

HANDLEMAN CO /MI/
Form 10-Q
March 12, 2004

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 third quarter ended January 31, 2004

Commission File Number 1-7923

Handleman Company

(Exact name of registrant as specified in its charter)

Michigan

38-1242806

(State or other jurisdiction of
incorporation or organization)

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

500 Kirts Boulevard, Troy, Michigan

48084-4142

Area Code 248 362-4400

(Address of principal executive offices)

(Zip code)

(Registrant's telephone number)

Indicate by checkmark 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 at least the past 90 days.

YES NO

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

YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| <u>CLASS</u> | <u>DATE</u> | <u>SHARES OUTSTANDING</u> |
|--------------------------------|---------------|---------------------------|
| Common Stock - \$.01 Par Value | March 5, 2004 | 23,851,008 |

HANDLEMAN COMPANY

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE AND NINE MONTH PERIODS ENDED JANUARY 31, 2004 AND 2003

(UNAUDITED)

(in thousands of dollars except per share data)

| | Three Months | | Nine Months | |
|--|--------------|------------|-------------|--------------|
| | 2004 | 2003 | 2004 | 2003 |
| | (13 Weeks) | (14 Weeks) | (39 Weeks) | (40 Weeks) |
| Revenues | \$ 443,902 | \$ 450,477 | \$ 919,095 | \$ 1,018,392 |
| Costs and expenses: | | | | |
| Direct product costs | 357,049 | 363,794 | 732,682 | 810,841 |
| Selling, general and administrative expenses | 53,787 | 54,724 | 139,102 | 154,360 |
| Impairment of subsidiary assets | | 33,100 | | 33,100 |
| Interest (income) expense, net | (248) | (173) | (255) | 79 |
| Income (loss) from continuing operations before income taxes and minority interest | 33,314 | (968) | 47,566 | 20,012 |
| Income tax (expense) benefit | (12,170) | 3,984 | (17,128) | (3,460) |
| Minority interest | | | | 366 |
| Income from continuing operations | 21,144 | 3,016 | 30,438 | 16,918 |
| Discontinued operations (Note 2): | | | | |
| Income from operations of discontinued subsidiary companies (including loss on disposal of \$665 for the nine months ended January 31, 2004) | | 672 | 5,341 | 4,691 |
| Income tax expense | | (261) | (2,743) | (1,776) |
| Income from discontinued operations | | 411 | 2,598 | 2,915 |
| Net income | \$ 21,144 | \$ 3,427 | \$ 33,036 | \$ 19,833 |
| Income per share: | | | | |
| Continuing operations - basic | \$ 0.87 | \$ 0.12 | \$ 1.23 | \$ 0.65 |
| Continuing operations - diluted | \$ 0.86 | \$ 0.12 | \$ 1.23 | \$ 0.65 |

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| | | | | |
|---|---------|---------|---------|---------|
| Discontinued operations - basic | \$ | \$ 0.01 | \$ 0.10 | \$ 0.11 |
| Discontinued operations - diluted | \$ | \$ 0.01 | \$ 0.10 | \$ 0.11 |
| Net income - basic | \$ 0.87 | \$ 0.13 | \$ 1.33 | \$ 0.76 |
| Net income - diluted | \$ 0.86 | \$ 0.13 | \$ 1.33 | \$ 0.76 |
| Weighted average number of shares outstanding during the period | | | | |
| Basic | 24,292 | 25,792 | 24,787 | 26,157 |
| Diluted | 24,506 | 25,845 | 24,912 | 26,178 |

The accompanying notes are an integral part of the consolidated financial statements.

HANDLEMAN COMPANY

CONSOLIDATED BALANCE SHEETS

AS OF JANUARY 31, 2004 AND MAY 3, 2003

(in thousands of dollars except share data)

| | January 31, 2004 (Unaudited) | May 3, 2003 |
|---|------------------------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 76,043 | \$ 62,698 |
| Accounts receivable, less allowances of \$11,130 at January 31, 2004 and \$24,269 at May 3, 2003 | 249,336 | 201,994 |
| Merchandise inventories | 132,286 | 119,979 |
| Other current assets | 9,795 | 17,993 |
| Total current assets | 467,460 | 402,664 |
| Property and equipment: | | |
| Land, buildings and improvements | 13,756 | 13,917 |
| Display fixtures | 30,767 | 32,876 |
| Computer hardware and software | 47,175 | 35,195 |
| Equipment, furniture and other | 35,106 | 33,073 |
| | 126,804 | 115,061 |
| Less accumulated depreciation | 65,594 | 59,328 |
| | 61,210 | 55,733 |
| Goodwill, net | 3,406 | 3,406 |
| Intangible assets, net | | 44,715 |
| Other assets, net | 19,848 | 19,046 |
| Total assets | \$ 551,924 | \$ 525,564 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$ 185,544 | \$ 159,747 |
| Debt, current portion | | 3,571 |
| Accrued and other liabilities | 39,385 | 40,630 |
| Total current liabilities | 224,929 | 203,948 |
| Debt, non-current | | 3,571 |
| Other liabilities | 5,794 | 9,199 |
| SHAREHOLDERS EQUITY | | |

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| | | |
|--|-------------------|-------------------|
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued | | |
| Common stock, \$.01 par value; 60,000,000 shares authorized; 23,907,000 and 25,659,000 shares issued at January 31, 2004 and May 3, 2003, respectively | 239 | 257 |
| Accumulated other comprehensive income (loss) | 5,921 | (4,716) |
| Unearned compensation | (7,868) | (3,141) |
| Retained earnings | 322,909 | 316,446 |
| | <u>321,201</u> | <u>308,846</u> |
| Total shareholders' equity | | |
| | <u>\$ 551,924</u> | <u>\$ 525,564</u> |

The accompanying notes are an integral part of the consolidated financial statements.

HANDLEMAN COMPANY

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

FOR THE NINE MONTH PERIOD ENDED JANUARY 31, 2004

(UNAUDITED)

(in thousands of dollars)

Nine Months (39 Weeks)

| | Common Stock | | Other Comprehensive Income (Loss) | | | Unearned Compensation | Retained Earnings | Total Shareholders Equity |
|---|------------------|--------|--|---------------------------------|------------|--------------------------|----------------------|---------------------------------|
| | Shares Issued | Amount | Foreign Currency Translation Adjustment | Minimum Pension Liability | | | | |
| May 3, 2003 | 25,659 | \$ 257 | \$ (591) | \$ (4,125) | \$ (3,141) | \$ 316,446 | \$ 308,846 | |
| Net income | | | | | | 33,036 | 33,036 | |
| Adjustment for foreign currency translation | | | 10,637 | | | | 10,637 | |
| Comprehensive income, net of tax | | | | | | | 43,673 | |
| Cash dividends, \$.14 per share | | | | | | (3,439) | (3,439) | |
| Common stock repurchased | (2,094) | (21) | | | | (38,232) | (38,253) | |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 342 | 3 | | | (4,727) | 14,156 | 9,432 | |
| Tax benefit from exercise of stock options | | | | | | 942 | 942 | |
| January 31, 2004 | 23,907 | \$ 239 | \$ 10,046 | \$ (4,125) | \$ (7,868) | \$ 322,909 | \$ 321,201 | |

The accompanying notes are an integral part of the consolidated financial statements.

HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE MONTH PERIODS ENDED JANUARY 31, 2004 AND 2003

(UNAUDITED)

(in thousands of dollars)

| | Nine Months | |
|---|-------------------|-------------------|
| | 2004 | 2003 |
| | (39 Weeks) | (40 Weeks) |
| | <u> </u> | <u> </u> |
| Cash flows from operating activities: | | |
| Net income | \$ 33,036 | \$ 19,833 |
| | <u> </u> | <u> </u> |
| Adjustments to reconcile net income to net cash provided from operating activities: | | |
| Depreciation | 11,867 | 14,029 |
| Amortization of acquisition costs | | 135 |
| Recoupment/amortization of acquired rights | 9,417 | 16,519 |
| Gain on disposal of property and equipment | 101 | 1,125 |
| Impairment of subsidiary assets | 665 | 33,100 |
| Tax benefit from exercise of stock options | 942 | 350 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in accounts receivable | (68,572) | 31,952 |
| Increase in merchandise inventories | (22,867) | (1,167) |
| Decrease in other operating assets | 8,623 | 5,551 |
| Increase (decrease) in accounts payable | 32,636 | (22,513) |
| Increase (decrease) in other operating liabilities | 280 | (15,107) |
| | <u> </u> | <u> </u> |
| Total adjustments | (26,908) | 63,974 |
| | <u> </u> | <u> </u> |
| Net cash provided from operating activities | 6,128 | 83,807 |
| | <u> </u> | <u> </u> |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (17,521) | (11,624) |
| Proceeds from disposition of properties and equipment | 250 | 4,738 |
| License advances and acquired rights | (6,522) | (14,242) |
| Proceeds from sale of subsidiary companies | 59,776 | |
| Additional investments in subsidiary companies | | (5,840) |
| | <u> </u> | <u> </u> |
| Net cash provided from (used by) investing activities | 35,983 | (26,968) |
| | <u> </u> | <u> </u> |
| Cash flows from financing activities: | | |
| Cash dividends | (3,439) | |
| Issuances of debt | 287,619 | 1,761,500 |
| Repayments of debt | (294,762) | (1,783,398) |
| Repurchase of common stock | (38,253) | (9,200) |
| Other changes in shareholders' equity, net | 20,069 | 8,052 |

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| | | |
|--|-----------|-----------|
| Net cash used by financing activities | (28,766) | (23,046) |
| Net increase in cash and cash equivalents | 13,345 | 33,793 |
| Cash and cash equivalents at beginning of period | 62,698 | 20,254 |
| Cash and cash equivalents at end of period | \$ 76,043 | \$ 54,047 |

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies

In the opinion of management, the accompanying Consolidated Balance Sheets and Consolidated Statements of Income, Shareholders' Equity and Cash Flows contain all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position of the Company as of January 31, 2004, the results of operations for the three and nine months and changes in cash flows for the nine months then ended. Because of the seasonal nature of the Company's business, revenues and earnings results for the nine months ended January 31, 2004 are not necessarily indicative of what the results will be for the full year. The Consolidated Balance Sheet as of May 3, 2003 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended May 3, 2003, including the discussion of the Company's critical accounting policies.

2. Discontinued Operations

During the second quarter ended November 1, 2003, the Company committed to a plan, and reached an agreement, to sell certain of its subsidiary companies (generally known as Anchor Bay Entertainment) within its North Coast Entertainment (NCE) business segment. In accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the financial results of these subsidiary companies are reported separately as discontinued operations in the Company's Consolidated Statements of Income for all periods presented since the operations and cash flows of these companies are eliminated from the ongoing operations of the Company upon completion of the sale. The Company does not have any continuing involvement in the operations of these companies after the disposal transaction. Under the provisions of SFAS No. 144, the Company recorded a pre-tax impairment charge of \$665,000 (\$1,057,000 after tax) in the second quarter of fiscal 2004; this impairment charge is included in Income from discontinued operations in the Company's Consolidated Statements of Income. The sale was completed on December 11, 2003 and generated approximately \$59,800,000 in cash.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

3. Restatement of Previously Issued Financial Statements

The accompanying consolidated financial statements for the three and nine months ended January 31, 2003 have been restated to recognize revenues upon customer receipt rather than at the time of shipment to reflect when risk of ownership is effectively transferred to the Company's customers. In addition, the Company has revised the accounting for two vendor contracts negotiated by a subsidiary of the Company during fiscal 2001. The Company has also reclassified costs associated with acquiring and preparing inventory for distribution from selling, general and administrative expenses to direct product costs for the three and nine months ended January 31, 2003, to conform to the presentation adopted in the fourth quarter of fiscal 2003; and as previously discussed, the Company has reported the financial results from certain subsidiary companies as discontinued operations. As a result of the aforementioned, the Company has restated and reclassified its financial statements for the three months and nine months ended January 31, 2003.

The following summarizes the restatements and reclassifications for the three and nine months ended January 31, 2003 (in thousands of dollars):

| Consolidated Statements of Income | Three Months Ended January 31, 2003 | Nine Months Ended January 31, 2003 |
|---|--|---|
| Revenues, previously reported | \$ 437,595 | \$ 1,057,450 |
| Adjustments for: | | |
| Revenue recognition | 29,751 | 15,404 |
| Discontinued operations | (16,869) | (54,462) |
| Revenues, restated | 450,477 | 1,018,392 |
| Direct product costs, previously reported | 347,679 | 824,045 |
| Adjustments for: | | |
| Revenue recognition | 23,800 | 13,604 |
| Vendor contracts | (81) | (215) |
| Reclassification of inventory related costs | 3,034 | 8,513 |
| Discontinued operations | (10,638) | (35,106) |
| Direct product costs, restated | 363,794 | 810,841 |
| Selling, general and administrative expenses, previously reported | 62,725 | 176,812 |
| Adjustments for: | | |
| Revenue recognition | 472 | 237 |
| Reclassification of inventory related costs | (3,034) | (8,513) |
| Discontinued operations | (5,439) | (14,176) |
| Selling, general and administrative expenses, restated | 54,724 | 154,360 |
| Interest (income) expense net, previously reported | (60) | 546 |
| Adjustments for: | | |
| Vendor contracts | 7 | 22 |
| Discontinued operations | (120) | (489) |

| | | |
|---|-------|----|
| Interest (income) expense net, restated | (173) | 79 |
|---|-------|----|

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

| Consolidated Statements of Income, continued | Three Months Ended January 31, 2003 | Nine Months Ended January 31, 2003 |
|---|--|---|
| (Loss) income before income taxes and minority interest, previously reported | (5,849) | 22,947 |
| Adjustments for: | | |
| Revenue recognition | 5,479 | 1,563 |
| Vendor contracts | 74 | 193 |
| Discontinued operations | (672) | (4,691) |
| (Loss) income from continuing operations before income taxes and minority interest, restated | (968) | 20,012 |
| Income tax benefit (expense), previously reported | 5,873 | (4,562) |
| Adjustments for: | | |
| Revenue recognition | (2,124) | (606) |
| Vendor contracts | (26) | (68) |
| Discontinued operations | 261 | 1,776 |
| Income tax benefit (expense)-continuing operations, restated | 3,984 | (3,460) |
| Income from discontinued operations, previously reported | | |
| Adjustments for: | | |
| Income from operations of discontinued subsidiary companies | 672 | 4,691 |
| Income tax expense - discontinued operations | (261) | (1,776) |
| Income from discontinued operations, restated | 411 | 2,915 |
| Net income, previously reported | 24 | 18,751 |
| Adjustments for: | | |
| Revenue recognition | 3,355 | 957 |
| Vendor contracts | 48 | 125 |
| Net income, restated | \$ 3,427 | \$ 19,833 |
| Net income per share - basic, previously reported | \$ 0.00 | \$ 0.72 |
| Adjustments for: | | |
| Revenue recognition | 0.13 | 0.04 |
| Vendor contracts | | |
| Net income per share - basic, restated | \$ 0.13 | \$ 0.76 |
| Net income per share - diluted, previously reported | \$ 0.00 | \$ 0.72 |
| Adjustments for: | | |
| Revenue recognition | 0.13 | 0.04 |
| Vendor contracts | | |
| Net income per share - diluted, restated | \$ 0.13 | \$ 0.76 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

4. Stock Plans

The Company currently has employee stock plans. Prior to fiscal 2004, the Company accounted for these plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related Interpretations. No stock-based employee compensation expense for stock options was reflected in net income for fiscal years prior to fiscal 2004, as all stock options granted under these plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. Effective May 4, 2003, the Company adopted the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation. The Company selected the prospective transition method, as defined in SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment to SFAS No. 123, Accounting for Stock-Based Compensation.

Under the prospective method, all stock options issued on or after May 4, 2003 are accounted for utilizing the fair value provisions of SFAS No. 123. The pre-tax costs related to stock options included in the determination of net income for the three and nine months ended January 31, 2004 was \$163,000 and \$419,000, respectively, which was less than that which would have been recognized if the fair value method had been applied to all stock option awards since the original effective date of SFAS No. 123.

The following table illustrates the effect on net income and earnings per share if the fair value based method had been applied to all outstanding and unvested stock options for each period presented (in thousands of dollars except per share data):

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------|-----------------------------------|---------------------|-----------------------------------|
| | January 31, 2004 | January 31, 2003 (Restated) | January 31, 2004 | January 31, 2003 (Restated) |
| Net income, as reported | \$ 21,144 | \$ 3,427 | \$ 33,036 | \$ 19,833 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 104 | | 247 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (412) | (483) | (1,088) | (1,327) |
| Pro forma net income | \$ 20,836 | \$ 2,944 | \$ 32,195 | \$ 18,506 |
| Net income per share: | | | | |
| Reported - basic | \$ 0.87 | \$ 0.13 | \$ 1.33 | \$ 0.76 |
| - diluted | \$ 0.86 | \$ 0.13 | \$ 1.33 | \$ 0.76 |
| Pro forma - basic | \$ 0.86 | \$ 0.11 | \$ 1.30 | \$ 0.71 |
| - diluted | \$ 0.85 | \$ 0.11 | \$ 1.29 | \$ 0.71 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

5. Accounts Receivable

The table below summarizes the components of accounts receivable balances included in the Company's Consolidated Balance Sheets (in thousands of dollars):

| | January 31, | May 3, 2003 |
|---|--------------------|--------------------|
| | 2004 | |
| | <u> </u> | <u> </u> |
| Trade accounts receivable | \$ 260,466 | \$ 226,263 |
| Less allowances for: | | |
| Gross profit impact of estimated future returns | (8,336) | (12,759) |
| Bankrupt customers | | (6,720) |
| Doubtful accounts | (2,794) | (4,790) |
| | <u> </u> | <u> </u> |
| Accounts receivable, net | <u>\$ 249,336</u> | <u>\$ 201,994</u> |

6. Acquired Rights

The Company, principally in its proprietary products business within its NCE business segment, acquired rights to video licenses giving it the exclusive privilege to manufacture and distribute such products. The costs of acquired rights included advances paid to licensors and costs to create a master to be used for duplication. The acquired rights were amortized based upon the sales volume method over a period which was the lesser of the terms of the agreements or the products' estimated useful lives. On a regular basis, the Company performed analyses comparing the carrying value of its acquired rights with the expected future economic benefit of these assets. Based on such analyses, the Company adjusted, when necessary, the value of its acquired rights.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

As discussed in Note 2 of Notes to Consolidated Financial Statements, the Company has sold certain subsidiary companies, and assets of these subsidiary companies included all amortized intangible assets of the Company.

The following information relates to intangible assets subject to amortization (in thousands of dollars):

| Amortized Intangible Assets | January 31, 2004 | | May 3, 2003 | |
|--------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| License advances | | | \$ 65,493 | \$ 41,347 |
| Masters | | | 33,794 | 13,225 |
| Total | | | \$ 99,287 | \$ 54,572 |

| Amortized Intangible Assets | January 31, 2004 | | May 3, 2003 | |
|--------------------------------|------------------|---|------------------|---|
| | Net Amount | Weighted Avg. Amortization Period | Net Amount | Weighted Avg. Amortization Period |
| License advances | | n/a | \$ 24,146 | 100 mos. |
| Masters | | n/a | 20,569 | 90 mos. |
| Total | | n/a | \$ 44,715 | 96 mos. |

The following is a summary of aggregate amortization expense (in thousands of dollars):

| Period | Amount |
|-------------------------------------|--------|
| Three months ended January 31, 2004 | \$ |
| Three months ended January 31, 2003 | 4,946 |
| Nine months ended January 31, 2004 | 9,417 |
| Nine months ended January 31, 2003 | 16,535 |

The following table summarizes estimated amortization expense based on the value of acquired rights as of January 31, 2004 (in thousands of dollars):

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| <u>Fiscal Year</u> | <u>Amount</u> |
|--------------------|---------------|
| 2004 | \$ 9,417 |
| 2005 | |
| 2006 | |
| 2007 | |
| 2008 | |

The Company does not have any intangible assets, other than goodwill, which are not subject to amortization.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

7. New Accounting Pronouncements

In May 2003, SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued by the Financial Accounting Standards Board (FASB). SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments based on whether such financial instruments embody an obligation of the issuer. The Company has evaluated the impact of this Statement and will adopt SFAS No. 150 as necessary. Currently, the Company does not have any financial instruments that meet the criteria defined in this Statement.

In December 2003, SFAS No. 132 (revised December 2003), Employers Disclosures about Pensions and Other Postretirement Benefits, was issued by the FASB. SFAS No. 132 (revised) expands employers disclosures related to pension plans and other postretirement benefit plans, specifically, disclosures related to the assets, obligations, cash flows and net periodic benefit costs of defined benefit pension plans. The Company will adopt the revisions of this Statement effective with its fiscal 2004 Annual Report on Form 10-K, as required.

In December 2003, a revision of Financial Interpretation (FIN) No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 , was issued by the FASB. The revisions of FIN No. 46 provide further guidance on the identification of entities for which control is achieved through means other than through voting rights and how to determine when and which business enterprises should consolidate a variable interest entity. The Company has evaluated the revisions of FIN No. 46 and does not expect this interpretation to have a significant impact on its operating results.

8. Segment Information

The Company has operated in two business segments: Handleman Entertainment Resources (H.E.R.) is responsible for music category management and distribution operations, and NCE was responsible for the Company s proprietary operations, which included music and video product.

The accounting policies of the segments are the same as those described in Note 1, Accounting Policies, contained in the Company s Form 10-K for the year ended May 3, 2003. Segment data includes intersegment revenues, as well as a charge allocating corporate costs to the operating segments. The Company evaluates performance of its segments and allocates resources to them based on income before interest, income taxes and minority interest (segment income).

As described in Note 2 of Notes to Consolidated Financial Statements, the Company has sold certain subsidiary companies, all of which had previously been reported in the NCE business segment. Fiscal 2004 amounts below represent all H.E.R. operations, as well as activity from remaining NCE operations other than from those companies which were sold. Fiscal 2003 amounts represent all H.E.R. operations, as well as NCE results including Madacy Entertainment, which was sold in the third quarter of fiscal 2003, and activity from remaining NCE operations other than from those companies which were sold in the second quarter of fiscal 2004.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The tables below present information about reported segments for the three months ended January 31, 2004 and January 31, 2003 (in thousands of dollars):

Three Months Ended January 31, 2004:

| | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
|------------------------------|---------------|------------|--------------|
| Revenues, external customers | \$ 443,534 | \$ | \$ 443,534 |
| Intersegment revenues | | | |
| Segment income (loss) | 34,487 | (589) | 33,898 |
| Capital expenditures | 10,805 | | 10,805 |

Three Months Ended January 31, 2003, Restated:

| | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
|---------------------------------|---------------|------------|--------------|
| Revenues, external customers | \$ 443,809 | \$ 6,523 | \$ 450,332 |
| Intersegment revenues | | 3,864 | 3,864 |
| Segment income (loss) | 33,031 | (1,449) | 31,582 |
| Impairment of subsidiary assets | (5,066) | (28,034) | (33,100) |
| Capital expenditures | 4,426 | 42 | 4,468 |

A reconciliation of total segment revenues to consolidated revenues and total segment income to consolidated income from continuing operations before income taxes and minority interest, for the three months ended January 31, 2004 and January 31, 2003 is as follows (in thousands of dollars):

| | <u>January 31, 2004</u> | <u>January 31, 2003 (Restated)</u> |
|--|-------------------------|--|
| Revenues | | |
| Total segment revenues | \$ 443,534 | \$ 454,196 |
| Corporate income | 368 | 145 |
| Elimination of intersegment revenues | | (3,864) |
| Consolidated revenues | \$ 443,902 | \$ 450,477 |
| Income From Continuing Operations Before Income Taxes and Minority Interest | | |
| Total segment income for reportable segments | \$ 33,898 | \$ 31,582 |
| Impairment of subsidiary assets | | (33,100) |
| Interest income | 408 | 493 |
| Interest expense | (160) | (320) |
| Unallocated corporate (expense) income | (832) | 377 |
| Consolidated income (loss) from continuing operations before income taxes and minority interest | \$ 33,314 | \$ (968) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The tables below present information about reported segments as of and for the nine months ended January 31, 2004 and January 31, 2003 (in thousands of dollars):

Nine Months Ended January 31, 2004:

| | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
|--|---------------|------------|--------------|
| Revenues, external customers | \$ 918,299 | \$ 129 | \$ 918,428 |
| Intersegment revenues | | | |
| Segment income (loss) | 47,815 | (522) | 47,293 |
| Total assets, excluding assets held for sale | 575,912 | 15 | 575,927 |
| Capital expenditures | 17,489 | 32 | 17,521 |

Nine Months Ended January 31, 2003, Restated:

| | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
|---------------------------------|---------------|------------|--------------|
| Revenues, external customers | \$ 986,663 | \$ 31,294 | \$ 1,017,957 |
| Intersegment revenues | | 17,037 | 17,037 |
| Segment income (loss) | 52,496 | (371) | 52,125 |
| Impairment of subsidiary assets | (5,066) | (28,034) | (33,100) |
| Total assets | 504,068 | 75,205 | 579,273 |
| Capital expenditures | 11,214 | 410 | 11,624 |

A reconciliation of total segment revenues to consolidated revenues, total segment income to consolidated income from continuing operations before income taxes and minority interest, and total segment assets to consolidated assets as of and for the nine months ended January 31, 2004 and January 31, 2003 is as follows (in thousands of dollars):

| | <u>January 31, 2004</u> | <u>January 31, 2003</u> <u>(Restated)</u> |
|--|-------------------------|--|
| Revenues | | |
| Total segment revenues | \$ 918,428 | \$ 1,034,994 |
| Corporate income | 667 | 435 |
| Elimination of intersegment revenues | | (17,037) |
| Consolidated revenues | \$ 919,095 | \$ 1,018,392 |
| Income from Continuing Operations Before Income Taxes and Minority Interest | | |
| Total segment income for reportable segments | \$ 47,293 | \$ 52,125 |
| Impairment of subsidiary assets | | (33,100) |
| Interest income | 1,101 | 827 |
| Interest expense | (846) | (906) |
| Unallocated corporate income | 18 | 1,066 |

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| | | |
|--|------------|------------|
| Consolidated income from continuing operations before income taxes and minority interest | \$ 47,566 | \$ 20,012 |
| <u>Assets</u> | | |
| Total segment assets | \$ 575,927 | \$ 579,273 |
| Assets held for sale | | 42,882 |
| Elimination of intercompany receivables and payables | (24,003) | (59,192) |
| Consolidated assets | \$ 551,924 | \$ 562,963 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

9. Comprehensive Income

Comprehensive income is summarized as follows (in thousands of dollars):

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------|-----------------------------------|---------------------|-----------------------------------|
| | January 31, 2004 | January 31, 2003 (Restated) | January 31, 2004 | January 31, 2003 (Restated) |
| Net income | \$ 21,144 | \$ 3,427 | \$ 33,036 | \$ 19,833 |
| Change in foreign currency translation adjustments | 6,442 | 3,681 | 10,637 | 6,687 |
| Total comprehensive income | \$ 27,586 | \$ 7,108 | \$ 43,673 | \$ 26,520 |

Accumulated other comprehensive income (loss) is comprised of the following (in thousands of dollars):

| | January 31, 2004 | May 3, 2003 |
|--|------------------|-------------------|
| Foreign currency translation adjustments | \$ 10,046 | \$ (591) |
| Minimum pension liability, net of tax | (4,125) | (4,125) |
| Total accumulated other comprehensive income (loss) | \$ 5,921 | \$ (4,716) |

10. Common Stock - Basic and Diluted Shares

A reconciliation of the weighted average shares used in the calculation of basic and diluted shares is as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------|---------------------|---------------------|---------------------|
| | January 31, 2004 | January 31, 2003 | January 31, 2004 | January 31, 2003 |
| Weighted average shares during the period-basic | 24,292 | 25,792 | 24,787 | 26,157 |
| Additional shares from assumed exercise of stock options | 214 | 53 | 125 | 21 |

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| | | | | |
|--|--------|--------|--------|--------|
| Weighted average shares adjusted for assumed exercise of stock options-diluted | 24,506 | 25,845 | 24,912 | 26,178 |
|--|--------|--------|--------|--------|

11. Contingencies

In January 2002, Kmart Corporation filed for Chapter 11 bankruptcy protection and requested that the Bankruptcy Court designate Handleman Company and several other companies critical trade vendors. The court approved this designation, and Handleman received \$49 million in payment of Kmart's obligations. In April 2003, the United States District Court ruled that the Bankruptcy Court's designation regarding critical trade vendors was not appropriate under the Bankruptcy Code. The District Court's order did not require repayment of the amounts received by the critical trade vendors. Kmart immediately appealed the District

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Court's ruling to the United States Court of Appeals. Handleman Company subsequently was permitted to intervene and participate in that appeal. Kmart emerged from bankruptcy in May 2003. During the pendency of its appeal to the Court of Appeals, Kmart filed a complaint before the Bankruptcy Court in June 2003, asking that the \$49 million be reimbursed. On February 24, 2004, the Court of Appeals affirmed the District Court's order. The Company is considering whether to ask the U.S. Supreme Court to grant a writ of certiorari and review this matter. The range of the potential liability is zero to \$49 million with no amount within this range representing a better estimate than any other amount. Since the Company is unable to estimate the effect on it of the outcome of this matter, no accrual has been recorded for this contingent liability. The Company's position is that, as a result of being named a critical trade vendor, its economic concessions were substantially equivalent to the \$49 million payment received.

There are no additional pending legal proceedings to which the Registrant or any of its subsidiaries is a party, other than routine legal matters which are incidental to the business and the outcome of which is not expected to be material to future results of consolidated operations, financial position and cash flows.

Item 2.

Handleman Company
Management's Discussion and Analysis of
Financial Condition and Results of Operations

The Company has operated in two business segments: Handleman Entertainment Resources (H.E.R.) and North Coast Entertainment (NCE). H.E.R. consists of music category management and distribution operations principally in North America and the United Kingdom (UK). NCE encompassed the Company's proprietary operations, which included music and video product.

During the second quarter of fiscal 2004, which ended November 1, 2003, the Company committed to a plan, and reached an agreement, to sell certain of its subsidiary companies (generally known as Anchor Bay Entertainment) within its NCE business segment. In accordance with accounting standards, the financial results of these subsidiary companies are reported separately as discontinued operations in the Company's Consolidated Statements of Income for all periods presented, since the ongoing operations and cash flows of these companies are eliminated from the ongoing operations of the Company upon completion of the sale. As a result, income from continuing operations for the third quarter and nine-month periods of fiscal 2004, which ended January 31, 2004, substantially included only H.E.R. operations. Comparable periods for fiscal 2003, which ended January 31, 2003, though predominately reflective of H.E.R. operations, also included results from Madacy Entertainment, which was sold during the third quarter of fiscal 2003, and activity from remaining NCE operations, other than those companies which were sold in the second quarter of fiscal 2004. The sale of Anchor Bay Entertainment was completed on December 11, 2003 and generated approximately \$59.8 million in cash. Reference should be made to Note 8 in Notes to Consolidated Financial Statements for additional information regarding the H.E.R. and NCE operating segments.

Overview

The Company's third quarter and first nine months of this fiscal year consisted of 13 and 39 weeks, respectively, whereas the comparable periods last year consisted of 14 and 40 weeks, respectively. The Company's fiscal year 2004 will end on May 1, 2004 and will consist of 52 weeks, whereas its fiscal year 2003 ended on May 3, 2003 and consisted of 53 weeks.

Net income for the third quarter of fiscal 2004 was \$21.1 million or \$.86 per diluted share, compared to \$3.4 million or \$.13 per diluted share for the third quarter of fiscal 2003. Net income for the third quarter of last year included after tax impairment charges related to the sale of Madacy Entertainment and the refocusing of Handleman Online, the Company's e-commerce unit, of \$14.1 million and \$3.3 million, respectively, or a total of \$0.67 per diluted share. Also, net income for the third quarter of last year included \$0.4 million, or \$.01 per diluted share, from discontinued operations.

Net income for the first nine months of this fiscal year was \$33.0 million or \$1.33 per diluted share, compared to \$19.8 million or \$.76 per diluted share for the comparable nine-month period of last year. Net income for the nine-month periods this year and last year included income from discontinued operations of \$2.6 million or \$.10 per diluted share and \$2.9 million or \$.11 per diluted share, respectively. Additionally, net income in the first nine months of fiscal 2003 included the previously mentioned after tax impairment charges related to Madacy Entertainment and Handleman Online, as well as net income of \$0.6 million or \$.02 per diluted share from operating activities of the Madacy Entertainment business unit.

Results of Operations

Unless otherwise noted, the following discussion relates only to results from continuing operations.

Revenues for the third quarter of fiscal 2004 decreased to \$443.9 million from \$450.5 million for the third quarter of fiscal 2003. Approximately 93% of the decrease in revenues for the third quarter of fiscal 2004 resulted from the absence of Madacy Entertainment revenues, due to the sale of that business unit in the third quarter of fiscal 2003. Income from continuing operations for the third quarter of fiscal 2004 was \$21.1 million or \$.86 per diluted share, compared to \$3.0 million or \$.12 per diluted share for the third quarter of fiscal 2003. The year-over-year increase in income from continuing operations principally resulted from the inclusion of impairment charges related to subsidiary assets in the third quarter of last year, as discussed above.

Revenues for the first nine months of fiscal 2004 were \$919.1 million, a 10% decrease from revenues of \$1,018.4 million for the first nine months of fiscal 2003. The absence of Madacy Entertainment from fiscal 2004 results accounted for 28% of this decrease in revenues, with the remaining decrease in revenues predominately due to lower H.E.R. revenues. Income from continuing operations for the nine months ended January 31, 2004 was \$47.6 million or \$1.23 per diluted share, compared to \$20.0 million or \$.65 per diluted share for the comparable nine-month period of last year.

H.E.R. revenues were \$443.5 million for the third quarter of fiscal 2004, down slightly from revenues of \$443.8 million for the third quarter of fiscal 2003. This slight decrease in revenues was a result of lower revenues within the H.E.R. United States (U.S.) operation of \$25.3 million, due to fewer stores serviced this year compared to last year. The decline in H.E.R. U.S. revenues was offset, in part, by higher revenues in the UK and Canadian operations of \$17.0 million and \$7.9 million, respectively. The revenue increases in the UK and Canada were partially due to stronger local currencies in both countries, accounting for 50% and 92% of the increased revenues, respectively.

H.E.R. revenues for the first nine months of this fiscal year were \$918.3 million, compared to \$986.7 million for the first nine months of last year. This decline was mainly due to lower revenues within the H.E.R. U.S. operation of \$127.2 million. This decrease in H.E.R. U.S. revenues was primarily attributable to lower year-over-year shipments on a comparable store basis to a key customer in the amount of \$105.7 million and fewer stores serviced this year, accounting for an additional \$77.1 million; these declines were offset, in part, by incremental revenues generated from a test program for potential new business. This decrease in H.E.R. U.S. revenues was partially offset by increased revenues within the UK and Canadian operations of \$40.2 million and \$15.9 million, respectively, over the same period last year. Approximately 36% and 81% of the increased revenues in the UK and Canada, respectively, resulted from stronger local currencies, as discussed earlier.

Consolidated direct product costs as a percentage of revenues was 80.4% for the third quarter ended January 31, 2004, compared to 80.8% for the third quarter ended January 31, 2003. This decrease was primarily due to lower direct product costs within the Company's UK operation, resulting from improved terms from vendors. Consolidated direct product costs for both the third quarters ended January 31, 2004 and January 31, 2003 included costs associated with acquiring and preparing inventory for distribution in the amount of \$3.0 million. Consolidated direct product costs as a percentage of revenues was 79.7% for the first nine months of fiscal 2004, compared to 79.6% for the first nine months of fiscal 2003. Direct product costs for the first nine months of fiscal 2004 and 2003 included costs associated with acquiring and preparing inventory for distribution of \$7.9 million and \$8.5 million, respectively.

Consolidated selling, general and administrative (SG&A) expenses were \$53.8 million or 12.1% of revenues for the third quarter of fiscal 2004, compared to \$54.7 million or 12.1% of revenues for the

third quarter of fiscal 2003. SG&A expenses for the third quarter of this fiscal year included \$3.3 million dollars of costs related to the performance share component of the Company's long-term incentive plan, compared to \$0.6 million for the comparable period last year; and a foreign currency translation adjustment charge of \$1.7 million related to the Mexico operation, resulting from the substantial liquidation of the investment in this business unit as it transitions from a full category management and distribution operation to a service model organization, similar to those currently in place in Brazil and Argentina. Also during the third quarter, the Company recognized foreign exchange gains of \$0.9 million, primarily resulting from the Company's UK and Canadian operations. Additionally, SG&A expenses for the third quarter of fiscal 2004 were reduced by the capitalization of internal labor costs, in the amount of \$3.3 million, associated with the development of computer software primarily related to the Company's implementation of an integrated Oracle ERP solution. Consolidated SG&A expenses for the first nine months of this year were \$139.1 million or 15.1% of revenues, compared to \$154.4 million or 15.2% of revenues for the first nine months of last year. The decrease in SG&A expenses for the nine-month period of this year was predominately a result of the lower year-over-year revenues, as discussed earlier.

Income before interest, income taxes and minority interest (operating income) for the third quarter of fiscal 2004 was \$33.1 million, compared to an operating loss of \$1.1 million for the third quarter of fiscal 2003. Operating income for the first nine months of this fiscal year was \$47.3 million, compared to \$20.1 million for the first nine months of last fiscal year. The improved operating income in the year-over-year three and nine-month periods was primarily attributable to the \$33.1 million pre-tax impairment charges recorded in the third quarter of last year related to the sale of Madacy Entertainment and the refocusing of Handleman Online.

H.E.R. operating income for the third quarter of this fiscal year was \$34.5 million, compared to \$28.0 million for the third quarter of last year, an increase of 23%. This increase in H.E.R. operating income was predominately due to an improvement in operating income at Handleman Online of \$7.2 million, resulting from the refocusing of that business unit in the third quarter last year; improvements in operating income in the UK and Canadian operations of \$5.6 million and \$1.8 million, respectively, resulting from lower direct product costs as a percentage of revenues; and a \$2.8 million improvement in operating income related to the Mexican operation, chiefly due to lower direct product costs. These improvements were partially offset by a decrease in year-over-year operating income at H.E.R. U.S. of \$10.9 million, predominately due to lower net sales resulting from fewer stores serviced and reduced shipments to a key customer. H.E.R. operating income for the first nine months of fiscal 2004 was \$47.8 million, compared to \$47.3 million for the first nine months of fiscal 2003.

Interest income, net for both the third quarters of fiscal 2004 and 2003 was \$0.2 million. Interest income, net for the nine months ended January 31, 2004 was \$0.3 million, compared to interest expense, net of \$0.1 million for the comparable nine-month period of last year. The improvement for the nine-month period was due to lower borrowing levels this year over last year. During the second quarter of this fiscal year, the Company prepaid its outstanding debt under a senior note agreement with a group of insurance companies, in the amount of \$7.1 million (\$3.5 million was scheduled to mature in February 2004, with the remaining \$3.6 million scheduled to mature in February 2005). As a result of the early payment, the Company incurred a pre-payment cost of \$474,000, which was included in interest income, net for the nine-month period ended January 31, 2004. The Company would have incurred interest expense of \$598,000 had it held the senior note to maturity.

The effective income tax rates for the third quarter and nine months ended January 31, 2004 were 36.5% and 36.0%, respectively. The tax rates last year do not provide a meaningful comparison since they reflected income tax benefits recognized in the third quarter ended January 31, 2003 related to the sale of Madacy Entertainment.

Other

Accounts receivable at January 31, 2004 was \$249.3 million, compared to \$202.0 million at May 3, 2003. This increase was principally due to the higher revenues in the third quarter of this year versus the fourth quarter of last year, which was attributable to the seasonal nature of the Company's business.

Merchandise inventories at January 31, 2004 was \$132.3 million, compared to \$120.0 million at May 3, 2003. The increase was primarily due to higher inventory levels within the H.E.R. U.S. operation to support the test program for potential new business.

Other current assets decreased to \$9.8 million at January 31, 2004 from \$18.0 million at May 3, 2003. The decrease in other current assets was primarily attributable to a reduction in income taxes receivable.

Property and equipment, net was \$61.2 million at January 31, 2004, compared to \$55.7 million at May 3, 2003. The increase was predominately due to additions related to the Company's investment in computer software.

Intangible assets, net are zero as of January 31, 2004, compared to \$44.7 million at May 3, 2003. The intangible assets comprising the balance at May 3, 2003 were related to the subsidiary companies which were sold during this fiscal year.

Accounts payable increased to \$185.5 million at January 31, 2004 from \$159.7 million at May 3, 2003. The increase in accounts payable was mainly due to the timing of vendor payments related to the increased inventory purchases for the holiday season.

Reference should be made to Notes 4 and 7 of the Notes to Consolidated Financial Statements, in this Form 10-Q, for new accounting pronouncements adopted in fiscal 2004, and those currently being evaluated by the Company.

During the third quarter of fiscal 2004, the Company repurchased 750,500 shares of its common stock at an average price of \$20.93 per share. As of January 31, 2004, the Company had repurchased 2.4 million shares, or 46% of the shares authorized by its Board of Directors under a 20% share repurchase program.

On February 24, 2004, the Company's Board of Directors approved an amendment to the Company's 2001 Stock Option and Incentive Plan. As a result of that amendment, a copy of which is attached to this Quarterly Report on Form 10-Q as Exhibit 10.1, stock options held by employees or directors who retire from the Company will no longer vest immediately upon retirement but will instead, with the consent of the Compensation and Stock Option Committee, continue to vest following retirement in accordance with the vesting schedule established at the time the options were granted.

In January 2002, Kmart Corporation filed for Chapter 11 bankruptcy protection and requested that the Bankruptcy Court designate Handleman Company and several other companies' critical trade vendors. The court approved this designation, and Handleman received \$49 million in payment of Kmart's obligations. In April 2003, the United States District Court ruled that the Bankruptcy Court's designation regarding critical

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trade vendors was not appropriate under the Bankruptcy Code. The District Court's order did not require repayment of the amounts received by the critical trade vendors. Kmart immediately appealed the District Court's ruling to the United States Court of Appeals. Handleman Company subsequently was permitted to intervene and participate in that appeal.

Kmart emerged from bankruptcy in May 2003. During the pendency of its appeal to the Court of Appeals, Kmart filed a complaint before the Bankruptcy Court in June 2003, asking that the \$49 million be reimbursed. On February 24, 2004, the Court of Appeals affirmed the District Court's order. The Company is considering whether to ask the U.S. Supreme Court to grant a writ of certiorari and review this matter. The range of the potential liability is zero to \$49 million with no amount within this range representing a better estimate than any other amount. Since the Company is unable to estimate the effect on it of the outcome of this matter, no accrual has been recorded for this contingent liability. The Company's position is that, as a result of being named a critical trade vendor, its economic concessions were substantially equivalent to the \$49 million payment received.

Liquidity and Capital Resources

The Company has an unsecured \$170 million line of credit arranged with a consortium of banks which expires in August 2006. Management believes that the revolving credit agreement, along with cash provided from operations, will provide sufficient liquidity to fund the Company's day-to-day operations, including seasonal increases in working capital, as well as repurchases of common stock under the Company's stock repurchase program. The Company had no borrowings against its line of credit at January 31, 2004 or May 3, 2003. As discussed above, during the second quarter of this year, the Company prepaid its outstanding debt under a senior note agreement with a group of insurance companies, in the amount of \$7.1 million.

On November 25, 2003, the Company announced a quarterly cash dividend of \$0.07 per share. As a result, \$1.7 million was paid on January 9, 2004 to shareholders of record at the close of business on December 24, 2003. For the nine months ended January 31, 2004, a total of \$0.14 per share or \$3.4 million in dividends has been paid to shareholders.

Net cash provided from operating activities for the first nine months of fiscal 2004 was \$6.1 million, compared to cash provided from operating activities of \$83.8 million for the comparable nine-month period of last year. The decrease in cash flows from operating activities was primarily related to unfavorable year-over-year changes in accounts receivable and inventory balances of \$100.5 million and \$21.7 million, respectively, and a decrease of \$42.3 million in non-cash charges compared to the same period of last year (principally impairment of subsidiary assets and recoupment/amortization of acquired rights). The above items were partially offset by higher net income of \$13.2 million in the first nine months of this year versus last year, and favorable changes in year-over-year balances in accounts payable and other operating assets and liabilities of \$55.1 million and \$18.5 million, respectively.

Net cash provided from investing activities increased to \$36.0 million for the nine months ended January 31, 2004 from net cash used by investing activities of \$27.0 million for the nine months ended January 31, 2003. This increase was chiefly due to proceeds of \$59.8 million from the sale of the Anchor Bay Entertainment business unit, which was completed on December 11, 2003.

Net cash used by financing activities increased to \$28.8 million for the nine months ended January 31, 2004 from \$23.0 million for the comparable nine-month period last year. This increase in cash used by financing activities was primarily due to increased repurchases of the Company's common stock of \$29.1 million and cash dividends paid of \$3.4 million, offset in part by lower year-over-year net repayments of debt totaling \$14.8 million and other changes in shareholder's equity, net of \$12.0 million, principally in connection with employee benefit plans.

The following table summarizes the Company's cash obligations and commitments as of January 31, 2004, along with their expected effect on liquidity and cash flows in future periods (in thousands of dollars):

| | Total | Less than 1 Year | 1-3 Years | 4-5 Years | After 5 Years |
|---|------------------|-----------------------------|----------------------|----------------------|--------------------------|
| Other long-term obligations | \$ 2,993 | \$ 157 | \$ 2,836 | \$ | \$ |
| Operating leases and other commitments | 26,748 | 2,803 | 16,050 | 2,872 | 5,023 |
| Less: operating sub-leases | (578) | | (578) | | |
| Outstanding letters of credit | 3,361 | 3,361 | | | |
| Total contractual cash obligations and commitments | \$ 32,524 | \$ 6,321 | \$ 18,308 | \$ 2,872 | \$ 5,023 |

Outlook

The Company expects sales from continuing operations for its fourth quarter to be comparable to, or slightly higher than sales from continuing operations of approximately \$261.0 million in the fourth quarter of last year. Accordingly, the Company expects fully diluted earnings per share from continuing operations for the fourth quarter of this year to approximate the \$0.22 per diluted share from continuing operations in the fourth quarter of last year.

This document contains forward-looking statements, which are not historical facts and involve risk and uncertainties. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements, including without limitation, conditions in the music industry, business with a key customer following its emergence from Chapter 11 proceedings, the ability to enter into profitable agreements with customers in the new businesses outlined in the Company's strategic growth plan, securing funding or providing sufficient cash required to build and grow new businesses, customer requirements, continuation of satisfactory relationships with existing customers and suppliers, effects of electronic commerce, effects of music product piracy, relationships with the Company's lenders, pricing and competitive pressures, the occurrence of catastrophic events or acts of terrorism, certain global and regional economic conditions, and other factors detailed from time to time in the Company's filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this document. Additional information that could cause actual results to differ materially from any forward-looking statements may be contained in the Company's Annual Report on Form 10-K.

Item 4.

Controls And Procedures

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) of the Securities Exchange Act of 1934 (the Act) as of January 31, 2004 was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures, as currently in effect, are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. There have been no changes in internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) during the third fiscal quarter ended January 31, 2004 that have materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Company intends to continually review and evaluate the design and effectiveness of its disclosure controls and procedures and to improve its controls and procedures over time and to correct any deficiencies that it may discover in the future. The goal is to ensure that senior management has timely access to all material financial and non-financial information concerning the Company's business. While the Company believes the present design of its disclosure controls and procedures is effective to achieve its goal, future events affecting its business may cause the Company to modify its disclosure controls and procedures.

PART II OTHER INFORMATION

Item 1. Legal Proceedings

Reference should be made to Note 11 in Notes to Consolidated Financial Statements in this Form 10-Q for information on the Company's legal proceedings.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 10.1 Amendment to Handleman Company 2001 Stock Option and Incentive Plan

Exhibit 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Exhibit 32 Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 Furnished to the Securities and Exchange Commission

(b) Reports on Form 8-K

During the quarter ended January 31, 2004, the Company filed the following Current Report on Form 8-K:

On November 26, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting Registrant's financial results for the second quarter ended November 1, 2003.

