derivative instrument of approximately \$189,000 and \$307,000, respectively.

#### Common Stock Warrants Issued to Senior Note Holders

In connection with the issuance of the senior notes in November 2006, the Company entered into a warrant agreement to grant the right to purchase 213,600 shares of the Company's common stock at an exercise price of \$8.00 per share at any time through May 31, 2009. These warrants were recorded at relative fair value and accounted for as a discount to the face value of the senior notes and a credit to additional paid-in capital in the amount of \$706,944. This discount will be recognized over the adjusted term of the senior notes with a charge to interest expense and a credit to senior notes payable. For the years ended March 31, 2007, 2006 and 2005, the Company recorded \$127,014, \$28,081 and \$30,668 of additional senior note accretion as additional interest expense.

#### Common Stock Warrants Issued to Financial Advisor

In July 2005, the Company granted to a financial advisor warrants to purchase up to 100,000 shares of common stock at \$8.00 per share. The warrants are subject to anti-dilution provisions, such as stock splits and stock dividends, and vested upon the completion of the initial public offering in April 2006. The Company fair valued the warrant at \$283,727 and recorded a charge upon vesting. The charge is included in interest expense on the accompanying consolidated statements of operations.

The following is a summary of the company's outstanding warrants:

	<u>Warrants</u>	<u>Weighted Average Exercise Price Per Warrant</u>
Warrants outstanding, April 1, 2004.....	207,118	7.03
Granted .....	183,375	8.00
Exercised .....	—	—
Forfeited .....	—	—
Warrants outstanding, March 31, 2005 .....	390,493	7.49
Granted .....	208,125	8.00
Exercised .....	—	—
Forfeited .....	—	—
Warrants outstanding and exercisable, March 31, 2006. . .	<u>598,618</u>	<u>\$7.67</u>
Granted .....	213,600	8.00
Exercised .....	—	—
Forfeited .....	—	—
Warrants outstanding and exercisable, March 31, 2007. . .	<u>812,218</u>	<u>\$7.75</u>

**NOTE 15 — RELATED PARTY TRANSACTIONS**

- A. The Company is operating under an agreement with MHW, Ltd. (“MHW”) whereby MHW acts as the Company’s agent in the distribution of its products across the United States. MHW’s president also serves as a director of the Company and has a de minimis indirect ownership interest in the Company. In addition, MHW has a 10% ownership interest in the Celtic Crossing brand, one of the Company’s products, in the United States and its territories, Canada, Mexico, and the Caribbean.

Pursuant to the MHW distribution agreement, MHW receives sales orders from the Company’s domestic wholesalers at prices agreed upon with the Company. MHW simultaneously purchases Company inventory necessary to fill those orders and ships that inventory to the various wholesalers. MHW then invoices, collects, and deposits remittances from those wholesalers into an MHW bank account designated for the Company. The funds are remitted to the Company on a bi-weekly basis. Although MHW is responsible for the billing function, the collected funds are the property of the Company and MHW is not liable to the Company for any unpaid balances due from wholesalers.

In addition to the distribution services provided for the Company, MHW also provides administrative and support services on behalf of the Company. For the years ended March 31, 2007, 2006 and 2005, aggregate charges recorded for all services provided were approximately \$268,826, \$227,303, and \$121,393, respectively, which have been included in general and administrative expenses on the accompanying consolidated statements of operations.

- B. The Company had transactions with Knappogue Corp., a shareholder in the Company. Knappogue Corp. is controlled by the Company’s CEO and his family. The transactions primarily involved rental fees for use of Knappogue Corp.’s interest in the Knappogue Castle for various corporate purposes including Company meetings and to entertain customers. For the years ended March 31, 2007, 2006 and 2005, fees incurred by the Company to Knappogue Corp. amounted to \$21,000, \$15,018 and \$18,620 respectively. These charges have been included in selling expense in the accompanying consolidated statements of operations.
- C. In April 2004, the Company contracted with BPW, Ltd., for business development services including providing introductions for the Company to agency brands that would enhance the



Company's portfolio of products and assisting the Company in successfully negotiating agency agreements with targeted brands. BPW, Ltd. is controlled by a director of the Company. The contract provides for a monthly retainer to BPW, Ltd. of \$3,500, a bonus payable to BPW Ltd. in equal quarterly installments upon the finalization of an agency brand agreement based upon estimated annual case sales by the Company during the first year of operations at the rate of \$1 per 9-liter case of volume, less any retainer previously paid, and a commission based upon actual future sales of the agency brand while under the Company's management. This contract is cancelable by either party, at their convenience, upon 30 days written notice. For the years ended March 31, 2007, 2006 and 2005, BPW, Ltd. was paid \$61,978, \$63,364 and \$41,802, respectively, under this contract. These charges have been included in general and administrative expense on the accompanying consolidated statements of operations.

- D. For the years ended March 31, 2007, 2006 and 2005, the Company purchased goods and services from Terra Manufacturing Limited ("Terra") and Carbery Milk Products Limited ("Carbery") of approximately \$3,301,943, \$2,738,678 and \$2,501,600, respectively. The Company had assumed the underlying supplier agreements with Terra and Carbery from CB-Ireland. Terra's affiliate, Tanis Investments, and Carbery are both shareholders in the Company. As of March 31, 2007 and 2006, the Company was indebted to these two affiliates in the amount of approximately \$668,097 and \$367,678 respectively, which is included in due to stockholders and affiliates on the accompanying consolidated balance sheet.
- E. For the years ended March 31, 2007, 2006 and 2005, the Company made royalty payments of approximately \$39,742, \$36,228 and \$37,500, respectively, for use of a patent, to an entity that is owned by two stockholders in the Company. These charges have been included in other expense on the accompanying consolidated statements of operations. The royalty agreement also includes the right to acquire the patent for the Trinity Bottle for €90,000 (\$120,015) for the duration of the licensing period, which expires on December 1, 2008.
- F. In February and August 2005, the Company executed agreements with the two Co-Managing Directors of CB Ireland whereby, effective March 11, 2005 and December 1, 2005, respectively, each individual resigned his position in CB Ireland in exchange for a consultancy agreement consisting of fifteen monthly payments totaling €196,875, plus Value Added Tax ("VAT"). The balance due, net of payments made, was \$0 and \$256,925 at March 31, 2007 and 2006, respectively. In addition, under the terms of these agreements, the stock options of these individuals were deemed to have accrued two years' vesting at the end of the consultancy period, the exercise period for their stock options was extended to December 1, 2008, and the Company agreed to pay off the outstanding balance of their 5% Convertible Subordinated Notes, each dated December 1, 2003, and each in the amount of €465,550 and their Subordinated Note, each dated December 1, 2003, and each in the amount of €133,323 at the earlier of one month following the completion of the Company's initial public offering or in four quarterly installments beginning January 1, 2006. The Company paid the outstanding balance on each of these subordinated notes in the amount of \$159,961 on April 19, 2006. The Company also reimbursed these individuals the legal fees incurred in connection with their consultancy agreements in the amounts of €8,000 and €5,000, respectively, plus VAT. For the years ended March 31, 2007, 2006 and 2005, the Company made payments of \$257,575, \$261,567 and \$20,000, respectively pursuant to these agreements. These charges have been included in general and administrative expense on the accompanying consolidated statements of operations. In September 2005, the Company consented to the sale of the 5% Convertible Notes held by the two Co-Managing Directors of CB Ireland and shares of common stock held by one of the Co-Managing Directors to third parties.

#### **NOTE 16 — COMMITMENTS AND CONTINGENCIES**

- A. The Company has entered into a supply agreement with Irish Distillers Limited ("Irish Distillers"), which provides for the production of Irish whiskeys for the Company through 2014, subject to automatic five year extensions thereafter. Under this agreement, the

Company is obligated to notify Irish Distillers annually of the amount of liters of pure alcohol it requires for the current year and contracts to purchase that amount. For the calendar year ended December 31, 2007, the Company has contracted to purchase approximately €566,349 in bulk Irish whiskey. The Company is not liable to Irish Distillers for any product not yet received. During the term of this supply agreement Irish Distillers has the right to limit additional purchases above the commitment amount.

- B. The Company has entered into a distribution agreement with Gaelic Heritage Corporation, Ltd. (“Gaelic”), an international supplier, to be the sole-producer of Celtic Crossing, one of the Company’s products, for an indefinite period.
- C. In August 2004, Castle Brands entered into an agency agreement with I.L.A.R. S.p.A., the producer of Pallini Limoncello and its flavor extensions, to be the sole and exclusive importer of Pallini Limoncello and its flavor extensions throughout the United States and its territories and possessions. This agreement is subject to automatic renewal for as much as five years per renewal period upon Castle Brands achievement of contractual case sale targets. The agreement expires on December 31, 2009.

Under this agreement, Castle Brands is permitted to import Pallini Limoncello and its flavor extensions at a set price, updated annually, and is obligated to set aside a portion of the gross margin toward a marketing fund for Pallini. The agreement also encompasses the hiring of a Pallini Brand Manager at Castle Brands with Pallini reimbursing the costs of this position up to a stipulated annual amount. These reimbursements are included in the accompanying consolidated financial statements as a reduction in selling expense.

- D. In September 2004, CB-USA entered into an exclusive distribution agreement with Gosling’s Export (Bermuda) Limited (“GXB”) to be the sole and exclusive importer of Gosling’s rum brands within the United States. Under this agreement, CB-USA will receive a net sales commission on each case sold. In February 2005, GXB sold its interest in the distribution agreement to Gosling-Castle Partners Inc.

CB-USA will receive a stipulated commission per case, subject to adjustment, provided certain case sales are achieved, for all sales in calendar years under the distribution agreement. The sales commission is net of agreed reimbursements, including taxes and payments to the marketing affiliate, GCP. This distribution agreement is for fifteen years, subject to extension.

- E. The Company subleases office space in Dublin, Ireland and New York, NY and leases office space in Houston, TX and Louisville, KY. The Dublin office lease commenced on June 1, 2004 and extends through February 28, 2009. Rent is payable quarterly in advance. The New York City lease commenced on August 15, 2004 and extends through March 30, 2008. The Houston lease commenced on February 24, 2000 and extends through March 31, 2008. The Louisville lease commenced June 1, 2004, became effective for the Company concurrent with the acquisition of McLain & Kyne, Ltd., and expires May 31, 2009. The Company has also entered into non-cancelable operating leases for certain office equipment.

Future minimum lease payments are as follows:

<u>For the years ending March 31,</u>	<u>Amount</u>
2008 .....	\$322,353
2009 .....	<u>5,265</u>
Total.....	<u>\$327,618</u>

In addition to the above annual rental payments, the Company is obligated to pay its pro-rata share of utility and maintenance expenses on the leased premises. Rent expense under operating leases amounted to approximately \$410,551, \$368,065 and \$290,000 for the years ended March 31, 2007, 2006 and 2005, respectively, and is included in general and administrative expense on the accompanying consolidated statements of operations.

- F. Pursuant to the distribution agreement signed in March 1998 between the Company and Gaelic, which was amended and restated in April 2001, the Company, which currently owns 60% of the Celtic Crossing trademark in the United States, has the option to purchase 70% of the trademark outside the United States from Gaelic at a specified price adjusted by interim, annual changes in the Irish Consumer Price Index.

In the event of the sale of the brand rights by either the Company or Gaelic, the non-selling party shall have the right of first refusal to purchase the interest at the same price as the proposed sale and the right to sell alongside the other party.

Pursuant to the agreement, the Company is required to pay royalties to Gaelic for each case purchased, such royalties are included within cost of sales in the accompanying consolidated statements of operations.

- G. Pursuant to a composite inter-company guarantee in the amount of €860,000 (\$1,146,810) completed in February 2005 between the Company, Castle Brands Spirits Company Limited and Castle Brands Spirits (GB) Limited, the Company has guaranteed the loans from Ulster Bank to the Company's European subsidiaries.
- H. The Company is subject to strict federal and state government regulations associated with the marketing, import, warehouse, transport, and distributions of spirits.
- I. On February 12, 2007, the Company entered into a credit agreement with Frost Nevada Investments Trust, which is controlled by Dr. Phillip Frost, one of its directors, which enables the Company to borrow up to \$5.0 million. Upon entering into the credit agreement, the Company paid the lender a facility fee of \$150,000. We never made any borrowings under this facility. The facility was terminated pursuant to its terms following the closing of our May 2007 private placement of common stock.

Upon entering into the credit agreement, the Company paid the lender a facility fee of \$150,000.

#### **NOTE 17 — CONCENTRATIONS**

- A. Credit Risk – The Company maintains its cash balances at various large financial institutions that, at times, may exceed federally and internationally insured limits. As of March 31, 2007 and 2006, the Company exceeded the insured limit by approximately \$6,400,000 and \$1,300,000, respectively. Management believes the Company is not exposed to any significant credit risk because the institutions are international money center banking institutions with strong financial positions.
- B. Suppliers – The Company has entered into a supplier agreement with Irish Distillers, Ltd., which provides for the production of single malt, blended and grain Irish whiskeys for the Company through 2015, with automatic renewal thereafter for successive five (5) calendar year renewal terms.

The Company has entered into a distribution agreement with Gaelic Heritage Corporation, Ltd. (“Gaelic”), an international supplier, to be the sole-producer of Celtic Crossing, one of the Company's products, for an indefinite period.

The Company has entered into a distribution agreement with ILAR, SPA (“ILAR”), an international supplier, to be the sole-producer of the Pallini premium Italian, expiring December 31, 2009, subject to a three or five year renewal, depending on case purchase.

The Company has entered into a distribution agreement with Gosling's Export (Bermuda) limited, an international supplier, to be the sole-producer of the Gosling's family of rum products for 15 years.

The Company has entered into a supplier agreement with Carbery Milk Products Limited, an international supplier, which provides for the production of the Company's vodka and cream products through December 31, 2008.

The Company has entered into a bottling and services agreement with Terra Limited which provides for the bottling of the Company's vodka, whiskey and cream products through February 28, 2009.

- C. Customers – Sales to one customer accounted for approximately 21.2% of the Company's revenues for the year ended March 31, 2007 and approximately 20.9% of accounts receivable at March 31, 2007.

**NOTE 18 — GOSLING-CASTLE PARTNERS INC. EXPORT AGREEMENT WITH GOSLING'S EXPORT (BERMUDA) LIMITED**

In February 2005, Gosling-Castle Partners Inc. secured the GXB global distribution rights under an Export Agreement (the "Agreement") with GXB. This agreement called for GCP to pay \$2,500,000 to GXB for the assignment of its global distribution rights in four equal installments at April 1, 2005, October 1, 2005, April 1, 2006 and October 1, 2006. All payments have been made in full as of March 31, 2007.

**NOTE 19 — GEOGRAPHIC INFORMATION**

The Company operates in one business – premium branded spirits. The Company's product categories are vodka, rum, liqueurs, and whiskey. The Company reports its operations in two geographic areas: International and United States.

The consolidated financial statements include revenues and assets generated in or held in foreign countries. The following table sets forth the percentage of consolidated revenue from continuing operations and consolidated assets from foreign countries.

	For the years ended March 31,					
	2007		2006		2005	
<b>Consolidated Revenue:</b>						
International . . . . .	\$ 8,478,474	33.7%	\$ 7,879,070	37.3%	\$ 5,891,000	46.7%
United States . . . . .	16,685,564	66.3%	13,270,565	62.7%	6,726,863	53.3%
Total Consolidated Revenue . .	<u>\$25,164,038</u>	<u>100%</u>	<u>\$21,149,635</u>	<u>100%</u>	<u>\$12,617,863</u>	<u>100%</u>
<b>Consolidated Depreciation and Amortization</b>						
International . . . . .	\$ 72,311	7.2%	\$ 74,874	8.3%	\$ 90,326	27.9%
United States . . . . .	928,577	92.8%	832,535	91.7%	233,159	72.1%
Total Consolidated Depreciation and Amortization . . . . .	<u>\$ 1,000,888</u>	<u>100%</u>	<u>\$ 907,409</u>	<u>100%</u>	<u>\$ 323,485</u>	<u>100%</u>
<b>Income Tax Benefit</b>						
United States . . . . .	148,147	100%	\$ 148,151	100%	—	0%
Vodka . . . . .	\$ 8,802,691	35.0%	\$ 7,787,351	36.8%	\$ 6,984,010	55.4%
Rum . . . . .	7,479,252	29.7%	5,798,258	27.4%	827,504	6.6%
Liqueurs . . . . .	5,027,252	20.0%	4,301,351	20.3%	2,063,630	16.4%
Whiskey . . . . .	3,657,178	14.5%	3,021,435	14.3%	2,742,719	21.6%
Other* . . . . .	197,665	0.8%	241,240	1.2%	—	—%
Total Consolidated Revenue . .	<u>\$25,164,038</u>	<u>100%</u>	<u>\$21,149,635</u>	<u>100.0%</u>	<u>\$12,617,863</u>	<u>100.0%</u>
<b>Consolidated Assets:</b>						
International . . . . .	\$ 5,966,448	10.9%	\$ 4,488,329	10.3%		
United States . . . . .	48,559,894	89.1%	39,155,881	89.7%		
Total Consolidated Assets . . .	<u>\$54,526,342</u>	<u>100.0%</u>	<u>\$43,644,210</u>	<u>100.0%</u>		

\* Includes related food products.

## **NOTE 20 — SUBSEQUENT EVENTS**

Unregistered Sales of Equity Securities – On April 18, 2007, the Company entered into a Securities Purchase Agreement (the “Securities Purchase Agreement”) with selected investors (each an “Investor” and collectively, the “Investors”). Pursuant to the terms of the Securities Purchase Agreement, the Company has sold in a private placement a total of 3,520,035 shares of its common stock, (the “Common Stock”), for aggregate gross proceeds of \$21,014,609. The transaction closed on May 9, 2007. The Investors included, among others, Frederick M. R. Smith and Phillip Frost, MD, each a director of the Company, and CNF Investments II, LLC, of which Robert J. Flanagan, a director of the Company, is a manager.

As part of the transaction, investors received warrants to purchase approximately 1,408,014 additional shares at an exercise price of \$6.57 per share (the “Warrants”). The Warrants will remain exercisable for a period of five years from the closing of the offering. The Warrants contain anti-dilution protection for stock splits and similar events, but do not contain any price-based anti-dilution adjustments.

Pursuant to the Securities Purchase Agreement, the Company and the Investors have made representations and warranties regarding matters that are customarily included in financings of this nature. Subject to time-related conditions or qualifications, such representations and warranties shall survive the closing. The Securities Purchase Agreement also contains indemnification agreements among the parties in the event of certain liabilities.

Registration Rights Agreement – On April 18, 2007, the Company entered into a Registration Rights Agreement (the “Registration Rights Agreement”) with the Investors. Pursuant to the Registration Rights Agreement, the Company has agreed to register the resale of the shares of Common Stock sold to the Investors pursuant to the Securities Purchase Agreement, including the shares issuable upon exercise of the Warrants. The Company has agreed to file with the SEC a registration statement with respect to this registration within 30 days after closing. The Company filed such registration statement on May 31, 2007, within this 30 day timeframe. If certain of its obligations under the Registration Rights Agreement are not met, the Company has agreed to make pro-rata liquidated damages payments to each Investor.

Litigation – Our subsidiary, Castle Brands Spirits Company Limited, is the holder of a trademark registration for the mark “BORU” with the United States Patent and Trademark Office. On May 9, 2007, Distillerie Stock U.S.A. Ltd. filed a Petition for Cancellation with the United States Patent and Trademark Office for the cancellation of the trademark registration for BORU on several grounds, including potential confusion between BORU and its existing registered trademark “BORA”. We have various defenses on the merits as well as procedural defenses which we expect to file in a timely manner against Distillerie Stock’s claims. We intend to vigorously pursue these defenses as appropriate. Currently, the matter is pending at the United States Patent and Trademark Office before the Trademark Trial and Appeal Board. While matters before the Trademark Trial and Appeal Board cannot result in monetary damages or directly affect the right to use a trademark, they can result in the cancellation of a trademark registration. Thus, it is possible this matter could result in the cancellation of our trademark registration for BORU in the United States. As a result, it is not feasible to predict the final outcome, and there can be no assurance that these claims might not be finally resolved adversely to us, resulting in material liability to our operations.

## **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A. Controls and Procedures**

#### *Evaluation of disclosure controls and procedures.*

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Security Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information that would be required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Security Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including the Chief Executive Officer, President and Chief Operating Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

As of March 31, 2007, we carried out an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer, President and Chief Operating Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on the foregoing, our Chief Executive Officer, President and Chief Operating Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this annual report.

#### *Section 404 compliance project.*

Beginning with our fiscal year ending March 31, 2008, Section 404 of the Sarbanes-Oxley Act of 2002 will require us to include management’s report on our internal control over financial reporting in our Annual Report on Form 10-K. The internal control report must contain (1) a statement of management’s responsibility for establishing and maintaining adequate internal control over our financial reporting, (2) a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of our internal control over financial reporting, (3) management’s assessment of the effectiveness of our internal control over financial reporting as of the end of our most recent fiscal year, including a statement as to whether or not our internal control over financial reporting is effective, and (4) at March 31, 2009, a statement that our registered independent public accounting firm has issued an attestation report on management’s assessment of our internal control over financial reporting.

In order to achieve compliance with Section 404 within the prescribed period, management has commenced a Section 404 compliance project under which management will engage outside consultants and adopt a detailed project work plan to assess the adequacy of our internal control over financial reporting, remediate any control deficiencies that may be identified, validate through testing that controls are functioning as documented and implement a continuous reporting and improvement process for internal control over financial reporting. During the fourth quarter of fiscal year ended March 31, 2007, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **Item 9B. Other Information**

None

## **PART III**

### **Item 10. Directors, Executive Officers and Corporate Governance**

The information required by this Item 10 is incorporated by reference from our definitive proxy statement for our 2007 annual meeting of stockholders, which will be filed no later than 120 days after March 31, 2007.

### **Item 11. Executive Compensation**

The information required by this Item 11 is incorporated by reference from our definitive proxy statement for our 2007 annual meeting of stockholders, which will be filed no later than 120 days after March 31, 2007.

### **Item 12. Security Ownership of Certain Beneficial Owners and Management**

The information required by this Item 12 is incorporated by reference from our definitive proxy statement for our 2007 annual meeting of stockholders, which will be filed no later than 120 days after March 31, 2007.

### **Item 13. Certain Relationships and Related Transactions and Director Independence**

The information required by this Item 13 is incorporated by reference from our definitive proxy statement for our 2007 annual meeting of stockholders, which will be filed no later than 120 days after March 31, 2007.

### **Item 14. Principal Accountant Fees and Services**

The information required by this Item 14 is incorporated by reference from our definitive proxy statement for our 2007 annual meeting of stockholders, which will be filed no later than 120 days after March 31, 2007.

## PART IV

### Item 15. Exhibits and Financial Statement Schedules

- (a) The following documents are filed as part of this Report:
1. Financial Statements – See Index to Consolidated Financial Statements and Financial Statement Schedule at Item 8 on page 49 of this Annual Report on Form 10-K.
  2. Financial Statement Schedules – See Financial Statement Schedule at Item 15(c) on page 87 of this Annual Report on Form 10-K. All other schedules are omitted because they are not applicable or not required.
  3. Exhibits – The following exhibits are filed as part of, or incorporated by reference into, this Annual Report on Form 10-K:

(b)

<b>Exhibit Number</b>	<b>Exhibit</b>
2.1	Agreement of Merger and Acquisitions, dated as of July 31, 2003, by and among GSRWB, Inc., The Roaring Water Bay Spirits Group Limited, The Roaring Water Bay Spirits Marketing and Sales Company Limited, Great Spirits Company LLC, Great Spirits Corp., Patrick Rigney, David Phelan, Carbery Milk Products Limited and Tanis Investments Limited(1)
2.2	Amendment to Agreement of Merger and Acquisitions, dated as of October 1, 2003, by and among GSRWB, Inc., The Roaring Water Bay Spirits Group Limited, The Roaring Water Bay Spirits Marketing and Sales Company Limited, Great Spirits Company LLC, Great Spirits Corp., Patrick Rigney, David Phelan, Carbery Milk Products Limited and Tanis Investments Limited(1)
3.1	Form of Amended and Restated Certificate of Incorporation of the Company(1)
3.2	Form of Amended and Restated Bylaws of the Company(1)
4.1	Form of Common Stock Certificate(1)
4.2	Shareholders Agreement, dated as of December 1, 2003, by and among GSRWB, Inc. and the holders of shares of Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock and the Common Stockholders(1)
10.1	Export Agreement, dated as of February 14, 2005 between Gosling Partners Inc. and Gosling's Export (Bermuda) Limited(1)(2)
10.2	Amendment No. 1 to Export Agreement, dated as of February 18, 2005, by and among Gosling-Castle Partners Inc. and Gosling's Export (Bermuda) Limited(1)(2)
10.3	National Distribution Agreement, dated as of September 3, 2004, by and between Castle Brands (USA) Corp. and Gosling's Export (Bermuda) Limited(1)(2)
10.4	Subscription Agreement, dated as of February 18, 2005, by and between Castle Brands Inc. and Gosling-Castle Partners Inc.(1)
10.5	Stockholders Agreement, dated February 18, 2005, by and among Gosling-Castle Partners Inc. and the persons listed on Schedule I thereto.(1)
10.6	Promissory Note, dated February 18, 2005, issued by Castle Brands Inc. in favor of Gosling-Castle Partners Inc.(1)



Exhibit Number	Exhibit
10.7	Agreement, dated as of August 27, 2004, between I.L.A.R. S.p.A. and Castle Brands (USA) Corp.(1)(2)
10.8	Supply Agreement, dated as of January 1, 2005, between Irish Distillers Limited and Castle Brands Spirits Group Limited and Castle Brands (USA) Corp.(1)(2)
10.9	Amendment No. 1 to Supply Agreement, dated as of September 20, 2005, to the Supply Agreement, dated as of January 1, 2005, among Irish Distillers Limited and Castle Brands Spirits Group Limited and Castle Brands (USA) Corp.(1)
10.10	Amended and Restated Worldwide Distribution Agreement, dated as of April 16, 2001, by and between Great Spirits Company LLC and Gaelic Heritage Corporation Limited(1)
10.11	Bottling and Services Agreement, dated as of September 1, 2002, by and between Terra Limited and The Roaring Water Bay Spirits Company Limited(1)(2)
10.12	Amendment to Bottling and Services Agreement, dated as of March 1, 2005, by and between Terra Limited and Castle Brands Spirit Company Limited(1)
10.13	Amended and Restated Convertible Note Purchase Agreement, dated as of August 16, 2005, by and between Castle Brands Inc., Mellon HBV SPV LLC and Black River Global Credit Fund Ltd.(1)
10.14	Amended and Restated Convertible Promissory Note, dated March 1, 2005, issued by Castle Brands Inc. in favor of Mellon HBV SPV LLC.(1)
10.15	Amended and Restated Convertible Promissory Note, dated June 27, 2005, issued by Castle Brands Inc. in favor of Mellon HBV SPV LLC.(1)
10.16	Convertible Promissory Note, dated August 16, 2005, issued by Castle Brands Inc. in favor of Black River Global Credit Fund Ltd.(1)
10.17	License Agreement, dated December 1, 2003, between The Roaring Water Bay (Research and Development) Company Limited and GSRWB, Inc.(1)
10.18	Amended and Restated Employment Agreement, effective as of May 2, 2005, by and between Castle Brands Inc. and Mark Andrews(1)
10.19	Amended and Restated Employment Agreement, effective as of May 2, 2005, by and between Castle Brands Inc. and T. Kelley Spillane(1)
10.20	Employment Agreement, dated as of May 2, 2005 by and between Castle Brands Inc. and Keith A. Bellinger(1)
10.21	Summary of employment agreement with Matthew F. MacFarlane(1)
10.22	Non-Competition Deed, dated December 1, 2003, between GSRWB, Inc. and David Phelan(1)
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10.23.1	Amendment, dated October 17, 2005, to the Letter Agreement, dated August 4, 2005, between Castle Brands Inc. and David Phelan.(1)
10.24	Letter Agreement, dated February 15, 2005, between Castle Brands Inc. and Patrick Rigney(1)

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10.29	Castle Brands Inc. 2003 Stock Incentive Plan, as amended(1)
10.30	Amendment to Castle Brands Inc. 2003 Stock Incentive Plan(1)
10.31	Letter Agreement, dated as of December 1, 2004, between MHW, Ltd. and Castle Brands (USA) Corp.(1)
10.32	Sublease, dated as of June 24, 2004, by and between Silvercrest Asset Management Group, LLC, as successor in interest to James C. Edwards & Co., Inc. and Castle Brands (USA) Corp.(1)
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10.35	First Amendment to Office Lease, dated March 14, 2001 (1)
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Exhibit Number	Exhibit
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99.1	Castle Brands Inc. Code of Business Conduct(1)

- (1) Incorporated herein by reference to the exhibit with the same number to our Registration Statement on Form S-1 (File No. 333-128676), which was declared effective on April 5, 2006.
- (2) Confidential portions of this document are omitted pursuant to a request for confidential treatment that has been granted by the Commission, and have been filed separately with the Commission.
- (c)

**Valuation and Qualifying Accounts (in thousands)**

<u>Description</u>	<u>Balance at beginning of period</u>	<u>Additions Charged to cost and expenses</u>	<u>Deductions</u>	<u>Balance at end of period</u>
Valuation reserve deducted in the balance sheet from the asset to which it applies:				
Accounts receivable:				
2007 Allowance for doubtful accounts.....	\$ 395	108	151	\$ 352
2006 Allowance for doubtful accounts.....	\$ 81	314	—	\$ 395
2005 Allowance for doubtful accounts.....	58	64	41	81
Inventory:				
2007 Allowance for excess and obsolescence.....	\$ 261	—	—	\$ 261
2006 Allowance for excess and obsolescence.....	\$ 164	97	—	\$ 261
2005 Allowance for excess and obsolescence.....	90	74	—	164
Deferred Taxes:				
2007 Valuation reserve .....	\$9,100	6,857	—	\$15,957
2006 Valuation reserve .....	\$5,000	4,100	—	\$ 9,100
2005 Valuation reserve .....	1,450	3,550	—	5,000

## 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, on June 29, 2007.

### CASTLE BRANDS INC.

By: /s/ MARK ANDREWS

Mark Andrews  
Chairman of the Board and  
Chief Executive Officer

## POWER OF ATTORNEY

Each individual whose signature appears below constitutes and appoints each of Mark Andrews, Keith Bellinger and Seth Weinberg, such person's true and lawful attorney-in-fact and agent with full power of substitution and resubstitution, for such person and in such person's name, place and stead, in any and all capacities, to sign any and all amendments to this report on Form 10-K, and to file the same, with all exhibits thereto, and all documents in connection therewith, with the Securities and Exchange Commission, granting unto each said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as such person might or could do in person, hereby ratifying and confirming all that any said attorney-in-fact and agent, or any substitute or substitutes of any of them, may lawfully do or cause to be done by virtue hereof.

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.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ MARK ANDREWS</u> Mark Andrews	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)	June 29, 2007
<u>/s/ KEITH A. BELLINGER</u> Keith A. Bellinger	President and Chief Operating Officer (Principal Financial Officer)	June 29, 2007
<u>/s/ ALFRED J. SMALL</u> Alfred J. Small	Vice President – Controller	June 29, 2007
<u>/s/ JOHN F. BEAUDETTE</u> John F. Beaudette	Director	June 29, 2007
<u>/s/ ROBERT J. FLANAGAN</u> Robert J. Flanagan	Director	June 29, 2007
<u>/s/ COLM LEEN</u> Colm Leen	Director	June 29, 2007
<u>/s/ PHILLIP FROST, M.D.</u> Phillip Frost, M.D.	Director	June 29, 2007
<u>/s/ RICHARD MORRISON</u> Richard Morrison	Director	June 29, 2007
<u>/s/ FREDERICK M.R. SMITH</u> Frederick M.R. Smith	Director	June 29, 2007
<u>/s/ KEVIN P. TIGHE</u> Kevin P. Tighe	Director	June 29, 2007

## EXHIBIT INDEX

<b>Exhibit Number</b>	<b>Exhibit</b>
2.1	Agreement of Merger and Acquisitions, dated as of July 31, 2003, by and among GSRWB, Inc., The Roaring Water Bay Spirits Group Limited, The Roaring Water Bay Spirits Marketing and Sales Company Limited, Great Spirits Company LLC, Great Spirits Corp., Patrick Rigney, David Phelan, Carbery Milk Products Limited and Tanis Investments Limited(1)
2.2	Amendment to Agreement of Merger and Acquisitions, dated as of October 1, 2003, by and among GSRWB, Inc., The Roaring Water Bay Spirits Group Limited, The Roaring Water Bay Spirits Marketing and Sales Company Limited, Great Spirits Company LLC, Great Spirits Corp., Patrick Rigney, David Phelan, Carbery Milk Products Limited and Tanis Investments Limited(1)
3.1	Form of Amended and Restated Certificate of Incorporation of the Company(1)
3.2	Form of Amended and Restated Bylaws of the Company(1)
4.1	Form of Common Stock Certificate(1)
4.2	Shareholders Agreement, dated as of December 1, 2003, by and among GSRWB, Inc. and the holders of shares of Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock and the Common Stockholders(1)
10.1	Export Agreement, dated as of February 14, 2005 between Gosling Partners Inc. and Gosling's Export (Bermuda) Limited(1)(2)
10.2	Amendment No. 1 to Export Agreement, dated as of February 18, 2005, by and among Gosling-Castle Partners Inc. and Gosling's Export (Bermuda) Limited(1)(2)
10.3	National Distribution Agreement, dated as of September 3, 2004, by and between Castle Brands (USA) Corp. and Gosling's Export (Bermuda) Limited(1)(2)
10.4	Subscription Agreement, dated as of February 18, 2005, by and between Castle Brands Inc. and Gosling-Castle Partners Inc.(1)
10.5	Stockholders Agreement, dated February 18, 2005, by and among Gosling-Castle Partners Inc. and the persons listed on Schedule I thereto.(1)
10.6	Promissory Note, dated February 18, 2005, issued by Castle Brands Inc. in favor of Gosling-Castle Partners Inc.(1)
10.7	Agreement, dated as of August 27, 2004, between I.L.A.R. S.p.A. and Castle Brands (USA) Corp.(1)(2)
10.8	Supply Agreement, dated as of January 1, 2005, between Irish Distillers Limited and Castle Brands Spirits Group Limited and Castle Brands (USA) Corp.(1)(2)
10.9	Amendment No. 1 to Supply Agreement, dated as of September 20, 2005, to the Supply Agreement, dated as of January 1, 2005, among Irish Distillers Limited and Castle Brands Spirits Group Limited and Castle Brands (USA) Corp.(1)
10.10	Amended and Restated Worldwide Distribution Agreement, dated as of April 16, 2001, by and between Great Spirits Company LLC and Gaelic Heritage Corporation Limited(1)
10.11	Bottling and Services Agreement, dated as of September 1, 2002, by and between Terra Limited and The Roaring Water Bay Spirits Company Limited(1)(2)

<b>Exhibit Number</b>	<b>Exhibit</b>
10.12	Amendment to Bottling and Services Agreement, dated as of March 1, 2005, by and between Terra Limited and Castle Brands Spirit Company Limited(1)
10.13	Amended and Restated Convertible Note Purchase Agreement, dated as of August 16, 2005, by and between Castle Brands Inc., Mellon HBV SPV LLC and Black River Global Credit Fund Ltd.(1)
10.14	Amended and Restated Convertible Promissory Note, dated March 1, 2005, issued by Castle Brands Inc. in favor of Mellon HBV SPV LLC.(1)
10.15	Amended and Restated Convertible Promissory Note, dated June 27, 2005, issued by Castle Brands Inc. in favor of Mellon HBV SPV LLC.(1)
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**EXHIBIT 21.1****Castle Brands Inc. Subsidiaries**

<b>Name</b>	<b>State/Country of Incorporation</b>	<b>Jurisdiction(s)</b>
Castle Brands (USA) Corp.	Delaware, USA	New York Texas (d/b/a “Delaware Great Spirits Corp.”)
Gosling-Castle Partners Inc.	Delaware, USA	
McLain & Kyne Ltd.	Kentucky, USA	Georgia Alabama
Castle Brands Spirits Group Limited	Ireland	
Castle Brands Spirits Company Limited	Ireland	
The Boru Vodka Company Limited	Ireland	
The Clontarf Irish Whiskey Company Limited	Ireland	
Castle Brands Whiskey Company Limited	Ireland	
Castle Brands Spirits Marketing and Sales Company Limited	Ireland	
Great Spirits (Ireland) Limited	Ireland	
Castle Brands Spirits Company (GB) Limited	United Kingdom	
The Roaring Water Bay Spirits Company (NI) Limited	Northern Ireland	

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statement of Form S-8 (No. 333-133567) and the Registration Statement on Form S-3 (No. 333-143422) of our report dated June 27, 2007 relating to our audits of the consolidated financial statements and financial statement schedule of Castle Brands Inc. and subsidiaries as of March 31, 2007, which is included in the Annual Report on Form 10-K for the year ended March 31, 2007. Our report on the March 31, 2007 financial statements included an explanatory paragraph regarding the Company's change in accounting principle for transactions in which the Company exchanges its equity instruments for goods and services. We also consent to the reference to us as Experts in the Registration Statement on Form S-3.

/s/ EISNER LLP

Eisner LLP

New York, New York

June 27, 2007

**SECTION 302 CERTIFICATION**

I, Mark Andrews, certify that:

1. I have reviewed this annual report on Form 10-K of Castle Brands Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) **[Reserved]**
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors or (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: June 29, 2007

/s/ Mark Andrews  
\_\_\_\_\_  
Mark Andrews  
Chairman & Chief Executive Officer  
(Principal Executive Officer)

**SECTION 302 CERTIFICATION**

I, Keith A. Bellinger, certify that:

1. I have reviewed this annual report on Form 10-K of Castle Brands Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) **[Reserved]**
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors or (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: June 29, 2007

/s/ Keith A. Bellinger  
\_\_\_\_\_  
Keith A. Bellinger  
President and Chief Operating Officer  
(Principal Financial Officer)

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In accordance with 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, Mark Andrews, the Chairman and Chief Executive Officer of Castle Brands Inc. (the “Registrant”) and Keith A. Bellinger, the President and Chief Operating Officer of the Registrant, each hereby certifies that:

1. The Registrant’s Annual Report on Form 10-K for the period ended March 31, 2007, (the “Periodic Report”), fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

Date: June 29, 2007

/s/ Mark Andrews  
\_\_\_\_\_  
Mark Andrews  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

/s/ Keith A. Bellinger  
\_\_\_\_\_  
Keith A. Bellinger  
President and Chief Operating Officer  
(Principal Financial Officer)







# CORPORATE INFORMATION

## OFFICERS

**Mark Andrews**  
*Chairman of the Board and  
Chief Executive Officer*

**Keith A. Bellinger**  
*President and  
Chief Operating Officer*

**Claes Fick**  
*Chief Commercial and  
Marketing Officer  
Castle Brands Spirits  
Company Limited*

**John Soden**  
*SVP—Managing Director—  
International Operations*

**T. Kelley Spillane**  
*SVP—U.S. Sales*

**Seth B. Weinberg**  
*SVP and General Counsel*

**Alfred Small**  
*VP—Controller*

## DIRECTORS

**Mark Andrews**  
*Chairman of the Board and  
Chief Executive Officer  
Castle Brands Inc.*

**John F. Beaudette**  
*President  
MHW, Ltd.*

**Robert J. Flanagan**  
*Executive Vice President  
Clark Enterprises Inc.*

**Phillip Frost, M.D.**  
*Chairman and  
Chief Executive Officer  
Opko Health, Inc.*

**Colm Leen**  
*Group Finance Director  
and Secretary  
Carbery Group*

**Richard C. Morrison**  
*Former Managing Director  
Babson Capital Management*

**Frederick M.R. Smith**  
*Consultant  
Credit Suisse*

**Kevin P. Tighe**  
*Partner  
Tighe Patton Armstrong  
Teasdale, PLLC*

## NOTICE OF ANNUAL MEETING

The annual meeting of stockholders will be held on September 12, 2007 at 10:00 a.m., ET at the American Stock Exchange, 86 Trinity Place, New York, NY 10006

## TRANSFER AGENT

Continental Stock Transfer  
and Trust Company  
17 Battery Place, 8th Floor  
New York, NY 10004  
(212) 509-4000

## CORPORATE HEADQUARTERS

Castle Brands Inc.  
570 Lexington Ave, 29th Floor  
New York, NY 10022  
(646) 356-0200

## COMMON STOCK

The common stock of Castle Brands Inc. is traded on the American Stock Exchange under the symbol "ROX."

## DISCLAIMER

This Annual Report contains forward-looking information. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be significantly impacted by certain risks and uncertainties described herein and in the company's Annual Report on Form 10-K for the year ended March 31, 2007 filed with the Securities and Exchange Commission.

Castle Brands Inc. | 570 Lexington Avenue, 29th Floor | New York, NY 10022 | 646-356-0200  
[www.castlebrandsinc.com](http://www.castlebrandsinc.com)