HANDLEMAN CO /MI/
Form 10-Q
September 16, 2003
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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 first quarter ended August 2, 2003 Commission File Number 1-7923

Handleman Company

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Michigan | 38-1242806 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | | |
|---|---|---|
| 500 Kirts Boulevard, Troy, Michigan | 48084-4142 | Area Code 248 362-4400 |
| (Address of principal executive offices) | (Zip code) | (Registrant s telephone number) |

Indicate by checkmark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days.

YES X NO _

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

YES X NO _

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

| CLASS | DATE | SHARES OUTSTANDING |
|---|---|---|
| Common Stock $.01 Par Value | September 5, 2003 | 24,836,255 |

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HANDLEMAN COMPANY

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**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**HANDLEMAN COMPANY**

**CONSOLIDATED STATEMENTS OF INCOME**

**(UNAUDITED)**

**(in thousands of dollars except per share data)**

| | Three Months (13 Weeks) Ended | |
|---|---|---|
| | August 2, 2003 | July 27, 2002 (Restated) |
| Revenues | $ 224,319 | $ 277,230 |
| Costs and expenses: | | |
| Direct product costs | 173,785 | 219,406 |
| Selling, general and administrative expenses | 46,984 | 53,169 |
| Interest (income) expense, net | (181) | 391 |
| Income before income taxes and minority interest | 3,731 | 4,264 |
| Income tax expense | (2,021) | (1,777) |
| Minority interest | | 174 |
| Net income | $ 1,710 | $ 2,661 |
| Net income per share | | |
| Basic | $ 0.07 | $ 0.10 |
| Diluted | $ 0.07 | $ 0.10 |
| Weighted average number of shares outstanding during the period | | |
| Basic | 25,326 | 26,476 |
| Diluted | 25,504 | 26,569 |

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

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**HANDLEMAN COMPANY**

**CONSOLIDATED BALANCE SHEETS**

**(in thousands of dollars except share data)**

| | August 2, 2003 (Unaudited) | May 3, 2003 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 47,547 | $ 62,698 |
| Accounts receivable, less allowances of $23,901 at August 2, 2003 and $24,269 at May 3, 2003 | 169,811 | 201,994 |
| Merchandise inventories | 142,888 | 119,979 |
| Other current assets | 16,139 | 17,993 |
| Total current assets | 376,385 | 402,664 |
| Property and equipment: | | |
| Land, buildings and improvements | 13,927 | 13,917 |
| Display fixtures | 33,081 | 32,876 |
| Computer hardware and software | 36,161 | 35,195 |
| Equipment, furniture and other | 33,664 | 33,073 |
| | 116,833 | 115,061 |
| Less accumulated depreciation | 62,743 | 59,328 |
| | 54,090 | 55,733 |
| Goodwill, net | 3,406 | 3,406 |
| Intangible assets, net | 43,649 | 44,715 |
| Other assets, net | 19,403 | 19,046 |
| Total assets | $ 496,933 | $ 525,564 |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | $ 152,346 | $ 159,747 |
| Debt, current portion | 3,571 | 3,571 |
| Accrued and other liabilities | 29,451 | 40,630 |
| Total current liabilities | 185,368 | 203,948 |
| Debt, non-current | 3,571 | 3,571 |
| Other liabilities | 9,355 | 9,199 |
| SHAREHOLDERS EQUITY | | |
| Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued | | |
| | 249 | 257 |

| | | |
|---|---|---|
| Common stock, $.01 par value; 60,000,000 shares authorized; 24,914,000 and 25,659,000 shares issued at August 2, 2003 and May 3, 2003, respectively | | |
| Accumulated other comprehensive loss | (4,385) | (4,716) |
| Unearned compensation | (8,748) | (3,141) |
| Retained earnings | 311,523 | 316,446 |
| Total shareholders equity | 298,639 | 308,846 |
| Total liabilities and shareholders equity | $ 496,933 | $ 525,564 |

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

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**HANDLEMAN COMPANY**

**CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY**

**(UNAUDITED)**

**(in thousands of dollars)**

| | Three Months (13 Weeks) Ended August 2, 2003 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Common Stock | | Other Comprehensive Income (Loss) | | | | |
| | Shares Issued | Amount | Foreign Currency Translation Adjustment | Minimum Pension Liability | Unearned Compensation | Retained Earnings | Total Shareholders Equity |
| May 3, 2003 | 25,659 | $ 257 | $ (591) | $ (4,125) | $ (3,141) | $ 316,446 | $ 308,846 |
| Net income | | | | | | 1,710 | 1,710 |
| Adjustment for foreign currency translation | | | 331 | | | | 331 |
| Comprehensive income, net of tax | | | | | | | 2,041 |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 147 | 1 | | | (5,607) | 7,849 | 2,243 |
| Common stock repurchased | (892) | (9) | | | | (14,802) | (14,811) |
| Tax benefit from exercise of stock options | | | | | | 320 | 320 |
| August 2, 2003 | 24,914 | $ 249 | $ (260) | $ (4,125) | $ (8,748) | $ 311,523 | $ 298,639 |

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

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**HANDLEMAN COMPANY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(UNAUDITED)**

**(in thousands of dollars)**

| | Three Months (13 Weeks) Ended | |
|---|---|---|
| | August 2, 2003 | July 27, 2002 (Restated) |
| Cash flows from operating activities: | | |
| Net income | $ 1,710 | $ 2,661 |
| Adjustments to reconcile net income to net cash provided from operating activities: | | |
| Depreciation | 3,483 | 5,113 |
| Amortization of acquisition costs | | 135 |
| Recoupment/amortization of acquired rights | 4,222 | 4,433 |
| Gain on disposal of property and equipment | (26) | (87) |
| Deferred income taxes | | (1,330) |
| Tax benefit from exercise of stock options | 320 | 350 |
| Changes in operating assets and liabilities: | | |
| Decrease in accounts receivable | 32,183 | 49,408 |
| Increase in merchandise inventories | (22,909) | (8,676) |
| Decrease in other operating assets | 1,906 | 7,828 |
| Decrease in accounts payable | (7,401) | (26,792) |
| Decrease in other operating liabilities | (11,022) | (12,553) |
| Total adjustments | 756 | 17,829 |
| Net cash provided from operating activities | 2,466 | 20,490 |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (1,814) | (2,149) |
| Proceeds from disposition of properties and equipment | | 21 |
| Acquired rights | (3,566) | (6,228) |
| Additional investments in subsidiary companies | | (5,840) |
| Net cash used by investing activities | (5,380) | (14,196) |
| Cash flows from financing activities: | | |
| Issuances of debt | | 806,578 |

| | | |
|---|---|---|
| Repayments of debt | | (829,914) |
| Repurchase of common stock | (14,811) | (1,496) |
| Other changes in shareholders equity, net | 2,574 | 4,090 |
| Net cash used by financing activities | (12,237) | (20,742) |
| Net decrease in cash and cash equivalents | (15,151) | (14,448) |
| Cash and cash equivalents at beginning of period | 62,698 | 20,254 |
| Cash and cash equivalents at end of period | $ 47,547 | $ 5,806 |

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

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. In the opinion of management, the accompanying consolidated balance sheets and consolidated statements of income, shareholders equity and cash flows contain all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position of the Company as of August 2, 2003, and the results of operations and changes in cash flows for the three months then ended. Because of the seasonal nature of the Company s business, sales and earnings results for the three months ended August 2, 2003 are not necessarily indicative of what the results will be for the full year. The consolidated balance sheet as of May 3, 2003, included in this Form 10-Q, was derived from the audited consolidated financial statements of the Company included in the Company s 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company s Form 10-K for the year ended May 3, 2003, including the discussion of the Company s critical accounting policies.

2. The accompanying consolidated financial statements for the three months ended July 27, 2002 have been restated to recognize revenues upon customer receipt rather than at the time of shipment to reflect when risk of ownership is effectively transferred to the Company s customers. In addition, the Company has revised the accounting for two vendor contracts negotiated by a subsidiary of the Company during fiscal 2001. The Company has also reclassified costs associated with acquiring and preparing inventory for distribution from selling, general and administrative expenses to direct product costs for the three months ended July 27, 2002, to conform to the presentation adopted in the fourth quarter of fiscal 2003. As a result of the aforementioned, the Company has restated its financial statements for the three months ended July 27, 2002.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

The following summarizes the restatement for the three months ended July 27, 2002 (in thousands of dollars):

| Consolidated Statement of Income | | Three Months Ended July 27, 2002 |
|---|---|---|
| Revenues, previously reported | $ | 270,964 |
| Adjustments for: | | |
| Revenue recognition | | 6,266 |
| Revenues, restated | | 277,230 |
| Direct product costs, previously reported | | 210,454 |
| Adjustments for: | | |
| Revenue recognition | | 6,357 |
| Vendor contracts | | (79) |
| Reclassification of inventory related costs | | 2,674 |
| Direct product costs, restated | | 219,406 |
| Selling, general and administrative expenses, previously reported | | 55,832 |
| Adjustments for: | | |
| Revenue recognition | | 11 |
| Reclassification of inventory related costs | | (2,674) |
| Selling, general and administrative expenses, restated | | 53,169 |
| Interest expense net, previously reported | | 383 |
| Adjustments for: | | |
| Vendor contracts | | 8 |
| Interest expense net, restated | | 391 |
| Income before income taxes and minority interest, previously reported | | 4,295 |
| Adjustments for: | | |
| Revenue recognition | | (102) |
| Vendor contracts | | 71 |
| Income before income taxes and minority interest, restated | | 4,264 |
| Income tax expense, previously reported | | (1,775) |
| Adjustments for: | | |
| Revenue recognition | | 23 |
| Vendor contracts | | (25) |

| | | |
|---|---|---|
| Income tax expense, restated | | (1,777) |
| | | |
| Net income, previously reported | | 2,694 |
| Adjustments for: | | |
| Revenue recognition | | (79) |
| Vendor contracts | | 46 |
| | | |
| Net income, restated | $ | 2,661 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

3. The Company currently has employee stock option plans. Prior to fiscal 2004, the Company accounted for these plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related Interpretations. No stock-based employee compensation expense for stock plans was reflected in net income for fiscal years prior to fiscal 2004, as all stock granted under these plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. Effective May 4, 2003, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation. The Company selected the prospective transition method, as defined in SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment to SFAS No. 123, Accounting for Stock-Based Compensation. Under the prospective method, all options issued after May 4, 2003 will be accounted for utilizing the fair value provisions of SFAS No. 123. The pre-tax costs related to stock-based employee compensation included in the determination of net income for the first quarter of fiscal 2004 was $114,000, which was less than that which would have been recognized if the fair value method had been applied to all awards since the original effective date of SFAS No. 123.

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

| | | Three Months Ended | |
|---|---|---|---|
| | | August 2, 2003 | July 27, 2002 (Restated) |
| Net income, as reported | | $ 1,710 | $ 2,661 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | | 52 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | | (274) | (408) |
| Pro forma net income | | $ 1,488 | $ 2,253 |
| Net income per share: | | | |
| Reported | - basic | $ 0.07 | $ 0.10 |
| | - diluted | 0.07 | 0.10 |
| Pro forma | - basic | 0.06 | 0.09 |
| | - diluted | 0.06 | 0.08 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

4. The table below presents information about the components of accounts receivable balances included in the Company s Consolidated Balance Sheets (in thousands of dollars):

| | August 2, 2003 | May 3, 2003 |
|---|---|---|
| Trade accounts receivable | $ 193,712 | $ 226,263 |
| Less allowances for: | | |
| Gross profit impact of estimated future returns | (12,150) | (12,759) |
| Bankrupt customers | (6,794) | (6,720) |
| Doubtful accounts | (4,957) | (4,790) |
| Accounts receivable, net | $ 169,811 | $ 201,994 |

5. The Company, principally in its proprietary products business, acquires rights to video licenses giving it the exclusive privilege to manufacture and distribute such products. The costs of acquired rights include advances paid to licensors and costs to create a master to be used for duplication. The acquired rights are amortized based upon the sales volume method over a period which is the lesser of the terms of the agreements or the products estimated useful lives. On a regular basis, the Company performs analyses comparing the carrying value of its acquired rights with the expected future economic benefit of these assets. Based on such analyses, the Company adjusts, if necessary, the value of its acquired rights.

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

| | August 2, 2003 | | May 3, 2003 | |
|---|---|---|---|---|
| Amortized Intangible Assets | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| License advances | $ 65,962 | $ 42,282 | $ 65,493 | $ 41,347 |
| Masters | 34,732 | 14,763 | 33,794 | 13,225 |
| Total | $ 100,694 | $ 57,045 | $ 99,287 | $ 54,572 |

| | August 2, 2003 | | May 3, 2003 | |
|---|---|---|---|---|
| Amortized Intangible Assets | Net Amount | Weighted Avg. Amortization Period | Net Amount | Weighted Avg. Amortization Period |
| License advances | $ 23,680 | 105 mos. | $ 24,146 | 100 mos. |
| Masters | 19,969 | 97 mos. | 20,569 | 90 mos. |

| | | | | |
|---|---|---|---|---|
| Total | $ 43,649 | 101 mos. | $ 44,715 | 96 mos. |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

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

| Period | Amount |
|---|---|
| Three months ended August 2, 2003 | $ 4,222 |
| Three months ended July 27, 2002 | 4,449 |

The following table summarizes estimated amortization expense based on the value of acquired rights as of August 2, 2003 (in thousands of dollars):

| Fiscal Year | Amount |
|---|---|
| 2004 | $ 18,791 |
| 2005 | 9,102 |
| 2006 | 6,776 |
| 2007 | 5,745 |
| 2008 | 4,604 |

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

6. In May 2003, SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued by the Financial Accounting Standards Board. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments based on whether such financial instruments embody an obligation of the issuer. The Company is evaluating the impact of this Statement and does not expect that SFAS No. 150 will have a significant effect on the consolidated financial position and results of operations of the Company.

7. The Company operates in two business segments: Handleman Entertainment Resources ( H.E.R. ) is a category manager and distributor of prerecorded music to mass merchants, principally in North America and the United Kingdom; and North Coast Entertainment ( NCE ), through its Anchor Bay Entertainment division, is responsible for the Company s proprietary operations, which markets video titles on DVD and VHS formats.

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 fiscal year ended May 3, 2003. Segment data includes intersegment revenues, as well as a charge allocating corporate costs to the operating segments. The Company evaluates performance of its segments and allocates resources to them based on income before interest, income taxes and minority interest ( segment income ).

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

The tables below present information about reported segments as of and for the three months ended August 2, 2003 and July 27, 2002 (in thousands of dollars):

| Three Months Ended August 2, 2003: | H.E.R. | NCE | Total |
|---|---|---|---|
| Revenues, external customers | $ 205,070 | $ 19,100 | $ 224,170 |
| Intersegment revenues | | | |
| Segment income | 1,521 | 1,600 | 3,121 |
| Total assets | 448,206 | 78,075 | 526,281 |
| Capital expenditures | 1,765 | 49 | 1,814 |

| Three Months Ended July 27, 2002, Restated: | H.E.R. | NCE | Total |
|---|---|---|---|
| Revenues, external customers | $ 252,097 | $ 24,988 | $ 277,085 |
| Intersegment revenues | | 4,231 | 4,231 |
| Segment income | 4,137 | 166 | 4,303 |
| Total assets | 467,649 | 154,586 | 622,235 |
| Capital expenditures | 1,888 | 261 | 2,149 |

A reconciliation of total segment revenues to consolidated revenues, total segment income to consolidated income before income taxes and minority interest, and total segment assets to consolidated assets as of and for the three months ended August 2, 2003 and July 27, 2002 is as follows (in thousands of dollars):

| | August 2, 2003 | July 27, 2002 (Restated) |
|---|---|---|
| Revenues | | |
| Total segment revenues | $ 224,170 | $ 281,316 |
| Corporate rental income | 149 | 145 |
| Elimination of intersegment revenues | | (4,231) |
| Consolidated revenues | $ 224,319 | $ 277,230 |
| Income Before Income Taxes and Minority Interest | | |
| Total segment income for reportable segments | $ 3,121 | $ 4,303 |
| Interest income | 377 | 154 |
| Interest expense | (196) | (545) |
| Unallocated corporate income | 429 | 352 |

| | | |
|---|---|---|
| Consolidated income before income taxes and minority interest | $ 3,731 | $ 4,264 |
| <u>Assets</u> | | |
| Total segment assets | $ 526,281 | $ 622,235 |
| Elimination of intercompany receivables and payables | (29,348) | (76,456) |
| Consolidated assets | $ 496,933 | $ 545,779 |

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

8. Comprehensive income is net income plus certain other items recorded directly to shareholders equity. Comprehensive income, net of tax was $2.0 million for the first quarter ended August 2, 2003, compared to $6.4 million, restated, for the first quarter ended July 27, 2002.

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

| | Three Months Ended | |
|---|---|---|
| | **August 2, 2003** | **July 27, 2002** |
| Weighted average shares during the period-basic | 25,326 | 26,476 |
| Additional shares from assumed exercise of stock options | 178 | 93 |
| Weighted average shares adjusted for assumed exercise of stock options-diluted | 25,504 | 26,569 |

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**Item 2.**

**Handleman Company**

**Management s Discussion and Analysis of**

**Financial Condition and Results of Operations**

The Company s consolidated financial statements for the three months ended July 27, 2002 have been restated to recognize revenues upon customer receipt, rather than at the time of shipment, to more accurately reflect when risk of ownership is effectively transferred to the Company s customers. The Company has also reclassified costs associated with acquiring and preparing inventory for distribution from selling, general and administrative ( SG&A ) expenses to direct product costs for the three months ended July 27, 2002, to conform to the presentation adopted in the fourth quarter of fiscal 2003. As a result of t