Castle Brands Inc
Form 10-Q
November 14, 2008

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

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2008
Commission File Number 001-32849
CASTLE BRANDS INC.

(Exact name of registrant as specified in its charter)

Delaware	**41-2103550**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
570 Lexington Avenue, 29th Floor, New York, New York	**10022**
(Address of principal executive offices)	(Zip Code)

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

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

o Large accelerated filer o Accelerated filer o Non-accelerated filer þ Smaller reporting company

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

The Company had 15,629,776 shares of $0.01 par value common stock outstanding at November 14, 2008.

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PART I. FINANCIAL INFORMATION
Item 1. Condensed Consolidated Financial Statements

CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets

	September 30, 2008 (Unaudited)	March 31, 2008
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 852,730	$ 1,552,385
Short-term investments	60,124	4,231,644
Accounts receivable net of allowance for doubtful accounts of $233,305 and $230,967	5,972,709	7,544,445
Due from affiliates	69,307	61,596
Inventories	7,914,646	8,535,993
Prepaid expenses and other current assets	1,240,463	811,711
TOTAL CURRENT ASSETS	16,109,979	22,737,774
EQUIPMENT net	685,853	753,317
OTHER ASSETS		
Intangible assets net of accumulated amortization of $2,884,162 and $2,517,199	13,235,573	13,591,191
Goodwill	3,745,287	3,745,287
Restricted cash	731,455	799,864
Other assets	322,635	509,493
TOTAL ASSETS	$ 34,830,782	$ 42,136,926
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Current maturities of notes payable and capital lease	$ 3,145	$ 99,784
Senior notes payable	9,796,233	
Accounts payable	5,461,597	2,818,910
Accrued expenses	522,550	2,142,845
Due to stockholders and affiliates	1,300,393	919,758
TOTAL CURRENT LIABILITIES	17,083,918	5,981,297
LONG-TERM LIABILITIES		
Senior notes payable		9,649,109
Notes payable and capital lease, less current maturities	9,000,000	9,001,335
Deferred tax liability	2,333,140	2,407,216
TOTAL LIABILITIES	28,417,058	27,038,957
COMMITMENTS AND CONTINGENCIES (Note 10)		

MINORITY INTERESTS		135,645		309,810
STOCKHOLDERS EQUITY				
Preferred stock, $.01 par value, 5,000,000 shares authorized, none outstanding				
Common stock, $.01 par value, 45,000,000 shares authorized; 15,629,776 shares issued and outstanding at September 30, and March 31, 2008, respectively		156,298		156,298
Additional paid in capital		105,223,847		104,806,044
Accumulated deficiency		(97,981,653)		(87,546,011)
Accumulated other comprehensive loss		(1,120,413)		(2,628,172)
TOTAL STOCKHOLDERS EQUITY		6,278,079		14,788,159
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	34,830,782	$	42,136,926

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Operations
(Unaudited)

	Three-months ended September 30,		Six-months ended September 30,	
	2008	**2007**	**2008**	**2007**
Sales, net*	$ 7,431,100	$ 8,920,952	$ 13,322,495	$ 14,545,037
Cost of sales*	5,085,928	6,436,721	9,038,613	9,941,259
Gross profit	2,345,172	2,484,231	4,283,882	4,603,778
Selling expense	3,874,105	4,436,622	7,303,449	8,674,230
General and administrative expense	2,146,424	2,091,109	4,218,397	4,152,029
Depreciation and amortization	244,352	284,274	487,859	555,701
Net operating loss	(3,919,709)	(4,327,774)	(7,725,823)	(8,778,182)
Other income	9,811		25,384	
Other expense	(16,487)	(10,297)	(28,212)	(21,464)
Foreign exchange gain(loss)	(1,822,077)	1,082,609	(1,920,988)	1,159,935
Interest expense, net	(528,894)	(313,354)	(1,034,244)	(800,814)
Current credit on derivative financial instrument				189,397
Income tax benefit	37,038	37,038	74,076	74,076
Minority interests	106,857	251,020	174,165	491,390
Net loss	$ (6,133,461)	$ (3,280,758)	$ (10,435,642)	$ (7,685,662)
Net loss per common share, basic and diluted	$ (0.39)	$ (0.21)	$ (0.67)	$ (0.52)
	15,629,776	15,629,776	15,629,776	14,898,083

Weighted average shares used in computation, basic and diluted

* Sales, net and Cost of sales include excise taxes of $1,127,135, $3,025,066, $2,105,189 and $4,328,056 for the three-months ended September 30, 2008 and 2007 and the six-months ended September 30, 2008 and 2007, respectively.

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Changes in Stockholders Equity
(Unaudited)

	Common Stock		Additional Paid in Capital	Accumulated Deficiency	Accumulated Other Comprehensive Loss	Total Stockholders Equity
	Shares	**Amount**				
BALANCE, MARCH 31, 2008	15,629,776	$ 156,298	$ 104,806,044	$ (87,546,011)	$ (2,628,172)	$ 14,788,159
Comprehensive loss:						
Net loss				(10,435,642)		(10,435,642)
Foreign currency translation adjustment					1,507,759	1,507,759
Total comprehensive loss						(8,927,883)
Stock-based compensation			417,803			417,803
BALANCE, SEPTMEBER 30, 2008	15,629,776	$ 156,298	$ 105,223,847	$ (97,981,653)	$ (1,120,413)	$ 6,278,079

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. and SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six-months ended September 30,	
	2008	**2007**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$ (10,435,642)	$ (7,685,662)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	487,859	555,701
Provision for doubtful accounts	41,228	36,343
Minority interest in net loss of consolidated subsidiary	(174,165)	(491,390)
Loss on disposal of equipment		1,051
Amortization of deferred financing costs	186,858	321,197
Current credit on derivative financial instrument		(189,397)
Income tax benefit	(74,076)	(74,076)
Effect of changes in foreign exchange	1,736,691	(1,038,734)
Stock-based compensation expense	417,803	536,896
Reversal of provision for obsolete inventories	(112,419)	
Non-cash interest charge	147,124	
Changes in operations, assets and liabilities:		
Decrease (increase) in accounts receivable	1,373,138	(3,933,607)
Increase in due from affiliates	(8,757)	
Decrease (increase) in inventory	563,011	(2,726,693)
Increase in prepaid expenses and supplies	(438,446)	(53,338)
Increase in other assets		151,191
Increase (decrease) in accounts payable and accrued expenses	1,237,356	(248,353)
Increase in due to related parties	408,107	281,747
Total adjustments	5,791,312	(6,871,462)
NET CASH USED IN OPERATING ACTIVITIES	(4,644,330)	(14,557,124)
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of equipment	(89,794)	(212,655)
Acquisition of intangible assets	(16,037)	(12,029)
Short-term investments purchased		(8,000,000)
Short-term investments sold	4,171,520	5,859,358
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	4,065,689	(2,365,326)
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayment of notes payable	(6,981,476)	(10,761,738)
Proceeds from notes payable	6,888,305	10,776,732
Payments of obligations under capital lease	(2,063)	(1,817)
Increase in restricted cash		(170,164)

Issuance of common stock				21,014,609
Payments for costs of common stock issuance				(1,396,123)
NET CASH (USED IN) PROVIDED BY FINANCING ACTIVITIES		(95,234)		19,461,499
EFFECTS OF FOREIGN CURRENCY TRANSLATION		(25,780)		1,007
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS		(699,655)		2,540,056
CASH AND CASH EQUIVALENTS BEGINNING		1,552,385		1,004,957
CASH AND CASH EQUIVALENTS ENDING	**$**	**852,730**	**$**	**3,545,013**

See accompanying notes to the condensed consolidated financial statements.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
Unaudited

NOTE 1 GOING CONCERN

The accompanying condensed consolidated financial statements have been prepared assuming that Castle Brands Inc. (the Company) will continue as a going concern. The Company has incurred significant operating losses and has not generated positive cash flows from its operating activities since inception. For the three and six-months ended September 30, 2008, the Company had a net loss of $6,133,461 and $10,435,642, respectively, and used cash of $3,257,497 and $4,644,330, respectively, in operating activities. As of September 30, 2008, the Company had an accumulated deficiency of $97,981,653. In addition, the Company was obligated to pay $10,000,000 in principal pertaining to senior notes maturing in May 2009. These conditions raised substantial doubt about the Company s ability to continue as a going concern. The report of the Company s Independent Registered Public Accounting Firm contained in the Company s Annual Report on Form 10-K, as amended, for the year ended March 31, 2008 (2008 Form 10-K), filed with the Securities and Exchange Commission (SEC), also contains an explanatory paragraph referring to an uncertainty concerning its ability to continue as a going concern.

The Company is continuing to implement a plan supporting the continued growth of existing brands through a variety of sales and marketing initiatives that the Company expects will generate cash flows from operations. As part of this plan, the Company intends to grow its business through continued expansion to new markets and within existing markets, as well as strengthening distributor relationships. The Company is also seeking additional brands and agency relationships to leverage the existing distribution platform, as well as a systematic approach to expense reduction, improvements in routes to market and production cost containment to improve existing cash flow.

As described in Note 12, on October 20, 2008, the Company completed a private placement with certain investors of $15,000,000 of its Series A Convertible Preferred Stock. The Company incurred approximately $1,700,000 in expenses associated with this transaction. In connection with the transaction, substantially all of the holders of Castle Brands (USA) Corp. s 9% senior secured notes, in the principal amount of $10,000,000 plus accrued but unpaid interest, and all holders of the Company s 6% convertible notes, in the principal amount of $9,000,000 plus accrued but unpaid interest, converted their notes into shares of Series A Preferred Stock. The closing of the cash investment and the conversion of substantially all of the outstanding debt provide the Company with sufficient funds to execute its planned operations for at least the next twelve months.

NOTE 2 ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying condensed consolidated financial statements do not include all of the information and footnote disclosures normally included in financial statements prepared in accordance with the rules and regulations of the SEC and U.S. generally accepted accounting principles (GAAP) and, in the opinion of management, contain all adjustments (which consist of only normal recurring adjustments) necessary for a fair presentation of such financial information. Results of operations for interim periods are not necessarily indicative of those to be achieved for full fiscal years. The condensed consolidated balance sheet as of March 31, 2008 is derived from the March 31, 2008 audited financial statements. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements for the fiscal year ended March 31, 2008 included in the 2008 Form 10-K. Please refer to the notes to the audited consolidated financial statements included in the 2008 Form 10-K for additional disclosures and a description of accounting policies.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
Unaudited

A. Description of business and business combination The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, Castle Brands (USA) Corp. (CB-USA) and McLain & Kyne, Ltd. (McLain & Kyne), and its wholly-owned foreign subsidiaries, Castle Brands Spirits Group Limited (CB-IRL) and Castle Brands Spirits Marketing and Sales Company Limited (CB-UK), and its 60% ownership interest in Gosling-Castle Partners, Inc. (GCP), 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.

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 importation, marketing and sale of fine spirit brands of vodka, whiskey, rums and liqueurs in the United States, Canada, Europe, Latin America and the Caribbean. Except for Gosling s rums and the bourbon products, which are bottled in the United States, all of the Company s products are imported from Europe. The vodka, Irish whiskeys and certain liqueurs are produced by CB-IRL, billed in Euros and imported into the United States. The risk of fluctuations in foreign currency is borne by the U.S. entities.

C. 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 September 30, 2008 and March 31, 2008, goodwill and other indefinite lived intangible assets that arose from acquisitions were $3,745,287 and $3,745,287, respectively. Goodwill and other identifiable 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.

Under SFAS No. 142, Goodwill and Other Intangible Assets (SFAS 142), impairment of goodwill must be tested at least annually by comparing the fair values of the applicable reporting units with the carrying amount of their net assets, including goodwill. If the carrying amount of the reporting unit s net assets exceeds the unit s fair value, an impairment loss would be recognized in an amount equal to the excess of the carrying amount goodwill over its implied fair value. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination with the fair value of the reporting unit deemed to be the purchase price paid.

The fair value of each reporting unit was determined at March 31, 2008 by weighting a combination of the present value of the Company s discounted anticipated future operating cash flows and values based on market multiples of revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) of comparable companies. Such valuations resulted in the Company recording a goodwill impairment loss of $8,750,000 for the year ended March 31, 2008. Such adjustments were attributable to downward revisions of earnings forecasted for future years, an increase in the incremental borrowing rate due to operating results that were worse than anticipated and an overall decrease to the value of the comparable companies.

CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
Unaudited

D. Impairment of long-lived assets In accordance with SFAS 144, Accounting for the Impairment or Disposal 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 three and six-months ended, or as of, September 30, 2008.

E. 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, are tax paid 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. Historically, the Company s sales in Ireland have been made in-bond , net of excise taxes. In September 2007, the Company made an initial sale to its new distributor in Ireland ex-bond that included $1,861,995 million in excise taxes and VAT. These taxes are reflected in both the Company s revenues and cost of sales as an equal increase to both.

F. Foreign currency The functional currency for the Company s foreign operations is the Euro in Ireland, and the British Pound in the United Kingdom. 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 shown as a separate line item in accompanying condensed consolidated statements of operations. The Company s vodka, Irish whiskeys and certain liqueurs are procured by CB-IRL and billed in Euros to the U.S. entities, with the risk of foreign exchange gain/loss resting with CB-USA. In addition, the Company has funded the continuing operations of the international subsidiaries. At each balance sheet date, the Euro denominated intercompany balances included on the books of CB-IRL are restated in U.S. Dollars at the exchange rate in effect at the balance sheet date, with the resulting foreign currency transaction gain or loss included in net loss.

G. Income taxes Under the asset and liability method of SFAS No. 109 Accounting for Income Taxes (SFAS 109), 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.

On January 1, 2007, the Company adopted the provisions of FIN 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies and sets forth consistent rules for accounting for uncertain tax positions in accordance with SFAS 109.

As a result of the implementation of FIN 48, the Company made a review of its portfolio of uncertain tax positions in accordance with recognition standards established by FIN 48. In this regard, an uncertain tax position represents the Company s expected treatment of a tax position taken in a filed tax return, or planned to be taken in a future tax return, that has not been reflected in measuring income tax expense for financial reporting purposes. As a result of this review, the Company determined that it had no material uncertain tax positions and, therefore, it has not recorded unrecognized tax benefits. The Company does not expect any material changes to its uncertain tax positions. The Company has did not recognize any interest or penalties arising from income taxes in the six-months ended September 30, 2008.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
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The tax years 2006 through 2008 remain open to examination by federal and state tax jurisdictions.

The Company has various foreign subsidiaries for which tax years 2002 through 2008 remain open to examination in certain foreign tax jurisdictions.

H. Recent accounting pronouncements

On October 10, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 157-3, Determining the Fair Value of a Financial Asset in a Market That Is Not Active. The FSP was effective upon issuance, including periods for which financial statements have not been issued. The FSP clarified the application of SFAS 157, Fair Value Measurements (SFAS 157), in an inactive market and provided an illustrative example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. The adoption of this FSP did not have a material impact on the Company s financial position and results of operations.

In May 2008, FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS 162). SFAS 162 identifies a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. generally accepted accounting principles for nongovernmental entities. SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. The Company does not believe the adoption of SFAS 162 will have a material effect on its condensed consolidated financial statements.

In April 2008, FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142. FSP FAS 142-3 is intended to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R), Business Combinations, (SFAS 141(R)) and other U.S. GAAP. FSP FAS 142-3 is effective for fiscal years beginning after December 15, 2008. Earlier application is not permitted. The Company is currently evaluating the impact of FSP FAS 142-3, but does not expect the adoption of this pronouncement to have a material impact on its financial position or results of operations.

In December 2007, FASB issued proposed FSP157-b, Effective Date of FASB Statement No. 157, (FSP157-b) that would permit a one-year deferral in applying the measurement provisions of SFAS 157 to non-financial assets and non-financial liabilities (non-financial items) that are not recognized or disclosed at fair value in an entity s financial statements on a recurring basis (at least annually). Therefore, if the change in fair value of a non-financial item is not required to be recognized or disclosed in the financial statements on an annual basis or more frequently, the effective date of application of SFAS 157 to that item is deferred until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. This deferral does not apply, however, to an entity that applies SFAS 157 in interim or annual financial statements before proposed FSP 157-b is finalized. The Company is currently evaluating the impact, if any, that the adoption of FSP157-b will have on its operating income or net earnings.

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CASTLE BRANDS INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Continued)
Unaudited

On December 4, 2007, the FASB issued SFAS No. 141(R) and SFAS No. 160, Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 (SFAS 160). SFAS 141(R) is required to be adopted concurrently with SFAS 160 and is effective for business combination transactions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is prohibited. Application of SFAS 141(R) and SFAS 160 is required to be adopted prospectively, except for certain provisions of SFAS 160, which are required to be adopted retrospectively. Business combination transactions accounted for before adoption of SFAS 141(R) should be accounted for in accordance with SFAS 141 and that accounting previously completed under SFAS 141 should not be modified as of or after the date of adoption of SFAS 141(R). The Company is currently evaluating the impact of SFAS 141(R) and SFAS 160, but does not expect the adoption of these pronouncements to have a material impact on its financial position or results of operations.

I. Reclassifications Certain prior year balances have been reclassified to conform to the current period classification.

NOTE 3 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 and contingent conversion of debentures. In computing diluted net loss per share for the three and six-months ended September 30, 2008 and 2007, 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 convertible debentures is anti-dilutive.

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

	September 30, 2008	**September 30, 2007**
Stock options	1,994,825	1,307,625
Stock warrants	2,305,432	2,255,432
Convertible debentures	1,192,380	1,192,380
Total	5,492,637	4,755,437

NOTE 4 INVESTMENTS

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

Estimated