

HANDLEMAN CO /MI/  
Form 10-Q  
March 10, 2006  
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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 January 31, 2006

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-7923

**HANDLEMAN COMPANY**

(Exact name of registrant as specified in its charter)

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

**38-1242806**  
(I.R.S. Employer Identification No.)

**500 Kirts Boulevard, Troy, Michigan**  
(Address of principal executive offices)

**48084-4142**  
(Zip Code)

(Registrant's telephone number, including area code) **248-362-4400**

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 at least the past 90 days.

YES ☒ NO ☐

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange 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. The number of shares of common stock outstanding as of March 3, 2006 was 20,158,357.

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## PART I - FINANCIAL INFORMATION

**Item 1. Financial Statements**

## HANDLEMAN COMPANY

## CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE-MONTH AND NINE-MONTH PERIODS ENDED JANUARY 31, 2006 AND 2005

(UNAUDITED)

(in thousands of dollars except per share data)

|                                                                              | Three Months (13 weeks) Ended |                     | Nine Months (39 weeks) Ended |                     |
|------------------------------------------------------------------------------|-------------------------------|---------------------|------------------------------|---------------------|
|                                                                              | January 31,<br>2006           | January 31,<br>2005 | January 31,<br>2006          | January 31,<br>2005 |
| Revenues                                                                     | \$ 485,021                    | \$ 459,270          | \$ 1,027,669                 | \$ 986,669          |
| Costs and expenses:                                                          |                               |                     |                              |                     |
| Direct product costs                                                         | (403,643)                     | (372,033)           | (851,646)                    | (796,670)           |
| Selling, general and administrative expenses                                 | (59,098)                      | (54,770)            | (153,951)                    | (145,219)           |
| Operating income                                                             | 22,280                        | 32,467              | 22,072                       | 44,780              |
| Investment (expense) income, net                                             | (1,135)                       | 145                 | 3,687                        | 2,192               |
| Income from continuing operations before income taxes                        | 21,145                        | 32,612              | 25,759                       | 46,972              |
| Income tax expense                                                           | (7,169)                       | (11,846)            | (5,295)                      | (16,645)            |
| Income from continuing operations                                            | 13,976                        | 20,766              | 20,464                       | 30,327              |
| Discontinued operations (Note 4):                                            |                               |                     |                              |                     |
| Loss from operations of discontinued subsidiary companies (loss on disposal) |                               |                     | (563)                        | (758)               |
| Income tax benefit                                                           |                               |                     | 201                          | 275                 |
| Loss from discontinued operations                                            |                               |                     | (362)                        | (483)               |
| Net income                                                                   | \$ 13,976                     | \$ 20,766           | \$ 20,102                    | \$ 29,844           |
| Income (loss) per share:                                                     |                               |                     |                              |                     |
| Continuing operations - basic                                                | \$ 0.69                       | \$ 0.94             | \$ 0.98                      | \$ 1.33             |
| Continuing operations - diluted                                              | \$ 0.68                       | \$ 0.94             | \$ 0.97                      | \$ 1.33             |
| Discontinued operations - basic                                              | \$                            | \$                  | \$ (0.02)                    | \$ (0.02)           |
| Discontinued operations - diluted                                            | \$                            | \$                  | \$ (0.02)                    | \$ (0.02)           |

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|                                                                  |                   |                   |                   |                   |
|------------------------------------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Net income - basic                                               | \$ 0.69           | \$ 0.94           | \$ 0.96           | \$ 1.31           |
|                                                                  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Net income - diluted                                             | \$ 0.68           | \$ 0.94           | \$ 0.95           | \$ 1.31           |
|                                                                  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Weighted average number of shares outstanding during the period: |                   |                   |                   |                   |
| Basic                                                            | 20,398            | 22,092            | 20,959            | 22,719            |
|                                                                  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Diluted                                                          | 20,692            | 22,143            | 21,167            | 22,775            |
|                                                                  | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

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

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## HANDLEMAN COMPANY

## CONSOLIDATED BALANCE SHEETS

AS OF JANUARY 31, 2006 AND APRIL 30, 2005

(in thousands of dollars except share data)

|                                                                                                     | January 31,<br>2006<br>(Unaudited) | April 30,<br>2005 |
|-----------------------------------------------------------------------------------------------------|------------------------------------|-------------------|
| <b>ASSETS</b>                                                                                       |                                    |                   |
| Current assets:                                                                                     |                                    |                   |
| Cash and cash equivalents                                                                           | \$ 8,217                           | \$ 30,826         |
| Accounts receivable, less allowances of \$13,467 at January 31, 2006 and \$10,809 at April 30, 2005 | 336,226                            | 232,409           |
| Merchandise inventories                                                                             | 193,191                            | 115,672           |
| Other current assets                                                                                | 15,711                             | 12,954            |
| <b>Total current assets</b>                                                                         | <b>553,345</b>                     | <b>391,861</b>    |
| Property and equipment:                                                                             |                                    |                   |
| Land, buildings and improvements                                                                    | 13,899                             | 13,865            |
| Display fixtures                                                                                    | 28,864                             | 29,619            |
| Computer hardware and software                                                                      | 62,435                             | 57,453            |
| Equipment, furniture and other                                                                      | 35,818                             | 33,924            |
|                                                                                                     | 141,016                            | 134,861           |
| Less accumulated depreciation                                                                       | 83,970                             | 74,681            |
|                                                                                                     | 57,046                             | 60,180            |
| Goodwill, net                                                                                       | 36,371                             | 3,406             |
| Intangible assets, net                                                                              | 43,662                             |                   |
| Other assets, net                                                                                   | 23,539                             | 21,552            |
| <b>Total assets</b>                                                                                 | <b>\$ 713,963</b>                  | <b>\$ 476,999</b> |
| <b>LIABILITIES</b>                                                                                  |                                    |                   |
| Current liabilities:                                                                                |                                    |                   |
| Debt, current portion                                                                               | \$ 5,385                           | \$                |
| Notes payable                                                                                       | 1,250                              |                   |
| Accounts payable                                                                                    | 266,443                            | 133,319           |
| Accrued and other liabilities                                                                       | 34,561                             | 31,019            |
| <b>Total current liabilities</b>                                                                    | <b>307,639</b>                     | <b>164,338</b>    |
| Debt, non-current                                                                                   | 97,000                             |                   |
| Other liabilities                                                                                   | 14,971                             | 13,778            |
| Commitments and contingencies (Note 10)                                                             |                                    |                   |
| <b>Total liabilities</b>                                                                            | <b>419,610</b>                     | <b>178,116</b>    |

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## SHAREHOLDERS' EQUITY

Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued

Common stock, \$.01 par value; 60,000,000 shares authorized; 20,158,000 and 21,446,000 shares issued at

January 31, 2006 and April 30, 2005, respectively

Accumulated other comprehensive income

Unearned compensation

Retained earnings

Total shareholders' equity

Total liabilities and shareholders' equity

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

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

FOR THE NINE-MONTH PERIOD ENDED JANUARY 31, 2006

(UNAUDITED)

(in thousands of dollars)

|                                                                     | Nine Months (39 weeks) |        |                                   |                           |                       |                            |                   |                            |
|---------------------------------------------------------------------|------------------------|--------|-----------------------------------|---------------------------|-----------------------|----------------------------|-------------------|----------------------------|
|                                                                     | Common Stock           |        | Other Comprehensive Income (Loss) |                           |                       |                            |                   |                            |
|                                                                     |                        |        | Foreign                           |                           |                       |                            |                   |                            |
|                                                                     | Shares Issued          | Amount | Currency Translation Adjustment   | Minimum Pension Liability | Unearned Compensation | Additional Paid-In Capital | Retained Earnings | Total Shareholders' Equity |
| April 30, 2005                                                      | 21,446                 | \$ 214 | \$ 15,860                         | \$ (8,610)                | \$ (8,395)            | \$                         | \$ 299,814        | \$ 298,883                 |
| Net income                                                          |                        |        |                                   |                           |                       |                            | 20,102            | 20,102                     |
| Adjustment for foreign currency translation                         |                        |        | (2,088)                           |                           |                       |                            |                   | (2,088)                    |
| Comprehensive income, net of tax                                    |                        |        |                                   |                           |                       |                            |                   | 18,014                     |
| Stock-based compensation:                                           |                        |        |                                   |                           |                       |                            |                   |                            |
| Performance shares/units                                            | 153                    | 2      |                                   |                           | 819                   | 1,247                      |                   | 2,068                      |
| Stock options                                                       | 10                     |        |                                   |                           | 925                   | (920)                      |                   | 5                          |
| Restricted stock and other                                          | 27                     |        |                                   |                           | 400                   | 379                        |                   | 779                        |
| Common stock repurchased                                            | (1,478)                | (14)   |                                   |                           |                       | (20,353)                   |                   | (20,367)                   |
| Reclassification of additional paid-in capital to retained earnings |                        |        |                                   |                           |                       | 19,647                     | (19,647)          |                            |
| Cash dividends, \$.24 per share                                     |                        |        |                                   |                           |                       |                            | (5,029)           | (5,029)                    |
| January 31, 2006                                                    | 20,158                 | \$ 202 | \$ 13,772                         | \$ (8,610)                | \$ (6,251)            | \$                         | \$ 295,240        | \$ 294,353                 |

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

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## HANDLEMAN COMPANY

### CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE NINE-MONTH PERIODS ENDED JANUARY 31, 2006 AND 2005

(UNAUDITED)

(in thousands of dollars)

|                                                                               | Nine Months (39 weeks) Ended |                     |
|-------------------------------------------------------------------------------|------------------------------|---------------------|
|                                                                               | January 31,<br>2006          | January 31,<br>2005 |
| Cash flows from operating activities:                                         |                              |                     |
| Net income                                                                    | \$ 20,102                    | \$ 29,844           |
| Adjustments to reconcile net income to net cash used by operating activities: |                              |                     |
| Depreciation and amortization                                                 | 14,035                       | 13,101              |
| Gain on sale of investment                                                    | (4,390)                      |                     |
| Unrealized investment loss (income)                                           | 479                          | (841)               |
| Recoupment of software development costs/license advances                     | 1,629                        |                     |
| Loss on disposal of property and equipment                                    | 116                          | 970                 |
| Stock-based compensation                                                      | 3,386                        | 3,830               |
| Changes in operating assets and liabilities:                                  |                              |                     |
| Increase in accounts receivable                                               | (50,715)                     | (57,423)            |
| Increase in merchandise inventories                                           | (41,356)                     | (40,007)            |
| Increase in other operating assets                                            | (238)                        | (328)               |
| Increase in accounts payable                                                  | 11,110                       | 31,103              |
| Decrease in other operating liabilities                                       | (2,712)                      | (646)               |
| Total adjustments                                                             | (68,656)                     | (50,241)            |
| Net cash used by operating activities                                         | (48,554)                     | (20,397)            |
| Cash flows from investing activities:                                         |                              |                     |
| Additions to property and equipment                                           | (9,000)                      | (12,355)            |
| Proceeds from disposition of property and equipment                           | 537                          | 343                 |
| Additions to software development costs/license advances                      | (2,634)                      |                     |
| Proceeds from sale of investment                                              | 4,390                        |                     |
| Cash investment in Crave Entertainment Group                                  | (122,759)                    |                     |
| Cash investment in REPS LLC                                                   | (19,107)                     |                     |
| Other equity investments                                                      | (4,616)                      |                     |
| Net cash used by investing activities                                         | (153,189)                    | (12,012)            |
| Cash flows from financing activities:                                         |                              |                     |
| Issuances of debt                                                             | 2,165,940                    | 1,106,798           |
| Repayments of debt                                                            | (2,063,664)                  | (1,106,798)         |
| Checks issued in excess of cash balances                                      | 100,522                      | 25,826              |
| Cash dividends                                                                | (5,029)                      | (5,017)             |

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|                                                       |          |           |
|-------------------------------------------------------|----------|-----------|
| Repurchases of common stock                           | (20,367) | (39,440)  |
| Cash proceeds from stock-based compensation plans     | 151      | 756       |
|                                                       | <hr/>    | <hr/>     |
| Net cash provided from (used by) financing activities | 177,553  | (17,875)  |
|                                                       | <hr/>    | <hr/>     |
| Effect of exchange rate changes on cash               | 1,581    | 2,308     |
| Net decrease in cash and cash equivalents             | (22,609) | (47,976)  |
| Cash and cash equivalents at beginning of period      | 30,826   | 73,713    |
|                                                       | <hr/>    | <hr/>     |
| Cash and cash equivalents at end of period            | \$ 8,217 | \$ 25,737 |
|                                                       | <hr/>    | <hr/>     |

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

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### 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, including normal recurring adjustments, necessary to present fairly the financial position of the Company as of January 31, 2006, and the results of operations and changes in cash flows for the three and 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, 2006 are not necessarily indicative of what the results will be for the full year. The Consolidated Balance Sheet as of April 30, 2005 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's fiscal year 2005 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 April 30, 2005, including the discussion of the Company's critical accounting policies.

#### 2. New Accounting Pronouncements

In December 2004, Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (revised 2004), was issued by the Financial Accounting Standards Board. SFAS No. 123R requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. The Company adopted SFAS No. 123, Accounting for Stock-Based Compensation, effective May 4, 2003. All stock-based awards issued after May 3, 2003 are expensed over the vesting period using the fair value method. The Company is currently reviewing the requirements of SFAS No. 123R to determine the impact on its financial statements. The Company will adopt the provisions of SFAS No. 123R at the beginning of its fiscal year 2007, as required.

#### 3. Acquisitions

##### *Crave Entertainment Group, Inc.*

On November 22, 2005, Handleman Company acquired the stock of privately-owned Crave Entertainment Group, Inc. (Crave). Crave is a distributor of video game software, including Crave-branded exclusively distributed video game software, as well as video game hardware and accessories to major retailers throughout the United States (U.S.). This acquisition expands the Company's customer base, broadens its product lines and provides growth opportunities for both organizations through cross-selling customers, services and products. This acquisition has been recorded in accordance with the provisions of SFAS No. 141, Business Combinations, and the operating results of Crave have been included in the Company's consolidated financial statements since the date of acquisition.

The purchase price for the acquisition of Crave totaled \$72,000,000 consisting of: (i) a \$58,900,000 promissory note (which was due and paid on November 28, 2005) that is subject to certain adjustments based upon Crave's working capital and net assets, and subject to increase to reimburse Crave's shareholders for increased taxes they will incur as a result of electing to treat the transaction as an asset purchase for tax purposes (the amount of adjustment, if any, has not yet been determined); (ii) \$5,000,000 paid into an escrow account to be distributed to the Crave shareholders 24 months after the closing date, subject to indemnification claims; (iii) approximately \$5,200,000 representing an advance to Crave to repay term, subordinated and

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

affiliate indebtedness; and (iv) an advance of \$2,900,000 delivered to Crave at closing to pay fees and expenses, and amounts payable to employee option holders. Handleman Company advanced Crave \$49,055,000 on November 22, 2005 to repay Crave's revolving line of credit. In addition, the Company incurred \$1,901,000 of costs, primarily commission and legal fees, related to the Crave acquisition. Handleman Company financed this acquisition through borrowings against its revolving line of credit.

The following table summarizes the estimated fair values of the Crave assets acquired and liabilities assumed at the date of acquisition (in thousands of dollars):

|                                             |            |
|---------------------------------------------|------------|
| Current assets                              | \$ 91,488  |
| Property and equipment, net                 | 1,009      |
| Intangible assets                           |            |
| Goodwill                                    | 26,062     |
| Trademark                                   | 5,700      |
| Customer relationships                      | 21,800     |
| Non-compete agreements                      | 2,160      |
| Software development costs/license advances | 3,940      |
| Other assets                                | 150        |
|                                             | <hr/>      |
| Total assets acquired                       | 152,309    |
| Total liabilities assumed                   | (29,353)   |
|                                             | <hr/>      |
| Total net assets acquired                   | \$ 122,956 |

The Company is in the process of obtaining a third-party valuation of the assets acquired from Crave, thus the allocation of the purchase price is subject to future adjustment. The valuation is expected to be completed in the fourth quarter of fiscal 2006 and any adjustments to the valuation of assets will be recorded in that period.

The trademark and customer relationships will be amortized, for book and tax purposes, over a period of 15 years, while the non-compete agreements will be amortized, for book and tax purposes over a three-year period. The entire amount of goodwill related to this acquisition is deductible for tax purposes over a 15-year period.

The Company has the following contingent liabilities related to the acquisition of Crave: (i) up to \$21,000,000 in earn out payments that are payable based upon Crave's adjusted EBITDA for the calendar years 2005, 2006 and 2007, as those figures are calculated for each of such years; and (ii) up to \$2,000,000 to be paid on or about January 2, 2008, if three certain Crave employees remain with that entity through December 31, 2007. The Company is accruing this \$2,000,000 liability over 25 months with the related expense included in Selling, general and administrative expenses in the Company's Consolidated Statements of Income.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table provides pro forma financial information for the results of operations assuming the Crave acquisition had been completed as of the beginning of the periods being presented in this Form 10-Q (amounts in thousands of dollars except per share data):

|                    | Three Months Ended  |                     | Three Months Ended  |                     |
|--------------------|---------------------|---------------------|---------------------|---------------------|
|                    | January 31,<br>2006 | January 31,<br>2006 | January 31,<br>2005 | January 31,<br>2005 |
|                    | As<br>Reported      | Pro Forma           | As Reported         | Pro Forma           |
|                    |                     |                     |                     |                     |
| Revenues           | \$ 485,021          | \$ 511,957          | \$ 459,270          | \$ 558,860          |
| Operating income   | \$ 22,280           | \$ 23,355           | \$ 32,467           | \$ 41,475           |
| Net income         | \$ 13,976           | \$ 14,295           | \$ 20,766           | \$ 25,304           |
| Earnings per share |                     |                     |                     |                     |
| - Basic            | \$ 0.69             | \$ 0.70             | \$ 0.94             | \$ 1.15             |
| - Diluted          | \$ 0.68             | \$ 0.69             | \$ 0.94             | \$ 1.14             |

  

|                    | Nine Months Ended   |                     | Nine Months Ended      |                     |
|--------------------|---------------------|---------------------|------------------------|---------------------|
|                    | January 31,<br>2006 | January 31,<br>2006 | January<br>31,<br>2005 | January 31,<br>2005 |
|                    | As<br>Reported      | Pro Forma           | As<br>Reported         | Pro Forma           |
|                    |                     |                     |                        |                     |
| Revenues           | \$ 1,027,669        | \$ 1,171,816        | \$ 986,669             | \$ 1,142,711        |
| Operating income   | \$ 22,072           | \$ 26,834           | \$ 44,780              | \$ 53,874           |
| Net income         | \$ 20,102           | \$ 20,807           | \$ 29,844              | \$ 33,723           |
| Earnings per share |                     |                     |                        |                     |
| - Basic            | \$ 0.96             | \$ 0.99             | \$ 1.31                | \$ 1.48             |
| - Diluted          | \$ 0.95             | \$ 0.98             | \$ 1.31                | \$ 1.48             |

**REPS LLC**

On June 24, 2005, Handleman Company acquired all of the operating assets and certain liabilities of REPS LLC ( REPS ). REPS provides in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers in the United States. The in-store merchandising structure of REPS is similar to the Company's in-store merchandising structure, thus providing the opportunity to consolidate certain functions and generate cost savings and synergies. This acquisition has been recorded in accordance with the provisions of SFAS No. 141 and the operating results of REPS have been included in the Company's consolidated financial statements since the date of acquisition.

The purchase price for the assets of REPS totaled \$20,459,000, of which \$18,750,000 was paid at closing. A promissory note in the amount of \$1,000,000 is payable on June 24, 2006 subject to any indemnification claims. A second promissory note in the amount of \$250,000 and the remaining \$459,000 of the purchase price was payable within 151 business days from the date of acquisition subject to finalization of working capital amounts. In February 2006, the Company made a payment in the amount of \$448,000 (including \$10,000 of interest) representing the payment of the second promissory note along with a payment representing a portion of the remaining unpaid purchase price based upon working capital adjustments. In addition, the Company incurred \$357,000 of legal and accounting fees related to the REPS acquisition. The Company has obtained a third-party valuation of certain intangible assets acquired from REPS.



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table summarizes the fair values of the REPS assets acquired and liabilities assumed at the date of acquisition (in thousands of dollars):

|                                   |                  |
|-----------------------------------|------------------|
| Current assets                    | \$ 4,212         |
| Property and equipment, net       | 227              |
| Intangible assets                 |                  |
| Goodwill                          | 6,903            |
| Trademark                         | 2,200            |
| Customer relationships            | 6,300            |
| Non-compete agreements            | 1,800            |
| Other assets                      | 10               |
| <b>Total assets acquired</b>      | <b>21,652</b>    |
| Total current liabilities assumed | (836)            |
| <b>Total net assets acquired</b>  | <b>\$ 20,816</b> |

The trademark and customer relationships will be amortized, for book and tax purposes, over a period of 15 years, while the non-compete agreements will be amortized, for book and tax purposes, over a four-year period. The entire amount of goodwill related to this acquisition is deductible for tax purposes over a 15-year period.

#### 4. Discontinued Operations

In the second quarter of fiscal 2004, the Company sold its Anchor Bay Entertainment subsidiary companies. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the financial results of these subsidiary companies were 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 were eliminated from the ongoing operations of the Company. The Company does not have any continuing involvement in the operations of these companies after the disposal transaction.

The Company has contingent liabilities related to Anchor Bay Entertainment. In the fourth quarter of fiscal 2004, the purchaser requested certain adjustments to the sale proceeds which remain unresolved. The Company does not believe there is a reasonable basis for these adjustments and therefore the potential exposure is in the range of zero to \$6,400,000. However, since no assurance can be given to the resolution of these unresolved requested adjustments, as they are neither probable nor estimable, no accrual has been recorded for these items.

Also, in the fourth quarter of fiscal 2004, a licensor of Anchor Bay Entertainment exercised its right to audit its royalty statements. As a result of this audit, the licensor asserted a claim against Anchor Bay Entertainment for royalties it believed were due them, in the amount of \$5,600,000, including interest. Pursuant to the Anchor Bay Entertainment sale agreement, the Company was potentially liable for certain royalty audit claims. During the second quarter of fiscal 2005, the Company recorded a pre-tax charge of \$758,000 (\$483,000 after tax), which represented settlement of certain components of the claim. During the third quarter of fiscal 2005, this licensor initiated legal proceedings related to this matter. The Company settled these legal proceedings during the second quarter of fiscal 2006 and recorded an additional pre-tax charge of \$563,000 (\$362,000 after tax), representing final settlement costs and legal fees. These charges were included in Income from discontinued operations in the Company's Consolidated Statements of Income.

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## 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,<br>2006 | April 30,<br>2005 |
|-------------------------------------------------|---------------------|-------------------|
| Trade accounts receivable                       | \$ 349,693          | \$ 243,218        |
| Less allowances for:                            |                     |                   |
| Gross profit impact of estimated future returns | (9,516)             | (8,356)           |
| Doubtful accounts                               | (3,951)             | (2,453)           |
| Accounts receivable, net                        | \$ 336,226          | \$ 232,409        |

6. Goodwill and Intangible Assets*Acquisitions*

As discussed in Note 3 of Notes to Consolidated Financial Statements, during fiscal 2006, the Company acquired REPS LLC and Crave Entertainment Group, Inc. None of the intangible assets recorded as a result of these acquisitions have significant residual values. The Company has obtained a third-party valuation of the intangible assets related to REPS LLC. The Company is in the process of finalizing the third-party valuation for the assets of Crave, thus the allocation of purchase price for Crave is subject to future adjustment. The Crave valuation is expected to be completed in the fourth quarter of fiscal 2006.

*Goodwill*

The Company accounts for goodwill and intangible assets in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. Accordingly, the Company performs an annual impairment test for goodwill and other intangible assets with indefinite lives in the fourth quarter of each fiscal year. The goodwill test for impairment is conducted on a reporting unit level, whereby the carrying value of each reporting unit, including goodwill, is compared to its fair value. Fair value is estimated using the present value of free cash flows method.

Goodwill represents the excess of consideration paid over the estimated fair values of net assets of businesses acquired. Goodwill included in the Consolidated Balance Sheets as of January 31, 2006 and April 30, 2005 was \$36,371,000 and \$3,406,000, respectively, which were net of amortization of \$1,224,000 at each of these balance sheet dates.

The following table summarizes the changes in carrying amount of goodwill for the nine months ended January 31, 2006 (in thousands of dollars):

|                                                 |          |
|-------------------------------------------------|----------|
| Balance as of April 30, 2005                    | \$ 3,406 |
| Goodwill acquired during the period related to: |          |
| REPS LLC                                        | 6,903    |
| Crave Entertainment Group, Inc.                 | 26,062   |

Balance as of January 31, 2006

\$ 36,371

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

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

*Intangible Assets*

The intangible assets acquired during fiscal 2006 are related to the acquisitions of REPS LLC and Crave Entertainment Group, Inc. and represent all of the intangible assets of the Company. On an annual basis, the Company will perform impairment analyses comparing the carrying value of its intangible assets with the future economic benefit of these assets. Based on such analyses, the Company will adjust, as necessary, the value of its intangible assets.

The Company, principally in its video game operations business segment, incurs software development costs, which include payments made to independent software developers under development agreements, and license advances paid to intellectual property right holders for use of their trademarks or copyrights. Software development costs are recorded in accordance with SFAS No. 86, Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed. These costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. These costs are amortized based upon the ratio of current revenues to total projected revenues, generally over a period of approximately 18 months. Technological feasibility is evaluated on a product-by-product basis. For products where proven game engine technology exists, this may occur early in the development cycle. Payments prior to technological feasibility, or amounts otherwise related to software development which are not capitalized, are charged immediately to research and development expense. The Company performs periodic analyses comparing the carrying value of its software development costs with the expected future economic benefit of these assets. Based on such analyses, the Company adjusts, when necessary, the value of its software development costs.

On a monthly basis, management evaluates software development agreements to determine if balances were in a prepaid or payable status when, due to sales volume, the Company had fully expensed advances made to developers and additional royalties were owed. Royalties payable to developers and licensors are classified as accrued royalties and included in Accrued and other liabilities in the Company's Consolidated Balance Sheets. Accrued royalties as of January 31, 2006 totaled \$2,269,000.

The following information relates to intangible assets subject to amortization as of January 31, 2006 (in thousands of dollars):

| Amortized                                   | Gross Carrying Amount | Accumulated Amortization | Net Amount | Weighted Average Amortization Period |
|---------------------------------------------|-----------------------|--------------------------|------------|--------------------------------------|
| Intangible Assets                           |                       |                          |            |                                      |
| Trademark                                   | \$ 7,900              | \$ 207                   | \$ 7,693   | 180 mos.                             |
| Customer relationships                      | 28,100                | 653                      | 27,447     | 180 mos.                             |
| Non-compete agreements                      | 3,960                 | 383                      | 3,577      | 41 mos.                              |
| Software development costs/license advances | 6,574                 | 1,629                    | 4,945      | 18 mos.                              |
| Total                                       | \$ 46,534             | \$ 2,872                 | \$ 43,662  | 132 mos.                             |

The Company had no intangible assets subject to amortization as of, and during, the fiscal year ended of April 30, 2005.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company's aggregate amortization expense for the three and nine-month periods ended January 31, 2006 was \$2,533,000 and \$2,872,000 respectively. The Company estimates future aggregate amortization expense as follows (in thousands of dollars):

| <u>Fiscal Years</u> | <u>Amounts</u> |
|---------------------|----------------|
| 2006                | \$ 4,588       |
| 2007                | 7,860          |
| 2008                | 5,498          |
| 2009                | 3,772          |
| 2010                | 2,709          |

7. Debt

On November 22, 2005, the Company entered into an amended and restated credit agreement with a consortium of banks for an unsecured revolving line of credit. The amended agreement extended the facility expiration date from August 2007 to November 2010 and increased the line of credit from \$150,000,000 to \$250,000,000. This facility will be incrementally reduced to \$200,000,000 through 2009 (a \$10,000,000 reduction in November 2007, a \$20,000,000 reduction in November 2008, and a \$20,000,000 reduction in November 2009).

The revolving credit agreement contains certain restrictions and covenants, relating to, among others, minimum debt service ratio, minimum leverage ratio and minimum consolidated net worth. The Company was in compliance with all of these covenants as of January 31, 2006. The Company had borrowings of \$102,385,000 against its line of credit at January 31, 2006 of which \$5,385,000 was classified as current and \$97,000,000 was classified as non-current. This debt was primarily incurred to finance the Crave acquisition. The Company had no borrowings as of April 30, 2005.

On February 7, 2006, the Company entered into an interest rate swap agreement related to \$75,000,000 of debt considered to be long-term on that date. The amount of the swap agreement will incrementally reduce to \$50,000,000 in April 2007, to \$25,000,000 in April 2008, and will expire in April 2009. The interest rate is fixed at 4.9675%, plus a charge that varies based on the ratio of debt to Earnings Before Interest, Taxes, Depreciation and Amortization ( EBITDA ), as defined in the revolving credit agreement.

8. Pension Plan

The Company has two defined benefit pension plans ( pension plans ) that cover substantially all full-time U.S. and Canadian employees. In addition, the Company has two nonqualified post retirement plans, [i.e. Supplemental Executive Retirement Plans ( SERP )] that cover select U.S. and Canadian employees. The information that follows, for all periods presented, combines U.S. and Canadian pension plans and U.S. and Canadian SERP.

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Components of net periodic benefit cost are as follows (in thousands of dollars):

|                                                                           | Pension Plans       |                     | SERP                |                     |
|---------------------------------------------------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                                                           | Three Months        |                     | Three Months        |                     |
|                                                                           | Ended               |                     | Ended               |                     |
|                                                                           | January 31,<br>2006 | January 31,<br>2005 | January 31,<br>2006 | January 31,<br>2005 |
| Service cost                                                              | \$ 496              | \$ 457              | \$ 116              | \$ 142              |
| Interest cost                                                             | 869                 | 766                 | 130                 | 145                 |
| Expected return on plan assets                                            | (1,055)             | (761)               |                     |                     |
| Amortization of unrecognized prior service cost, actuarial gain and other | 572                 | 413                 | 100                 | 128                 |
| Net periodic benefit cost                                                 | \$ 882              | \$ 875              | \$ 346              | \$ 415              |

  

|                                                                           | Pension Plans       |                     | SERP                |                     |
|---------------------------------------------------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                                                           | Nine Months Ended   |                     | Nine Months Ended   |                     |
|                                                                           | January 31,<br>2006 | January 31,<br>2005 | January 31,<br>2006 | January 31,<br>2005 |
| Service cost                                                              | \$ 1,537            | \$ 1,361            | \$ 347              | \$ 428              |
| Interest cost                                                             | 2,360               | 2,292               | 391                 | 435                 |
| Expected return on plan assets                                            | (2,829)             | (2,276)             |                     |                     |
| Amortization of unrecognized prior service cost, actuarial gain and other | 1,705               | 1,237               | (234)               | 383                 |
| Net periodic benefit cost                                                 | \$ 2,773            | \$ 2,614            | \$ 504              | \$ 1,246            |

For the nine months ended January 31, 2006, contributions to the Company's defined benefit pension plans were \$3,781,000. The Company anticipates contributing an additional \$1,597,000 to the pension plans in the remainder of fiscal 2006, for a total contribution of \$5,378,000. The Company contributed \$1,267,000 to the SERP plans in the first nine months of fiscal 2006 and anticipates contributing an additional \$300,000 in the remainder of fiscal 2006 for a total contribution of \$1,567,000.

#### 9. Stock Plans

The Company has stock-based compensation plans in the form of stock options, performance shares/units and restricted stock. Stock options issued prior to fiscal 2004 are accounted for under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion

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No. 25, Accounting for Stock Issued to Employees and Financial Accounting Standards Board ( FASB ) Interpretation ( FIN ) No. 44, Accounting for Certain Transactions Involving Stock Compensation (an Interpretation of APB Opinion No. 25). Compensation expense for the Company's stock-based plans accounted for under APB Opinion No. 25 has been reflected in the Company's Consolidated Statements of Income for all periods presented, as all awards granted under these plans have been accounted for under the variable accounting method. Under variable accounting, the excess of market value over the option price of outstanding stock options is determined at each reporting period and aggregate compensation expense is adjusted and recognized over the vesting period. Compensation expense associated with vested options issued prior to fiscal year 2004 continues to be adjusted to the market value of the options until the options are either exercised or terminated. Effective May 4, 2003, the Company adopted the

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

fair value recognition provisions of SFAS No. 123. 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. Under the prospective method, all stock-based awards issued after May 3, 2003 are accounted for utilizing the fair value provisions of SFAS No. 123 and are expensed over the vesting period.

The amounts related to stock-based compensation included in the determination of net income for the three and nine months ended January 31, 2006 and January 31, 2005 was expense of \$1,570,000 and \$1,406,000, respectively, and expense of \$3,386,000 and \$3,830,000, respectively. The following table illustrates the effect on net income and earnings per share if the fair value recognition provisions of SFAS No. 123 had been applied to all stock-based awards for each period presented (in thousands of dollars except per share data):

|                                                                                                                                             | Three Months Ended |                  | Nine Months Ended |                  |
|---------------------------------------------------------------------------------------------------------------------------------------------|--------------------|------------------|-------------------|------------------|
|                                                                                                                                             | January 31, 2006   | January 31, 2005 | January 31, 2006  | January 31, 2005 |
| Net income                                                                                                                                  | \$ 13,976          | \$ 20,766        | \$ 20,102         | \$ 29,844        |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects                                  | 1,038              | 896              | 2,093             | 2,634            |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (1,106)            | (1,677)          | (3,198)           | (3,961)          |
| Pro forma net income                                                                                                                        | \$ 13,908          | \$ 19,985        | \$ 18,997         | \$ 28,517        |
| Net income per share:                                                                                                                       |                    |                  |                   |                  |
| Reported basic                                                                                                                              | \$ 0.69            | \$ 0.94          | \$ 0.96           | \$ 1.31          |
| diluted                                                                                                                                     | 0.68               | 0.94             | 0.95              | 1.31             |
| Pro forma basic                                                                                                                             | 0.68               | 0.90             | 0.91              | 1.26             |
| diluted                                                                                                                                     | 0.67               | 0.90             | 0.90              | 1.25             |

**10. Contingencies**

See Notes 3 and 4 of Notes to Consolidated Financial Statements for contingencies related to Crave Entertainment Group and Anchor Bay Entertainment.

There are no additional pending legal proceedings to which the Registrant or any of its subsidiaries is a party, other than routine legal matters that are incidental to the business and the ultimate outcome of which is not expected to be material to future results of consolidated operations, financial position and cash flows. The Company has provided for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

**11. Segment Information**

The Company has determined, using the management approach, that it operates in two business segments: category management and distribution operations which primarily provides music products to select mass merchants; and video game operations which represents Crave Entertainment Group's distribution of video game hardware, software and accessories to major retailers. Prior to the acquisition of Crave, the Company operated in only one operating segment, category management and distribution operations.

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 April 30, 2005. Segment data includes a charge allocating corporate costs to the operating segments, where applicable. The Company evaluates performance of its segments and allocates resources to them based on income before interest and income taxes (segment income).

The tables below present information about reported segments for the three months ended January 31, 2006 and January 31, 2005 (in thousands of dollars):

|                                             | Category<br>Management<br>and<br>Distribution<br>Operations | Video<br>Game<br>Operations | Total      |
|---------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| <b>Three Months Ended January 31, 2006:</b> |                                                             |                             |            |
| Revenues, external customers                | \$ 431,210                                                  | \$ 53,811                   | \$ 485,021 |
| Segment income                              | 21,096                                                      | 1,011                       | 22,107     |
| Capital expenditures                        | 1,219                                                       | 189                         | 1,408      |

|                                             | Category<br>Management<br>and<br>Distribution<br>Operations | Video<br>Game<br>Operations | Total      |
|---------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| <b>Three Months Ended January 31, 2005:</b> |                                                             |                             |            |
| Revenues, external customers                | \$ 459,270                                                  |                             | \$ 459,270 |
| Segment income                              | 32,211                                                      |                             | 32,211     |
| Capital expenditures                        | 1,622                                                       |                             | 1,622      |

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of total segment revenues to consolidated revenues from continuing operations and total segment income to consolidated income from continuing operations before income taxes for the three months ended January 31, 2006 and January 31, 2005 is as follows (in thousands of dollars):

|                                                                    | January 31, 2006 | January 31, 2005 |
|--------------------------------------------------------------------|------------------|------------------|
| <b>Revenues</b>                                                    |                  |                  |
| Total segment revenues                                             | \$ 485,021       | \$ 459,270       |
| Corporate revenues                                                 |                  |                  |
| Consolidated revenues from continuing operations                   | \$ 485,021       | \$ 459,270       |
| <b>Income From Continuing Operations Before Income Taxes</b>       |                  |                  |
| Total segment income for reportable segments                       | \$ 22,107        | \$ 32,211        |
| Investment income                                                  | 1,320            | 525              |
| Investment expense                                                 | (2,455)          | (380)            |
| Unallocated corporate income                                       | 173              | 256              |
| Consolidated income from continuing operations before income taxes | \$ 21,145        | \$ 32,612        |

The tables below present information about reported segments for the nine months ended January 31, 2006 and January 31, 2005 (in thousands of dollars):

|                                            | Category<br>Management<br>and<br>Distribution<br>Operations | Video<br>Game<br>Operations | Total        |
|--------------------------------------------|-------------------------------------------------------------|-----------------------------|--------------|
| <b>Nine Months Ended January 31, 2006:</b> |                                                             |                             |              |
| Revenues, external customers               | \$ 973,858                                                  | \$ 53,811                   | \$ 1,027,669 |
| Segment income                             | 20,285                                                      | 1,011                       | 21,296       |
| Total assets                               | 624,640                                                     | 128,699                     | 753,339      |
| Capital expenditures                       | 8,811                                                       | 189                         | 9,000        |
| <b>Nine Months Ended January 31, 2005:</b> |                                                             |                             |              |
| Revenues, external customers               | \$ 986,669                                                  |                             | \$ 986,669   |
| Segment income                             | 43,979                                                      |                             | 43,979       |
| Total assets                               | 558,469                                                     |                             | 558,469      |
| Capital expenditures                       | 12,355                                                      |                             | 12,355       |



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of total segment revenues to consolidated revenues from continuing operations, total segment income to consolidated income from continuing operations before income taxes, and total segment assets to consolidated assets as of and for the nine months ended January 31, 2006 and January 31, 2005 is as follows (in thousands of dollars):

|                                                                     | <u>January 31, 2006</u> | <u>January 31, 2005</u> |
|---------------------------------------------------------------------|-------------------------|-------------------------|
| <b><u>Revenues</u></b>                                              |                         |                         |
| Total segment revenues                                              | \$ 1,027,669            | \$ 986,669              |
| Corporate revenues                                                  |                         |                         |
| Consolidated revenues from continuing operations                    | <u>\$ 1,027,669</u>     | <u>\$ 986,669</u>       |
| <b><u>Income From Continuing Operations Before Income Taxes</u></b> |                         |                         |
| Total segment income for reportable segments                        | \$ 21,296               | \$ 43,979               |
| Investment income                                                   | 6,390                   | 2,715                   |
| Investment expense                                                  | (2,703)                 | (523)                   |
| Unallocated corporate income                                        | 776                     | 801                     |
| Consolidated income from continuing operations before income taxes  | <u>\$ 25,759</u>        | <u>\$ 46,972</u>        |
| <b><u>Assets</u></b>                                                |                         |                         |
| Total segment assets                                                | \$ 753,339              | \$ 558,469              |
| Elimination of intercompany receivables and payables                | (39,376)                | (7,520)                 |
| Consolidated assets                                                 | <u>\$ 713,963</u>       | <u>\$ 550,949</u>       |

12. **Income Taxes**

The effective income tax rates for the third quarters of fiscal 2006 and 2005 were 33.9% and 36.3%, respectively. The effective income tax rate for the first nine months of fiscal 2006 was 20.6%, compared to 35.4% for the same period last year. The significantly lower income tax rate in the first nine months of this year was due to the partial release of a valuation allowance related to a capital loss and the tax benefit from the cancellation of a worthless debt from an insolvent subsidiary, both occurring in the second quarter of this fiscal year, in the amounts of \$2,118,000 and \$1,028,000, respectively.

13. **Comprehensive Income**

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

| <u>Three Months Ended</u> |                         | <u>Nine Months Ended</u> |                         |
|---------------------------|-------------------------|--------------------------|-------------------------|
| <u>January 31, 2006</u>   | <u>January 31, 2005</u> | <u>January 31, 2006</u>  | <u>January 31, 2005</u> |

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|                                                    |                   |                   |                   |                   |
|----------------------------------------------------|-------------------|-------------------|-------------------|-------------------|
| Net income                                         | \$ 13,976         | \$ 20,766         | \$ 20,102         | \$ 29,844         |
| Change in foreign currency translation adjustments | 1,248             | 1,033             | (2,088)           | 7,271             |
|                                                    | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |
| Total comprehensive income                         | \$ 15,224         | \$ 21,799         | \$ 18,014         | \$ 37,115         |
|                                                    | <u>          </u> | <u>          </u> | <u>          </u> | <u>          </u> |

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The table below summarizes the components of accumulated other comprehensive income included in the Company's Consolidated Balance Sheets (in thousands of dollars):

|                                              | January 31, 2006 | April 30, 2005 |
|----------------------------------------------|------------------|----------------|
| Foreign currency translation adjustments     | \$ 13,772        | \$ 15,860      |
| Minimum pension liability, net of tax        | (8,610)          | (8,610)        |
| Total accumulated other comprehensive income | \$ 5,162         | \$ 7,250       |

#### 14. 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, 2006   | January 31, 2005 | January 31, 2006  | January 31, 2005 |
| Weighted average shares during the period basic                                | 20,398             | 22,092           | 20,959            | 22,719           |
| Additional shares from assumed exercise of stock options                       | 294                | 51               | 208               | 56               |
| Weighted average shares adjusted for assumed exercise of stock options diluted | 20,692             | 22,143           | 21,167            | 22,775           |

## **Table of Contents**

### Handleman Company

#### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Handleman Company operates in two business segments: category management and distribution operations and video game operations. As a category manager, the Company manages a broad assortment of prerecorded music titles to optimize sales and inventory productivity in leading retail stores in the United States ( U.S. ), United Kingdom ( UK ) and Canada. Services offered as a category manager include direct-to-store shipments, marketing and in-store merchandising. The video game operations are related to Crave Entertainment Group, Inc. ( Crave ), which distributes video game hardware, software and accessories to major retailers throughout the U.S.

On November 22, 2005, the Company acquired the stock of privately-owned Crave Entertainment Group, Inc. The acquisition of Crave expands the Company's customer base, broadens its product lines and allows growth opportunities for both organizations through cross-selling customers, services and products. The operating results of Crave have been included in the Company's Consolidated Financial Statements since the date of acquisition. See Note 3 of Notes to Consolidated Financial Statements for additional information related to this acquisition.

During the first quarter of fiscal 2006, the Company acquired all of the operating assets and certain liabilities of REPS LLC ( REPS ). REPS provides nationwide in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers. The in-store merchandising structure of REPS is similar to the Company's in-store merchandising structure, thus providing the opportunity to consolidate certain functions and generate cost savings and synergies. See Note 3 of Notes to Consolidated Financial Statements for additional information related to this acquisition.

#### **Overview**

Net income for the third quarter of fiscal 2006 was \$14.0 million or \$0.68 per diluted share, compared to \$20.8 million or \$0.94 per diluted share for the third quarter of fiscal 2005. Net income for the third quarter of fiscal 2006 and fiscal 2005 was entirely from continuing operations.

Net income for the first nine months of fiscal 2006 was \$20.1 million or \$0.95 per diluted share, compared to \$29.8 million or \$1.31 per diluted share for the first nine months of fiscal 2005. Net income for the first nine months of fiscal 2006 included income from continuing operations of \$20.5 million or \$0.97 per diluted share and a loss from discontinued operations of \$0.4 million or \$0.02 per diluted share; whereas net income for the first nine months of fiscal 2005 included income from continuing operations of \$30.3 million or \$1.33 per diluted share and a loss from discontinued operations of \$0.5 million or \$0.02 per diluted share.

#### **Results of Operations**

Unless otherwise noted, the following discussion relates only to results from continuing operations. See Note 4 of Notes to Consolidated Financial Statements for a discussion of discontinued operations.

Revenues for the third quarter of fiscal 2006 increased to \$485.0 million from \$459.3 million for the third quarter of fiscal 2005. This improvement in revenues was primarily due to the addition of \$53.8 million and \$6.9 million of revenues attributable to Crave and REPS, respectively, which were acquired during the current fiscal year. Increased revenues also resulted from higher revenues in the UK operations of \$14.1 million, primarily driven by higher consumer purchases of music in mass merchant retailers. These increases were offset, in part, by a \$47.9 million decline in revenues in the U.S., which was principally attributable to a reassignment of 425 stores of certain customers to other suppliers during the first and second quarters of this fiscal year.

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Revenues for the first nine months of fiscal 2006 were \$1,027.7 million, compared to \$986.7 million for the first nine months of fiscal 2005. This improvement in year-over-year revenues was due to the addition of \$53.8 million and \$13.7 million of revenues attributable to Crave and REPS, respectively, as well as increased revenues in the UK and Canadian operations of \$26.2 million and \$7.8 million, respectively. The increase in UK revenue was the result of higher consumer purchases of music in mass merchant retailers, while 81% of the increase in Canadian revenues was attributable to a strengthening of the local currency. These increases were offset, in part, by a \$60.3 million decline in revenues in the U.S., which was primarily related to the reassignment of customer stores earlier in the fiscal year.

Direct product costs as a percentage of revenues was 83.2% for the third quarter ended January 31, 2006, compared to 81.0% for the third quarter ended January 31, 2005. The increase in direct product costs as a percentage of revenues for the third quarter of fiscal 2006 was primarily attributable to the following: (i) increased customer rebates in the U.S. and UK contributed 0.7% and 0.2%, respectively, to the overall increase in direct product costs as a percentage of revenues; (ii) increased revenues attributable to less than full category management services, which carry a higher direct product cost as a percentage of revenues than full category management services, contributed 0.6% to the overall increase in direct product costs as a percentage of revenues; and (iii) increased costs related to customer merchandising programs in the third quarter of this year compared to the same period last year contributed 0.4% to the overall increase in direct product costs as a percentage of revenues. Direct product costs for the third quarters of fiscal 2006 and 2005 included costs associated with acquiring and preparing inventory for distribution of \$5.4 million and \$4.3 million, respectively.

Direct product costs as a percentage of revenues was 82.9% for the first nine months of fiscal 2006, compared to 80.7% for the first nine months of fiscal 2005. The increase in direct product costs as a percentage of revenues for the first nine months of this year versus last year included a year-over-year increase of \$2.7 million in costs associated with acquiring and preparing inventory for distribution. Direct product costs for the first nine months of fiscal years 2006 and 2005 included costs associated with acquiring and preparing inventory for distribution of \$13.6 million and \$10.9 million, respectively.

Selling, general and administrative ( SG&A ) expenses were \$59.1 million or 12.2% of revenues for the third quarter of fiscal 2006, compared to \$54.8 million or 11.9% of revenues for the third quarter of fiscal 2005. The increase in SG&A expenses over the comparable prior year period was primarily due to the addition of Crave and REPS expenses of \$5.3 million and \$3.8 million, respectively, offset, in part, by lower compensation-related costs of \$2.1 million, lower outside service costs of \$1.3 million and a reduction in freight expense of \$1.2 million. SG&A expenses for the first nine months of this year were \$154.0 million or 15.0% of revenues, compared to \$145.2 million or 14.7% of revenues for the first nine months of last year.

Operating income for the third quarter of fiscal 2006 was \$22.3 million, compared to operating income of \$32.5 million for the third quarter of fiscal 2005. This decrease in operating income was principally due to increased direct product costs as a percentage of sales as previously discussed. Operating income for the first nine months of this fiscal year was \$22.1 million, compared to operating income of \$44.8 million for the first nine months of last fiscal year.

Investment (expense) income, net (which includes interest expense) for the third quarter of fiscal 2006 was expense of \$1.1 million, compared to income of \$0.1 million for the third quarter of fiscal 2005. Interest expense in the third quarter of this year totaled \$2.5 million, compared to \$0.4 million in the third quarter of last year. This year-over-year increase in interest expense was due to the increased borrowings in the third quarter of this year to finance the acquisition of Crave. Also, during the third quarter of fiscal 2006, the Company recorded investment income of \$0.5 million related to additional cash received on the sale of an investment in PRN, a company that provides in-store media networks. This sale occurred during the Company's second quarter of fiscal 2006. Under the terms of the sale agreement, the Company may receive additional proceeds of up to \$1.5 million on the sale as follows: (i) approximately \$1.1 million in September 2006 from funds in escrow, subject to general indemnification claims; and (ii) approximately \$0.4 million in September 2009 from funds in escrow, subject to tax

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indemnification claims. Also during the third quarter of fiscal 2006, the Company recorded investment income of \$0.5 million related to investment gains on assets held for the Company's Supplemental Executive Retirement Plan compared to \$0.3 million recorded in the third quarter of fiscal 2005. Investment income, net for the first nine months of fiscal 2006 was \$3.7 million, compared to \$2.2 million for the first nine months of fiscal 2005.

The effective income tax rates for the third quarters of fiscal 2006 and 2005 were 33.9% and 36.3%, respectively. The effective income tax rate for the first nine months of fiscal 2006 was 20.6%, compared to 35.4% for the same period last year. The significantly lower income tax rate in the first nine months of this year was due to the partial release of a valuation allowance related to a capital loss and the tax benefit from the cancellation of a worthless debt from an insolvent subsidiary, both occurring in the second quarter of this fiscal year, in the amounts of \$2,118,000 and \$1,028,000, respectively.

### **Other**

Accounts receivable at January 31, 2006 was \$336.2 million, compared to \$232.4 million at April 30, 2005. This increase was mainly due to the higher revenues in the third quarter of this year, compared to those in the fourth quarter of last year due to the seasonal nature of the Company's business. Accounts receivable at January 31, 2006 also included balances for Crave and REPS of \$30.6 million and \$6.3 million, respectively, which were not included in the Company's Consolidated Balance Sheet as of April 30, 2005.

Merchandise inventories at January 31, 2006 was \$193.2 million, compared to \$115.7 million at April 30, 2005. This increase was partially due to the Company's requirement for maintaining a wider assortment of product necessary to support its customers' diverse needs. Additionally, merchandise inventories at January 31, 2006 included Crave product of \$29.6 million, which was not included in the Company's Consolidated Balance Sheet as of April 30, 2005.

Goodwill, net at January 31, 2006 was \$36.4 million, compared to \$3.4 million at April 30, 2005. The increase was due to goodwill associated with the acquisitions of Crave during the third quarter of fiscal 2006 and REPS during the first quarter of fiscal 2006. See Notes 3 and 6 of Notes to Consolidated Financial Statements for further information related to the acquisitions, and the related goodwill and intangible assets, respectively.

Intangible assets, net at January 31, 2006 was \$43.7 million, compared to zero at April 30, 2005. These intangible assets relate to the Company's newly acquired subsidiaries, Crave and REPS, and are comprised of trademark, customer relationships, non-compete agreements, software development costs and license advances. See Notes 3 and 6 of Notes to Consolidated Financial Statements for further information related to the Crave and REPS acquisitions and the related goodwill and intangible assets, respectively.

Debt, current portion was \$5.4 million at January 31, 2006, compared to zero at April 30, 2005. This increase was due to borrowings against the Company's line of credit to finance the Crave acquisition.

Accounts payable was \$266.4 million at January 31, 2006, compared to \$133.3 million at April 30, 2005. This increase was primarily a result of the Company's maintaining a higher level of inventory, as previously mentioned, and the timing of vendor payments related to increased inventory purchases for the holiday season. Accounts payable at January 31, 2006 included Crave accounts payable of \$9.1 million, which was not included in the Company's Consolidated Balance Sheet as of April 30, 2005.

Debt, non-current was \$97.0 million at January 31, 2006, compared to zero at April 30, 2005. This increase was due to borrowings against the Company's line of credit to finance the Crave acquisition.

During the third quarter of fiscal 2006, the Company repurchased 500,000 shares of its common stock at an average price of \$12.97 per share. As of January 31, 2006, the Company had repurchased 1,874,000 shares, or 57% of the authorized shares under the current 15% share repurchase program approved by its Board of Directors.

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There are no 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 ultimate outcome of which is not expected to be material to future results of consolidated operations, financial position and cash flows. The Company has provided for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

### **Liquidity and Capital Resources**

The Company has an unsecured line of credit with a consortium of banks. In November 2005, the credit agreement was amended whereby the expiration date was extended from August 2007 to November 2010 and the line of credit was increased from \$150.0 million to \$250.0 million. This facility will be incrementally reduced to \$200.0 million through 2009 (a \$10.0 million reduction in November 2007, a \$20.0 million reduction in November 2008, and a \$20.0 million reduction in November 2009). Management believes that the revolving credit agreement, along with cash provided from operations, will provide sufficient liquidity to finance the acquisition of Crave Entertainment Group, fund the Company's day-to-day operations, including seasonal increases in working capital, as well as payments of cash dividends and repurchases of common stock under the Company's share repurchase program. The Company had borrowings of \$102.4 million against its line of credit at January 31, 2006 and no borrowings as of April 30, 2005.

On February 7, 2006, the Company entered into an interest rate swap agreement on \$75.0 million of outstanding debt considered to be long-term on that date. This long-term outstanding debt was principally incurred to finance the Crave acquisition. The amount of the swap agreement will incrementally reduce to \$50.0 million in April 2007, to \$25.0 million in April 2008, and will expire in April 2009. The interest rate is fixed at 4.9675%, plus a charge that varies based on the ratio of debt to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), as defined in the revolving credit agreement.

As a result of the acquisition of REPS in the first quarter of fiscal 2006, the Company has recorded short-term notes payable totaling \$1.3 million subject to any indemnification claims and confirmation of the purchase price, respectively. In February 2006, the Company paid \$250,000 of these short-term notes payable.

See Note 3 of Notes to Consolidated Financial Statements for more information related to the acquisitions of Crave and REPS.

On November 22, 2005 the Company announced a quarterly cash dividend of \$0.08 per share. As a result, \$1.6 million was paid on January 6, 2006 to shareholders of record at the close of business on December 21, 2005. For each of the nine-month periods ended January 31, 2006 and January 31, 2005, dividends totaling \$5.0 million were paid to shareholders.

Net cash used by operating activities for the nine months ended January 31, 2006 was \$48.6 million, compared to net cash used by operating activities of \$20.4 million for the same nine-month period of last year. This increase was principally due to unfavorable year-over-year changes in accounts payable balances and net income of \$20.0 million and \$9.7 million, respectively, partially offset by a favorable year-over-year change in accounts receivable balances of \$6.7 million and a reduction in non-cash charges of \$1.8 million in the nine-month period ended January 31, 2006 versus the comparable period last year.

Net cash used by investing activities was \$153.2 million for the nine months ended January 31, 2006, compared to net cash used by investing activities of \$12.0 million for the nine months ended January 31, 2005. This change was predominately due to an increase in cash investments in Crave and REPS of \$122.8 million and \$19.1 million, respectively.

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Net cash provided from financing activities was \$177.6 million for the nine months ended January 31, 2006 compared to net cash used by financing activities of \$17.9 million for the comparable nine-month period of last year. This change was principally due to an increase in net debt issuances of \$102.3 million, an increase in checks issued in excess of cash balances of \$74.7 million, predominately due to the timing of payments to vendors in the U.S. and UK, and a decline in the amount used to repurchase the Company's common stock of \$19.1 million over the comparable nine-month period last year.

The following table summarizes the Company's contractual cash obligations and commitments as of January 31, 2006 along with their expected effects on its liquidity and cash flows in future periods (in thousands of dollars):

|                                                           | <b>Contractual Cash Obligations and Commitments</b> |                  |                   |                  |                  |
|-----------------------------------------------------------|-----------------------------------------------------|------------------|-------------------|------------------|------------------|
|                                                           |                                                     | <b>Less than</b> | <b>1 3</b>        | <b>4 5</b>       | <b>After</b>     |
|                                                           | <b>Total</b>                                        | <b>1 Year</b>    | <b>Years</b>      | <b>Years</b>     | <b>5 Years</b>   |
| Debt obligations                                          | \$ 102,385                                          | \$ 5,385         | \$ 97,000         | \$               | \$               |
| Notes payable                                             | 1,250                                               | 1,250            |                   |                  |                  |
| Operating leases                                          | 33,729                                              | 2,152            | 20,227            | 5,442            | 5,908            |
| Less: operating sub-leases                                | (1,803)                                             | (102)            | (1,225)           | (476)            |                  |
| Purchase obligations                                      | 22,024                                              | 22,024           |                   |                  |                  |
| Other obligations                                         | 108,926                                             | 4,348            | 40,281            | 26,343           | 37,954           |
| Outstanding letters of credit                             | 3,361                                               | 3,361            |                   |                  |                  |
| <b>Total contractual cash obligations and commitments</b> | <b>\$ 269,872</b>                                   | <b>\$ 38,418</b> | <b>\$ 156,283</b> | <b>\$ 31,309</b> | <b>\$ 43,862</b> |

Operating leases represent non-cancelable operating leases entered into by the Company, primarily related to buildings and other equipment. Purchase obligations were those entered into through the normal course of business, principally related to the purchase of inventory. Other obligations mainly include contractual commitments for information technology related services.

**Outlook**

The Company's current customer base primarily operates in the mass merchant and leading retailer segment of the music and video game industries. In the U.S., music sales in the mass merchant segment declined by approximately 3% during the Company's third fiscal quarter compared to the same period last year. Music industry sales overall declined by approximately 6% during this same period. This is the second consecutive quarter of declines in the mass merchant's segment. The video game industry has also shown a decline for five consecutive months ending in January 2006.

Declining music industry sales and uncertainty about the success of upcoming new music releases, coupled with the recent softness in console video game industry sales are expected to have a negative impact on the Company's near-term operating performance. Accordingly, the Company expects its operating results for the balance of its fiscal year 2006 to be substantially below the same period of the prior year. The uncertainty surrounding these factors precludes the Company from providing more specific guidance at this time. Should these industry factors continue, the Company will re-evaluate if it is appropriate to provide future earnings guidance.

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This document contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements including, without limitation, risks associated with achieving the business integration objectives expected with the Crave Entertainment Group acquisition, changes in the music and video game industries, continuation of satisfactory relationships with existing customers and suppliers, establishing satisfactory relationships with new customers and suppliers, effects of electronic commerce inclusive of digital music distribution, success of new music and video game releases, dependency on technology, ability to control costs, relationships with the Company's lenders, pricing and competitive pressures, dependence on third-party carriers to deliver products to customers, the ability to secure funding or generate sufficient cash required to build and grow new businesses, 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. Handleman Company notes that the preceding conditions are not a complete list of risks and uncertainties. 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 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company has no market risk from derivative instruments that would have a material effect on the Company's financial position, results of operations or cash flows.

### **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, 2006 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 as appropriate to allow timely decisions regarding required disclosure, 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, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting with the exception of implementation of internal controls relating to Crave Entertainment Group, which was acquired on November 22, 2005. The Company's disclosure controls and procedures have been updated to ensure the financial information of Crave has been properly reported.

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 Company's 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.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

As a result of the acquisition of Crave Entertainment Group on November 22, 2005, trends in the video game industry may now have a direct impact on the Company's financial performance.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On February 23, 2005, the Company's Board of Directors authorized a share repurchase program. Under this authorization, which has no expiration date, the Company can repurchase up to 15% of its then outstanding balance of 21,787,611 shares. The table below sets forth information with respect to shares repurchased under the 15% authorization in the third quarter ended January 31, 2006.

| <b>Period</b>                              | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average<br/>Price Paid<br/>per Share</b> | <b>Total Number of<br/>Shares Purchased as<br/>Part of Publicly<br/>Announced Plans or<br/>Programs</b> | <b>Maximum Number of<br/>Shares that May Yet<br/>be Purchased Under<br/>the Plans or Programs</b> |
|--------------------------------------------|-----------------------------------------------------|---------------------------------------------|---------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| October 30, 2005 through December 3, 2005  | 152,000                                             | \$ 13.280                                   | 152,000                                                                                                 | 1,742,142                                                                                         |
| December 4, 2005 through December 31, 2005 | 213,500                                             | \$ 13.069                                   | 213,500                                                                                                 | 1,528,642                                                                                         |
| January 1, 2006 through January 31, 2006   | 134,500                                             | \$ 12.480                                   | 134,500                                                                                                 | 1,394,142                                                                                         |
| <b>Total</b>                               | <b>500,000</b>                                      | <b>\$ 12.975</b>                            | <b>500,000</b>                                                                                          | <b>1,394,142</b>                                                                                  |

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

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

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SIGNATURES: Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HANDLEMAN COMPANY

DATE: March 10, 2006

BY: /s/ Stephen Strome

STEPHEN STROME

Chairman of the Board and

Chief Executive Officer

(Principal Executive Officer)

DATE: March 10, 2006

BY: /s/ Thomas C. Braum, Jr.

THOMAS C. BRAUM, JR.

Senior Vice President and

Chief Financial Officer

(Principal Financial Officer)