

HANDLEMAN CO /MI/
Form 10-K
August 13, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended May 3, 2008

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)

48084-5225
(Zip Code)

Registrant's telephone number, including area code: 248-362-4400

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

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Title of each class	Name of each exchange on which registered
COMMON STOCK \$.01 PAR VALUE	PINK SHEET ELECTRONIC QUOTATION SERVICE
Securities registered pursuant to Section 12(g) of the Act: NONE	

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.). YES NO

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter. The aggregate market value as of October 27, 2007 was \$41,213,000.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. The number of shares of common stock outstanding as of July 11, 2008 was 20,450,893.

DOCUMENTS INCORPORATED BY REFERENCE

Handleman Company's definitive Proxy Statement to be filed for the 2008 Annual Meeting of Shareholders is incorporated by reference into Part III, with the exception of the Corporate Governance and Nominating Committee Charter and the Audit Committee Charter contained therein.

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PART I

Item 1. BUSINESS

Handleman Company, a Michigan corporation (herein referred to as the Company or Handleman or Registrant), which has its executive offices in Troy, Michigan, is the successor to a proprietorship formed in 1934, and to a partnership formed in 1937. Handleman Company operated as a category manager and distributor of prerecorded music and console video game hardware, software and accessories to leading retailers in the United States (U.S.), United Kingdom (UK) and Canada.

Copies of the Forms 10-K, Forms 10-Q, Forms 8-K, all amendments to those reports and certain other materials are available, as soon as reasonably practicable after said material is electronically filed with or furnished to the Securities and Exchange Commission, free of charge on the Registrant s website, www.handleman.com.

RECENT DEVELOPMENTS

In recent years, music industry sales have declined at double-digit rates as the industry was impacted by digital distribution, downloading and piracy. In addition, the Company s gross margins were compressed because lower-margin promotional products became a greater proportion of annual sales. This level of continued erosion of CD music sales is expected to continue into the foreseeable future. In response to this dramatic decline, the Company implemented significant cost reduction plans to reduce expenses and streamline operations. These plans included work force reductions; the consolidation of the operations of two U.S. automated distribution facilities into one facility; the reduction of benefits programs and realignment of medical plans; initiatives to reduce customer product returns; and various other cost cutting initiatives. However, the reduction in music sales volume and the loss of gross margin outpaced the Company s ability to reduce overhead costs; as a result, the Company experienced steep operating losses in the past two fiscal years.

The Company s customers have responded to the decline in music industry sales by contracting the amount of retail space devoted to music sales.

Additionally, the Company violated certain debt covenants within its credit agreements in the fourth quarter of fiscal 2008, which ended May 3, 2008. Those violations were cured soon thereafter by an amendment to the credit facilities. In recent months, trade creditors have expressed concern about whether the Company might be contemplating or be required to file a bankruptcy proceeding. As a result, the Company became concerned about whether it would have access to sufficient financing and vendor credit to meet its business needs.

As a result of concerns about the prospects for the music business and the availability of financing, in April 2008 the Board of Directors of the Company approved that management proceed with the sale of the U.S. and Canadian operations, which were actively being marketed as of May 3, 2008. On June 2, 2008, Handleman announced that it is exiting the music business in North America and that it had sold a portion of its U.S. inventory and its U.S. music business related to Wal-Mart Stores, Inc. (Wal-Mart) to Anderson Merchandisers L.P. (Anderson). Handleman also announced that it will work with its other non-Wal-Mart U.S. customers to achieve a smooth transition to other music suppliers, which is expected to occur by the end of August 2008. Further, Handleman executed a definitive agreement with Anderson in July 2008 for the sale of all of the inventory and fixed assets and all operations of its Canadian subsidiary, Handleman Canada. The closing on the sale of assets of Handleman Canada is subject to Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009; the closing will occur shortly thereafter.

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Handleman's other operations include Crave Entertainment Group, Inc. (Crave), a full-service distributor of video game software, hardware and related accessories, and a specialty video game publisher; Handleman UK Limited (Handleman UK), a UK-based distributor and store merchandiser of music, video, books, computer games and other products; Artist to Market Distribution (A2M), an independent music distributor that works directly with branded artists and artists' management to streamline the supply chain and deliver new music product to the marketplace at a lower cost; and REPS LLC (REPS), a national in-store merchandiser.

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Handleman retained the investment banking firm W.Y. Campbell & Company in April 2008 for the purpose of exploring a possible sale or other strategic options for Crave. In June 2008, an Offering Memorandum was completed and the Company began actively marketing Crave for sale at that time. In the first quarter of fiscal 2009, the Company also broadened the scope for W.Y. Campbell & Company to include strategic initiatives related to REPS as well.

Further, Handleman is in discussions and has reached an agreement in principle with Tesco Stores Limited (Tesco) in the UK regarding the sale of certain of its Handleman UK assets and operations. Handleman has also signed an agreement for the sale of A2M assets in July 2008 for \$357,000, which primarily included inventory and intellectual property.

Handleman believes that its decision to exit the music business was the best strategic decision for its shareholders. Further, Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company's day-to-day operations provided the Company is able to sell its assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If the Company is able to generate cash proceeds in excess of what is needed to satisfy the Company's debt obligations, the Company is considering the possibility of distributing any such proceeds to shareholders rather than pursue reinvestment opportunities.

Credit Agreements

On April 30, 2007, Handleman and certain of its subsidiaries entered into two five-year credit agreements, as amended, that constituted a \$250 million multi-tranche credit facility. These agreements contain several operating and financial covenants that include restrictions on dividends and share repurchases, acquisitions and investments, indebtedness, prepayments, liens and affiliate transactions, capital structure and business, guaranteed indebtedness and asset sales. In addition, Handleman must maintain a minimum excess availability in order to borrow under these agreements. The level of indebtedness and the associated covenants affect the Company's operations.

Management believes that cash provided from operations and asset sales could provide sufficient liquidity to fund the Company's day-to-day operations provided that the Company is able to sell its remaining assets within a reasonable period of time. If the Company receives substantially less than anticipated, the Company's liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If these actions are unsuccessful, then the Company's ability to continue as a going concern could be in doubt. See the discussion under Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources, and Note 8 of Notes to Consolidated Financial Statements for detailed information related to the new credit agreements.

Stock Delisting

Effective March 26, 2008, Handleman Company's stock began trading on the Pink Sheet Electronic Quotation Service, trading symbol HDLM.PK. Prior to March 19, 2008, Handleman's stock traded on the New York Stock Exchange Euronext (NYSE), under the symbol HDL. Handleman's stock was delisted by the NYSE prior to the NYSE market opening on March 25, 2008. The NYSE's determination resulted from the Company's average market capitalization over a consecutive thirty trading-day period being below the NYSE minimum quantitative continued listing criteria of \$25 million.

Going Concern

The Company's financial statements have been presented on the basis that it is a going concern, which contemplates the continuity of operations, realization of assets and the satisfaction of liabilities in the ordinary course of business. As discussed in Notes 2 and 8 of Notes to Consolidated Financial

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Statements, the Company has been unable to obtain additional financing to satisfy its operating and capital requirements through May 2, 2009. In addition, in April 2008, the Company's Board of Directors approved exiting the music business in North America. The Company announced this decision in the first quarter of fiscal 2009, along with the announcement that it began marketing its Crave subsidiary, selling certain assets in the United Kingdom, as well as seeking other strategic alternatives for its remaining entities. These factors, among others, raise doubt about the Company's ability to continue as a going concern. The Company's independent registered public accounting firm issued a going concern audit opinion on the Company's financial statements as of May 3, 2008.

ASDA Supply Arrangements

During the third quarter of fiscal 2008, Handleman UK determined, in conjunction with its customer ASDA, a subsidiary of Wal-Mart Stores, Inc., that their business relationship related to the greeting cards business would terminate in May 2008. Under this arrangement, which began in October 2006, Handleman UK provided the distribution and servicing of greeting cards to ASDA stores. The Company was unable to negotiate a fee arrangement with ASDA that would be sufficient to cover the related operating costs. Greeting card sales to ASDA represented \$71.4 million of the Company's consolidated revenues for the fiscal year ended May 3, 2008 (fiscal 2008) and \$39.3 million of consolidated revenues for the fiscal year ended April 28, 2007 (fiscal 2007).

During the first quarter of fiscal 2008, the Company announced that Handleman UK and ASDA decided not to continue their music supply arrangement. Under this arrangement, Handleman UK provided category management and distribution of music CD's and, to a limited extent, DVD's to ASDA stores. The decision not to continue the music supply arrangement was due to the inability of Handleman UK and ASDA to reach terms that were mutually beneficial. Handleman UK continued to provide music category management and distribution services to ASDA through August 2007. Sales to ASDA under the music supply arrangement represented \$57.3 million of the consolidated revenues for the first four months of fiscal 2008 (through the agreed upon termination date), and \$268.0 million of the Company's consolidated revenues during fiscal 2007.

Tesco Supply Agreement

Handleman UK began providing distribution, replenishment and store merchandising services to Tesco in support of its entertainment business - specifically music, video and video games in the first quarter of fiscal 2008. Tesco, the largest supermarket and general merchandise retailer in the United Kingdom, is also one of the world's leading international retailers. Under the arrangement, Tesco retained ownership title to the inventory, which was housed in and distributed from a Handleman UK distribution facility. This arrangement was characterized as a fee-for-service model, whereby Handleman UK's revenue was based upon fee per unit charges related to distribution services and hourly rate charges related to merchandising services provided by Handleman UK's field sales organization. This agreement allowed Handleman Company to extend its core services to over 700 Tesco stores in the United Kingdom. Revenues for this new business model with Tesco generated \$50.0 million of consolidated revenues for the Company since inception in the first quarter of fiscal 2008.

Subsequently, in the first quarter of fiscal 2009, Handleman began actively marketing for sale certain Handleman UK assets, began negotiations and reached an agreement in principle to sell certain assets and operations of Handleman UK related to the Tesco business, and certain of the Company's corporate intellectual properties to Tesco. Following its discontinuance of business with ASDA and Tesco, Handleman UK will have no on-going business operations and Handleman UK will be wound down as quickly as possible.

Change in Certifying Accountant

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On March 20, 2008, the Company's Board of Directors approved Grant Thornton LLP as its new independent registered public accounting firm, replacing PricewaterhouseCoopers LLP. During the Company's fiscal years ended April 29, 2006 and April 28, 2007 and through March 20, 2008, Grant Thornton LLP served as the independent registered public accounting firm for the Company's benefit plans.

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On November 28, 2007, Mr. Stephen Strome resigned from his position as Chief Executive Officer and as a Director for Handleman's Board of Directors. Handleman appointed Mr. Albert A. Koch as President and Chief Executive Officer, through Handleman's engagement of AP Services, LLC. AP Services is affiliated with Alix Partners, a financial advisory and consulting firm, where Mr. Koch is Vice Chairman, Managing Director and Partner.

On February 18, 2008, Thomas C. Braum resigned from his position as Executive Vice President and Chief Financial Officer. Handleman appointed Mr. Khaled Haram who served in that role until June 30, 2008. Mr. Haram had been with Handleman Company since April 2006 when he was hired as Senior Vice President and Chief Information Officer. In 2007, he assumed the responsibility for Handleman UK. On June 30, 2008, Handleman appointed Ms. Rozanne Kokko as Senior Vice President and Chief Financial Officer to replace Mr. Haram who had resigned. Ms. Kokko has been with Handleman since 1997 when she was hired as Director of Internal Audit. During her 11 years at Handleman, she has held positions in both business and finance including, Senior Vice President, Finance and National Team; Vice President General Manager for the Wal-Mart U.S. Customer Team in Bentonville, Arkansas; Vice President, General Manager for the National Customer Team, which included Kmart, Shopko and Pamida; and Vice President of Finance.

DESCRIPTION OF BUSINESS

During fiscal 2008, Handleman Company had the following reporting segments: category management and distribution operations, video game operations and all other. As a category manager and distributor of product, the Company created value for its customers by leveraging its core competencies of logistic services, field services and intellectual services. During fiscal 2008, the Company predominately provided full category management services for prerecorded music product to leading retail chains in the U.S., Canada and UK. As discussed previously, the Company has substantially exited or is exiting the music category management and distribution operations in the U.S. and Canada during fiscal 2009. In accordance with accounting guidance, the U.S. and Canadian operations have been classified as discontinued operations for financial reporting purposes. The video game operations are related to Crave and the all other segment primarily represents REPS.

The following table sets forth revenues from continuing operations and the percentage contribution to consolidated revenues for fiscal 2008 and 2007 (in millions of dollars):

	Fiscal Years Ended	
	May 3, 2008 (53 weeks)	April 28, 2007 (52 weeks)
Category management and distribution operations	\$ 219.5	\$ 322.7
<i>% of Total</i>	44.4	57.8
Video game operations	259.6	219.7
<i>% of Total</i>	52.5	39.3
All other	44.2	45.2
<i>% of Total</i>	8.9	8.1
Corporate income, including eliminations	(28.7)	(29.2)
<i>% of Total</i>	(5.8)	(5.2)

Total revenues from continuing operations	<u>\$ 494.6</u>	<u>\$ 558.4</u>
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Category Management and Distribution Operations

As a category manager and distributor of pre-recorded music, the Company created value for its customers by leveraging its core competencies of intellectual services, field services and logistic services. Using these competencies, the Company managed the selection, acquisition, delivery, retail ticketing, display and return of music product for the Company's retail customers (retailers) stores. The Company distributed throughout vast geographic regions, but adapted individual store selections to local tastes.

The music industry, in which the Company predominately operated, is seasonal in nature. As a result, certain working capital items have been higher at some interim reporting dates than at others. For example, inventory and accounts payable were typically higher at the end of the Company's second quarter as a result of increased inventory purchases in anticipation of higher holiday season shipments, whereas accounts receivable was typically higher at the end of the Company's third quarter due to holiday season shipments not yet paid by customers.

Vendors

The Company purchased from many different vendors. The volume of purchases from individual vendors fluctuated from year to year based upon the salability of selections being offered by such vendors. Though a small number of major, financially sound vendors accounted for a high percentage of purchases, Handleman selected product from a variety of additional vendors in order to maintain the appropriate product selection for its customer's consumers.

As the public's taste for the products the Company supplied was broad and varied, Handleman was required to maintain sufficient inventories to satisfy diverse tastes. The Company minimized the effect of obsolescence through planned purchasing methods and computerized inventory controls. Because substantially all vendors from which the Company purchased product offered some level of return allowances and price protection, Handleman reduced its exposure to markdown risk unless vendors were unable to fulfill their return obligations or non-salable product purchases exceeded vendor return limitations. Vendors offered a variety of charge-based return programs whereby, a penalty was charged based on a per unit rate or a percentage of product value. Accordingly, the Company may have possessed in its inventories non-salable product that could only be returned to vendors with cost penalties or may have been non-returnable until the Company could comply with the provisions of the vendors' return policies.

The Company generally did not have distribution contracts with its vendors; consequently, either party could have discontinued the relationship without notice.

Customers

The Company's customers were leading retailers in the U.S., Canada and the UK, who benefited from the services Handleman provided for a variety of reasons. The Company selected products to be sold in their customers' stores from a multitude of vendors that offered numerous titles, different formats (e.g., compact discs, music DVDs) and different payment and return arrangements. In addition, Handleman relieved its customers from the complexity of managing the numerous stock keeping units (SKUs) required per department, the variability of salable items among individual stores of a retailer, the wide array of programs offered by the multitude of vendors, the hits' nature of the business and the risk of inventory obsolescence.

Operations

The Company distributed products from its facilities in North America and the United Kingdom. In addition to economies of scale and through-put considerations in determining the number of facilities it operated, the Company also considered freight costs to and from customers stores and the importance of timely delivery of new releases. Due to the nature of the music business, display of new releases close to vendor authorized street dates is an important driver of both retail sales and customer satisfaction.

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The Company utilized its proprietary systems and a third party Enterprise Resource Planning suite of software products to automate and integrate the functions of ordering product, receiving, warehousing, order fulfillment, ticket printing and perpetual inventory maintenance. The inventory management system also provided the basis for title specific billing that allowed the Company to better serve its customers.

The Company has automated distribution equipment in its distribution facilities located in Indianapolis, Indiana; Toronto, Ontario; Warrington, United Kingdom; and Bolton, United Kingdom. On May 4, 2007, the Company ceased operations at its automated distribution facility in Richmond, Virginia as part of its cost savings measures. Handleman began marketing the lease on the Indianapolis, Indiana distribution facility in the first quarter of fiscal 2009. The Toronto, Ontario facility lease is expected to be assigned to Anderson in connection with the Canadian asset purchase agreement, and Tesco is expected to assume the lease for the Bolton, United Kingdom facility at the close of that asset purchase agreement. Handleman is seeking a sub-lessor for the Warrington, United Kingdom facility.

Competition

Handleman was primarily a category manager of music products, whose business was highly competitive as to both price and alternative supply arrangements. Besides competition among the Company's customers, the Company's customers competed with alternative sources from which consumers could acquire the same product, such as (1) internet direct sales, including direct-to-home shipment and direct downloading through a consumer's home computer, (2) downloading through cellular telephones, (3) music product piracy via the internet, (4) specialty retail outlets, (5) electronic specialty stores, and (6) record clubs. The market is continually introducing new methods of in-home delivery of entertainment software products. The Company was also in direct competition for sales to its customers with (1) manufacturers that bypass wholesalers and sell directly to retailers, (2) independent distributors, and (3) other category managers. In addition, some large retailers have vertically integrated so as to provide their own category management and/or in-store merchandising. Some of these companies, however, also purchase from independent category managers.

Other Developments

On May 4, 2007, the Company ceased distribution operations at its Richmond, Virginia automated distribution center facility. In accordance with accounting guidelines, the Company recorded associated shut down costs during the first quarter of fiscal 2008. Additionally, the Company recorded related severance costs in the fourth quarter of 2007, the amount of which was immaterial. The Company planned to utilize the Richmond, Virginia fixed assets, including machinery and equipment, in its other U.S. distribution facility.

Video Game Operations

Video game operations, an operating segment for Handleman Company was added as a result of the Company's acquisition of Crave Entertainment Group, Inc. on November 22, 2005. As previously discussed, the Company has retained an investment banking firm for the purpose of exploring a possible sale or other strategic options for Crave.

Crave, through one of its subsidiary companies, purchases video game software, hardware and accessories from first and third party hardware and software manufacturers, which support all Sony, Nintendo and Microsoft video game platforms. Crave specializes in the value-priced game category, which carries retail prices ranging from \$9.99 to \$19.99. As a distributor, Crave may enter into exclusive distribution agreements with these video game suppliers. Under these exclusive distribution agreements, Crave has the right to sole distribution of the agreed upon video

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software games. During the past fiscal year, exclusive distribution arrangements represented a greater portion of Crave's video game business. The agreements vary by supplier and may obligate Crave to pay minimum distribution fees or purchase a specified number of units over a designated period of time. Payments under these exclusive distribution agreements are usually made at the time the agreements are signed, at the time of manufacturing, or in some instances, at the time of product receipt by Crave. Under certain of these exclusive distribution agreements, additional payments to these suppliers may be required if pre-defined minimum purchase volumes are exceeded.

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Products are distributed from the Company's automated distribution center in Indianapolis, Indiana and are shipped directly to major retailers throughout the United States. Many retailers utilize third-party distributors, like Crave, due to the flexibility offered for distribution and packaging needs that cannot always be satisfied dealing directly with the publisher. Crave also offers its retail customers:

integrated vendor managed inventory;

direct-to-store shipments of shelf ready products;

assortment planning and product procurement;

promotional planning and execution;

merchandising and display support; and

dedicated support personnel.

Crave, through another subsidiary company, also publishes video game titles under its Crave Entertainment brand. Titles are released in the value-price category and are distributed by Crave. As a publisher, Crave incurs obligations to contracted video game software developers and, in some cases obligations to intellectual property right holders.

Under its software development agreements, payments are typically based on the achievement of defined milestones, which vary by agreement. Such milestones include payments due at the signing of the agreements, design and/or technical achievements and delivery of completed product; these advances are typically not refundable. Certain software development agreements may require Crave to make additional payments based on pre-defined sales volumes. These developed games are the property of Crave.

Under Crave's intellectual property licensing agreements, payments are made to licensors in exchange for the rights to utilize intellectual properties owned by the licensors (e.g. popular animated characters, including all designs, themes and story lines) that may be used in the development of video game software. Payments to licensors allow Crave the limited right to use these intellectual properties, and at no time does Crave take ownership of these intellectual properties. Advances under these licensing agreements typically occur at the signing of the agreements and are not refundable. Certain intellectual property licensing agreements may require Crave to make additional payments based on sales volumes.

All Other

The all other segment primarily represents REPS LLC. The Company acquired REPS during fiscal 2006. REPS provides nationwide in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers. Following the acquisition, the Company integrated the field service operations of Handleman Company's category management and distribution operations in the U.S. with the REPS organization. This integration lent itself to cost savings through synergies and allowed the Company to more efficiently service its customers. As a result of this integration, REPS performed in-store field service associated with the Company's category

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management suite of services. The REPS field service representatives visit individual retail stores and meet with store management to discuss upcoming promotions, special merchandising efforts, department changes and current programs, which will increase revenues. They also manage inventory turns by monitoring inventory levels, identifying slow moving product and returning merchandise to their customer's distribution facilities. With the determination by the Company's Board of Directors in the fourth quarter of fiscal 2008 that Handleman Company will exit the music business in North America, REPS will continue to provide in-store merchandising for customers other than Handleman Company.

* * * * *

See Management's Discussion and Analysis of Financial Condition and Results of Operations for additional information regarding the Company's activities.

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As of May 3, 2008, Handleman Company had approximately 2,600 employees, with none belonging to a labor union.

Item 1A.

RISK FACTORS

Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. The discussion in this document, in particular the discussion under Recent Developments and the related discussion of the Company's future plans, contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. There are risks associated with forward looking statements. Forward-looking statements are based on current expectations or beliefs concerning future events. Such statements can be identified by the use of terminology such as anticipate, believe, estimate, expect, intend, may, could, possible, plan, project, will, forecast and similar words or expressions. Do not place undue reliance on forward-looking statements since actual results may vary significantly from forward-looking statements.

Handleman cannot assure that it will have adequate financing arrangements with its lenders.

Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company's day-to-day operations provided that the Company is able to sell its remaining assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's liquidity would be dependent upon further amendments to its credit agreements or securing alternative funding. If these actions are unsuccessful, then the Company's ability to continue as a going concern would be in doubt.

Handleman cannot assure the successful sale of its remaining assets or that the sale of its assets will be at anticipated terms.

While Handleman is reasonably confident that it will be able to successfully sell its remaining assets, it cannot make any assurances that there will be a reasonable demand for these assets. With the decline in the music and video industries, Handleman faces risks that further declines of sales in its operating markets will hinder its ability to successfully sell its assets.

Handleman anticipates that sales of its remaining assets will be made on terms that are approved by the Board of Directors and may be conducted by competitive bidding, public sales or privately negotiated sales. The prices at which the Company will be able to sell these assets will depend largely on factors beyond the Company's control, including, without limitation, the condition of financial markets, the availability of financing to prospective purchasers of the assets, public market perceptions and limitations on transferability of certain assets. Because some of the Company's remaining assets, particularly intellectual property assets, may decline in value over time, the consummation of the sale of these assets in time to generate meaningful value is critical. In addition, the Company may not obtain as high a price for its illiquid assets as might have been obtained were the Company not seeking strategic alternatives for its various business operations.

Handleman cannot assure that there will not be any unanticipated complications in the transitions of its businesses.

While the transition of the U.S. Wal-Mart music business has been successful to date, Handleman cannot assure that there will not be unanticipated complications related to the transition of this business. Handleman may be subject to claims filed by Wal-Mart and/or Anderson related to the sale of the business, settling of accounts receivable disputes regarding customer music returns, accounts payable disputes regarding

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vendor claims or other related party claims. Similarly, as Handleman transitions its other non-Wal-Mart U.S. music customers to other suppliers, Handleman may be subject to similar risks. These risks include potential accounts receivable disputes with Handleman's former customers, accounts payable disputes with vendors and disputes with the music providers to which Handleman's former customers are transitioned.

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Handleman also faces risks related to the sale of its Canadian operations. One risk, while not anticipated, is that the Canadian Heritage Ministry could withhold its approval of the sale to a date that is later than the period in which the Canadian operation must purchase its holiday season music product. If this occurs, it could significantly impact the purchase price that Anderson is willing to offer for the Canadian business. Another risk is that the Canadian Heritage Ministry denies its approval of the transaction. This would force Handleman to identify another buyer willing to purchase the Canadian operation. If Handleman were unable to identify a purchaser, then it might be forced to liquidate the Canadian assets.

Further, Handleman faces certain risks related to the sale of its UK operations. While Handleman and Tesco have reached an agreement in principle for the sale of the UK assets, the parties' negotiations may not reach a definitive agreement at terms that are favorable to Handleman. In addition, Tesco could assert its rights pursuant to its service agreement with Handleman related to the purchase of certain of Handleman's assets. Further, as Handleman ceases its operations in the UK, Handleman must resolve payment issues related to its former ASDA greeting cards business.

The Company's decision to exit the North American music business has resulted in the termination of employee relationships. Handleman is, therefore, subject to risk of employee lawsuits. While Handleman has made every effort to comply with laws related to these situations, there is a risk that an employee might assert that Handleman terminated his/her relationship in violation of certain laws, and that Handleman is required to pay the employee damages related to the employment termination. Even if Handleman were to prevail in such matters, Handleman would have to defend itself in matters related to employee rights and benefits.

Handleman must resolve matters related to its U.S. pension plan.

Handleman Company has certain risks related to its U.S. pension plan. Handleman's pension plan is at risk related to the current economic downturn. To the extent that Handleman's pension plan has investments in volatile instruments, Handleman is at risk that its pension plan will be underfunded at any given time. Handleman is currently in the process of immunizing its pension plan thereby removing a significant portion of the economic risk. The plan will move to an 80% long-bond portfolio and 20% equity exposure from 60% equity exposure and a 40% long-bond portfolio. This significantly reduces asset/liability mismatch risk. While immunization would significantly reduce Handleman's risk related to the fluctuating market, Handleman will still be subject to certain other risks. If Handleman elects to terminate its U.S. pension plan, Handleman faces the risk that the pension plan would be significantly underfunded. If the pension plan is underfunded, then Handleman would be required to contribute cash to meet the shortfall. If Handleman elects not to terminate the plan, but does not want to continue to actively fund the pension plan, then Handleman would be required to either find an interested investor willing to purchase the pension plan from Handleman or purchase a non-participating group annuity contract for all participants. As there is not an active market for pension plan purchasers, it might be very difficult to find an investor interested in purchasing its pension plan. If Handleman purchases a non-participating group annuity contract, Handleman would be required to pay a large amount of cash to do so. Handleman's options, with the exception of purchasing a non-participating group annuity contract, increase Handleman's regulatory risk that the Pension Benefit Guaranty Corporation (PBGC) may force the U.S. plan's termination, which would require a large cash contribution to the plan.

Handleman's foreign subsidiaries will have to pass a Solvency Test in order to remit a dividend to Handleman Company, the parent company.

As foreign operations are sold and cash is generated, Handleman must establish that its foreign subsidiaries are solvent prior to them paying a dividend to Handleman. To the extent that Handleman Company is relying on this dividend as part of its cash management efforts, a foreign subsidiary's inability to remit the dividend could create substantial financial risks for Handleman's liquidity. As the solvency test relates to Handleman Canada, Handleman may have to meet its obligations related to the Canadian

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pension plan prior to the Canadian subsidiary remitting a dividend. As it relates to Handleman UK, Handleman Company may have to resolve all outstanding vendor payment disputes prior to the UK subsidiary remitting a dividend to Handleman. If foreign subsidiaries remit a dividend to Handleman during a period when such foreign subsidiaries are considered insolvent, then the Directors of those subsidiaries may be subjected to legal consequences, for which Handleman would have to provide them with indemnification.

Handleman Company may eventually not have a business operation.

As Handleman Company pursues the sale of its assets, it may eventually not have a business operation and its principal asset may consist of its cash balances. As a result, Handleman may be considered a shell company as defined in Rule 12b-2 of the Securities Exchange Act of 1934, as amended. The Company's Board of Directors intends to consider the appropriate application of the remaining cash balances, if any, including a possible distribution to shareholders after Handleman has settled all, or substantially all, of its obligations. Handleman cannot, however, provide any assurance that it will have any remaining cash to make such a distribution.

Handleman's inability to retain the services of its current personnel may impact its ability to successfully sell the assets of the Company.

Handleman's ability to successfully sell the assets of the Company is dependent, in large part, upon its ability to retain its remaining personnel. The retention of qualified personnel is particularly difficult under the current circumstances. While Handleman has offered its critical employees retention and severance plans, there is no legal obligation that would require the employee to remain employed at Handleman. In the event critical employees decided to terminate their employee relationships with Handleman, Handleman would have to retain outside consultants to perform their duties or offer a premium salary in order to hire employees to work for the Company.

Handleman may eventually rely on outside consultants and advisors to perform critical functions.

As Handleman progresses in the sale of its assets, it may become more dependent on outside consultants and advisors to perform critical functions. While Handleman anticipates that it will maintain Handleman employees in certain critical accounting, finance and tax positions, Handleman may have to rely on consultants, outside legal counsel and other contractors to perform day-to-day tasks. There is a risk that these non-Handleman employees will have interests and arrangements that may be different from the Company's shareholders' interests, including, but not limited to, other client priorities and relationships with entities that the Company may do business with in the future. Further, if the Company was unable to continue to employ qualified outside advisors and consultants to perform critical functions, the Company may be unable to meet its regulatory reporting obligations in a timely manner and the system of internal accounting controls may not function as intended.

Item 1B.

UNRESOLVED STAFF COMMENTS

Handleman Company does not have any unresolved staff comments to report.

Item 2.

PROPERTIES

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As of May 3, 2008, Handleman Company occupied leased warehouses located in Indianapolis, Indiana; Toronto, Ontario; Warrington, United Kingdom; and Bolton, United Kingdom; as well as four leased satellite offices ranging in size from 1,400 square feet to 7,500 square feet, located in the states of Minnesota, Tennessee and Arkansas. Crave Entertainment Group leases its 9,000 square foot corporate office in Newport Beach, California.

The Company is evaluating its options and alternative uses for the Warrington, UK facility for the period following the discontinuance of the ASDA music and greeting card distribution arrangements. Additionally, based on the Company's decision to exit the music business in North America, the Company

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is marketing the leases on the distribution facility in Indianapolis, Indiana and the unoccupied sales offices in Minnesota and Montreal, Quebec. Furthermore, the Company anticipates that the leases on the Toronto, Ontario and Bolton, United Kingdom distribution facilities will be assumed by Anderson and Tesco, respectively, at the close of the previously mentioned sales transactions in each of those countries.

The Company owns its 130,000 square foot corporate office building located in Troy, Michigan. During the first quarter of fiscal 2009, the Company began actively marketing the building for sale.

Item 3.

LEGAL PROCEEDINGS

See Note 12 of Notes to Consolidated Financial Statements for a discussion of the Company's contingencies.

Handleman Company is not currently involved in any legal proceedings that are material or for which it does not believe it has adequate reserves. Any other legal proceedings in which the Company is involved are 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 establishes reserves for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

Item 4.

**SUBMISSION OF MATTERS
TO A VOTE OF SECURITY HOLDERS**

During the fourth quarter of fiscal 2008, Handleman Company did not submit any matters to a vote of its security holders.

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PART II

Item 5. **MARKET FOR REGISTRANT'S COMMON EQUITY,
RELATED STOCKHOLDER MATTERS AND ISSUER
PURCHASES OF EQUITY SECURITIES**

Effective March 26, 2008, Handleman Company's stock began trading on the Pink Sheet Electronic Quotation Service, trading symbol HDLM.PK. Prior to March 19, 2008, Handleman's stock traded on the New York Stock Exchange Euronext (NYSE), under the symbol HDL. Handleman's stock was delisted by the NYSE prior to the NYSE market opening on March 25, 2008. The NYSE's action resulted from the Company's average market capitalization over a consecutive thirty trading-day period being below the NYSE minimum quantitative continued listing criteria of \$25 million.

Below is a summary of the market price of the Company's common stock:

Quarter	Fiscal Years Ended					
	May 3, 2008			April 28, 2007		
	Low	High	Close	Low	High	Close
First	\$ 4.81	\$ 7.60	\$ 4.84	\$ 6.78	\$ 9.18	\$ 7.02
Second	2.45	5.00	2.51	6.70	8.40	8.04
Third	1.21	2.56	1.40	6.50	8.97	7.50
Fourth	0.18	1.64	0.77	6.60	7.99	7.51

As of July 11, 2008, the Company had 2,603 shareholders of record.

During the fourth quarter of fiscal 2007, the Company announced that it has suspended indefinitely its quarterly cash dividends of \$0.08 per share of common stock in connection with amending its credit agreements. Pursuant to Handleman Company's credit agreements, as described in Note 8 of Notes to Consolidated Financial Statements, the Company has restrictions on its payment of cash dividends and, therefore, the suspension of quarterly cash dividend payments remains indefinite.

Below is a summary of the dividends declared during the past two fiscal years:

Quarter	Fiscal Years Ended	
	May 3, 2008	April 28, 2007
First	\$	\$.08

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Second	.08
Third	.08
Fourth	

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 Company did not repurchase any shares of its common stock during the fiscal years ended May 3, 2008 or April 28, 2007 due to the Company's cash position. The Company has repurchased 2,044,000 shares or 63% of the shares authorized under the current share repurchase program, as of May 3, 2008. Pursuant to Handleman Company's credit agreements, as previously discussed and as described in Note 8 of Notes to Consolidated Financial Statements, the Company is prohibited from repurchasing its common stock.

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Item 7.

MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company's fiscal year 2008, which consisted of 53 weeks, ended on May 3, 2008 and its fiscal year 2007, which consisted of 52 weeks, ended on April 28, 2007.

During fiscal 2008, Handleman Company had the following reporting segments: category management and distribution operations, video game operations and all other. As a category manager and distributor of product, the Company created value for its customers by leveraging its core competencies of logistic services, field services and intellectual services. During fiscal 2008, the Company predominately provided full category management services for prerecorded music product to leading retail chains in the United States (U.S.), United Kingdom (UK) and Canada.

In recent years, music industry sales have declined at double-digit rates as the industry was impacted by digital distribution, downloading and piracy. In addition, the Company's gross margins were compressed because lower-margin promotional products became a greater proportion of annual sales. This level of continued erosion of CD music sales is expected to continue into the foreseeable future. In response to this dramatic decline, the Company implemented significant cost reduction plans to reduce expenses and streamline operations. These plans included work force reductions; the consolidation of the operations of two U.S. automated distribution facilities into one facility; the reduction of benefit programs and the realignment of medical plans; initiatives to reduce customer product returns; and various other cost cutting initiatives. However, the reduction in music sales volume and loss of gross margin outpaced the Company's ability to reduce overhead costs, and as a result, the Company experienced steep operating losses in the past two fiscal years.

The Company's customers have responded to the decline in music industry sales by contracting the amount of retail space devoted to music sales.

Additionally, the Company violated certain debt covenants within its credit agreements in the fourth quarter of fiscal 2008. Those violations were cured soon thereafter by an amendment to the credit facilities. In recent months, trade creditors have expressed concern about whether the Company might be contemplating or be required to file a bankruptcy proceeding. As a result, the Company became concerned about whether it would have access to sufficient financing and vendor credit to meet its business needs.

As a result of concerns about the prospects for the music business and the availability of financing, in April 2008 the Board of Directors of the Company approved that management proceed with the sale of the U.S. and Canadian operations, which were actively being marketed as of May 3, 2008. On June 2, 2008, Handleman announced that it is exiting the music business in North America and that it had sold a portion of its U.S. inventory and its U.S. music business related to Wal-Mart to Anderson Merchandisers L.P. (Anderson). Handleman also announced that it will work with its other non-Wal-Mart U.S. customers to achieve a smooth transition to other music suppliers by the end of August 2008. Further, Handleman has reached a definitive agreement with Anderson for the sale of all of the inventory and fixed assets and all operations of its Canadian subsidiary, Handleman Canada. The closing on the sale of assets of Handleman Canada is subject to Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009.

In accordance with accounting guidance, the U.S. and Canadian operations have been classified as discontinued operations in the Company's Consolidated Statements of Operations for all periods presented. In addition, the U.S. and Canadian assets and liabilities have been classified as held for sale in the Company's Consolidated Balance Sheet as of May 3, 2008.

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Handleman believes that its decision to exit the music business was the best strategic decision for its shareholders. Further, Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company's day-to-day operations provided the Company is able to sell its assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's

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liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If the Company is able to generate cash proceeds in excess of what is needed to satisfy the Company's debt obligations, the Company is considering the possibility of distributing any such proceeds to shareholders rather than pursue reinvestment opportunities. Whether there will be any excess cash proceeds for distribution to shareholders is subject to a number of material risks and uncertainties that may prevent any such distribution from occurring. Accordingly, while the Company believes that a cash distribution is possible, actual results may differ from current estimates, perhaps materially.

Within the category management and distribution operations segment, the Company's revenues were categorized as follows: (i) Category Management Revenues—sales to customers who received the full suite of category management services included with their purchase of Handleman-owned tangible products (primarily music); this suite of services included assortment management, product warehousing, ticketing, direct to store shipments, in-store field service and customer returns management; (ii) Greeting Cards Revenues—sales to customers who received only certain category management services with the purchase of Handleman-owned greeting cards, including assortment management on replenishment orders, product warehousing, direct to store shipments, in-store field service and customer returns management; (iii) Fee-for-Services Revenues—revenues generated from the sale of services performed by the Company, such as in-store field service and/or warehousing and distribution of customer-owned product; in these arrangements the customer did not purchase tangible product from Handleman Company.

Handleman UK, in conjunction with its customer (ASDA), determined that their business relationship related to the greeting cards business would terminate in May 2008. Under this arrangement, which began in October 2006, Handleman UK provided the distribution and servicing of greeting cards to ASDA stores. The Company was unable to negotiate a fee arrangement with ASDA that would be sufficient to cover the operating costs related to that business. Greeting card sales to ASDA represented \$71.4 million of the Company's consolidated revenues fiscal 2008, and \$39.3 million of consolidated revenues for the fiscal year ended April 28, 2007.

On May 24, 2007, the Company announced that Handleman UK and ASDA decided not to continue their music supply arrangement. Under this arrangement, Handleman UK provided category management and distribution of music CDs and, to a limited extent, DVDs to ASDA stores. The decision not to continue the music supply arrangement was due to the inability of Handleman UK and ASDA to reach terms that were mutually beneficial. Handleman UK continued to provide music category management and distribution services to ASDA through August 2007. Music and DVD sales to ASDA represented \$57.3 million of the Company's consolidated revenues for the first four months of fiscal 2008 (through the agreed upon termination date), and \$268.0 million of the Company's consolidated revenues during the fiscal year ended April 28, 2007. As of May 3, 2008, the Company has realized a reduction in working capital attributable to the discontinuance of the ASDA music and video business in the amount of approximately \$44.3 million primarily related to inventory and accounts receivable. The cash generated from this reduction was used primarily to fund additional seasonal working capital requirements for the Company's video games operations and to repay debt.

See Note 5 of Notes to Consolidated Financial Statements for additional information related to the termination of the ASDA greeting cards and music supply arrangements.

Handleman UK began providing distribution, replenishment and store merchandising services to Tesco in support of its entertainment business - specifically music, video and video games in the first quarter of fiscal 2008. Tesco, the largest supermarket and general merchandise retailer in the United Kingdom, is also one of the world's leading international retailers. Under the arrangement, Tesco retained ownership title to the inventory, which was housed in and distributed from a Handleman UK distribution facility. This arrangement was characterized as a fee-for-service model, whereby Handleman UK's revenue was based upon fee per unit charges related to distribution services and hourly rate charges related to merchandising services provided by Handleman UK's field sales organization. This agreement allowed Handleman Company to extend its core services to over 700 Tesco stores in the United Kingdom. Revenues for this new business model with Tesco generated \$50.0 million of consolidated revenues for the Company since inception in the first quarter of fiscal 2008.

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Subsequently, in the first quarter of fiscal 2009, Handleman began actively marketing for sale certain Handleman UK assets, began negotiations and reached an agreement in principle to sell certain assets and operations of Handleman UK related to the Tesco business, and certain of the Company's corporate intellectual properties to Tesco. Following its discontinuance of business with ASDA and Tesco, Handleman UK will have no on-going business operations and Handleman UK will be wound down as quickly as possible.

The video game operations are related to Crave Entertainment Group, Inc. (Crave). This segment generates revenues from the sale and distribution of Handleman-owned video game hardware, software and accessories. Product is primarily shipped directly to individual stores. During the fourth quarter of fiscal 2008, Handleman retained an investment banking firm for the purpose of exploring a possible sale or other strategic options for Crave and began actively marketing Crave in June 2008. There is a reasonable likelihood that upon the sale of Crave, a loss will be incurred because the carrying value of the entity will not be recovered.

The all other segment primarily represents REPS LLC (REPS). REPS predominately generates revenues from the in-store merchandising of home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers. During the first quarter of fiscal 2009, the Company retained the same investment banking firm to explore a possible sale or other strategic initiatives related to REPS. There is a reasonable likelihood that upon the sale of REPS, a loss will be incurred because the carrying value of the entity will not be recovered.

The following table sets forth revenues from continuing operations and the percentage contribution to consolidated revenues for the fiscal years ended May 3, 2008 and April 28, 2007 (in millions of dollars):

	Fiscal Years Ended	
	May 3, 2008 (53 weeks)	April 28, 2007 (52 weeks)
Category management and distribution operations	\$ 219.5	\$ 322.7
<i>% of Total</i>	44.4	57.8
Video game operations	259.6	219.7
<i>% of Total</i>	52.5	39.3
All other	44.2	45.2
<i>% of Total</i>	8.9	8.1
Corporate income, including eliminations	(28.7)	(29.2)
<i>% of Total</i>	(5.8)	(5.2)
Total revenues from continuing operations	\$ 494.6	\$ 558.4

Revenues from continuing operations by geographic area, which is based upon the country in which the legal subsidiary is domiciled, for the fiscal years ended May 3, 2008 and April 28, 2007 are as follows (in millions of dollars):

Fiscal Years Ended
May 3, 2008 (53

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	weeks) <u> </u>	April 28, 2007 <u>(52 weeks)</u>
United States	\$ 275.0	\$ 235.7
United Kingdom	219.4	322.6
Other	0.2	0.1
	<u> </u>	<u> </u>
Total revenues from continuing operations	<u>\$ 494.6</u>	<u>\$ 558.4</u>

See Note 13 of Notes to Consolidated Financial Statements for information regarding long-lived assets by geographic region.

Table of Contents**Critical Accounting Estimates**

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. The Company continually evaluates its estimates and assumptions, which are based on historical experience and other various factors that are believed to be reasonable under the circumstances. The results of these estimates and assumptions form the basis for making judgments about the carrying values of certain assets and liabilities. Historically, actual results have not significantly deviated from those determined using the estimates and assumptions described.

The following are the Company's critical accounting estimates:

Recognition of Revenues and Future Returns Handleman Company recognizes revenues upon delivery of product to its customers (FOB destination). As a category manager of music product and distributor of video game product, the Company coordinates freight service for product purchased by its customers with the assumption of risk effectively remaining with the Company until its customers receive the product. Customer inspection of merchandise is not a condition of the sale. The Company also manages product returns that include both salable and non-salable product, as well as damaged merchandise, and provides credits for such customer returns. The Company reduces revenues and direct product costs for estimated future returns at the time of revenue recognition. The estimate for future returns includes both salable and non-salable product. On a quarterly basis, the Company reviews the estimate for future returns and records adjustments as necessary. The significant factors estimated by the Company when preparing its future returns reserve are (i) customer return rate and (ii) gross margin percentage on customer returns. For each factor, the Company considers historical trends and future forecasts when calculating the required reserve amount. Routinely, the estimates used in these factors are compared to actual results, and any variances have typically not been significant.

The effect of the indicated increase/(decrease) in these factors is shown below (in thousands of dollars):

	Percentage Point Change	Impact on Fiscal 2008 Income from Continuing And Discontinued Operations
Customer Return Rate	+/-1 pt.	\$(291)/\$291
Gross Margin Rate on Customer Returns	+/-1 pt.	\$(194)/\$194

Stock-based Compensation The Company has stock-based compensation plans in the form of stock options, performance shares, performance units and restricted stock. Beginning in fiscal 2007, the Company adopted the fair value based method of accounting for stock compensation plans in accordance with Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment (reissued 2004), using the modified prospective transition method. Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based compensation in accordance with SFAS No. 123, beginning in fiscal 2004, on a prospective basis. Under the fair value method, the Company measures awards as of the grant date utilizing the Black-Scholes option pricing model and compensation expense is recognized over the service period, which is usually the vesting period. The Black-Scholes model requires various highly judgmental assumptions including volatility, forfeiture rates and expected option life. If any of the assumptions used were to change significantly, or if a different valuation model were used, stock-based compensation expense may differ materially from that recorded in the current period. The Company includes the value of stock-based compensation in compensation expense; however, stock-based awards granted prior to adoption of the fair value method are accounted for under the variable accounting method. Under variable accounting, the excess of market value over the option price of outstanding stock

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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 continues to be adjusted to the market value of the options until the options are either exercised or terminated. Stock-based compensation expense is included as a component of Selling, general and administrative expenses in the Company's Consolidated Statements of Operations.

Pension Expense The determination of pension obligation, costs and liabilities related to the Company's pension plans is dependent upon its selection of certain assumptions provided to the Company's third party actuaries. These assumptions may have an effect on the amount and timing of future contributions. Assumptions include discount rate, expected long-term rate of return on plan assets, rate of compensation increase, average remaining service period and life expectancy. The discount rate assumption is based primarily on the results of a cash flow matching analysis, which matches the future cash outflows of the plan to a yield curve comprised of a hypothetical portfolio of zero coupon bonds. The expected long-term rate of return for the Company's pension plan assets is based on historical returns for the different asset classes, weighted based on the median of the target allocation for each asset class.

The compensation rate reflects the Company's long-term actual experience and near-term outlook. During fiscal 2007 and fiscal 2008, the Company approved amendments to freeze U.S. and Canadian service-based future benefit plans, respectively. Accordingly, the amortization period was changed from the average remaining service period of active participants to the average remaining lifetime of all participants. The average remaining lifetime is the average number of years remaining to be lived on the basis of a given set of age-specific rate of dying, which was calculated using the 1994 Group Annuity Reserving for Males and Females. Actual results could differ from the Company's assumptions. Such differences are accumulated and amortized over future periods in accordance with accounting principles generally accepted in the United States of America, and therefore, generally affect the Company's recognized expense and recorded obligation in future periods. The Company adopted SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132R, as of April 28, 2007. In accordance with SFAS No. 158, the Company recognizes the over funded or under funded status of its pension plans as an asset or liability, with an offsetting adjustment to Accumulated other comprehensive income in the Company's Consolidated Balance Sheets.

The May 3, 2008 funded status of the Company's pension plans is affected by May 3, 2008 assumptions. Pension expense for fiscal 2008 is based on the plan design and assumptions as of April 28, 2007. Note that the following sensitivities may be asymmetric and are specific to fiscal 2008. They also may not be additive, so the impact of changing multiple factors simultaneously cannot be calculated by combining the individual sensitivities shown. The effect of the indicated increase/(decrease) in selected factors is shown below (in thousands of dollars):

	May 3, 2008		
	Percentage Point Change	Pension Plans Funded Status and Equity	Impact on Fiscal 2008 Expense in Continuing and Discontinued Operations
Discount rate	+/-1 pt.	\$6,694/\$(8,327)	\$(719)/\$419
Actual return on assets	+/-1 pt.	\$496/\$(495)	\$(55)/\$56
Expected return on assets	+/-1 pt.		\$(610)/\$610

The foregoing indicates that changes in the discount rate can have a significant effect on the funded status of the Company's pension plans, stockholders' equity and expense. The Company cannot predict these bond yields or investment returns, and therefore, cannot reasonably estimate whether adjustments to its stockholders' equity in subsequent years will be significant.

Income Taxes The provision for income taxes is based on reported income before income taxes. Deferred income taxes are provided for the effect of temporary differences between the amounts of assets and liabilities recognized for financial reporting purposes and amounts recognized for income tax

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purposes. Valuation allowances are recognized to reduce deferred tax assets when it is more likely than not that the assets will not be realized. In assessing the likelihood of realization, consideration is given to all available evidence including estimates of future taxable income and the character of income needed to realize future benefits. The calculation of current and deferred tax assets (including valuation allowances) and liabilities requires management to apply significant judgment related to the application of complex tax laws, changes in tax laws or related interpretations, uncertainties related to the outcomes of tax audits and changes in the Company's operations or other facts and circumstances. Further, management must continually monitor changes in these factors. Changes in such factors may result in changes to management estimates and could require the Company to adjust its tax assets and liabilities and record additional income tax expense or benefits. With the adoption of FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, in fiscal 2008, Handleman Company makes assumptions about individual tax positions before any part of the related benefit can be recognized in its financial statements. A company must consider whether it is more likely than not that a tax position will be sustained upon examination by a taxing authority. In accordance with FIN No. 48, significant judgment is required in assessing the timing and amounts of deductible and taxable items. The Company establishes reserves when, despite its belief that its tax return positions are supportable, it is determined that certain positions may be successfully challenged by the taxing authorities. When facts and circumstances change, the Company adjusts these reserves through its provision for income taxes.

Inventory Valuation Merchandise inventories are recorded at the lower of cost (average cost method) or market. The Company accounts for inventories using the full cost method that includes costs associated with acquiring and preparing inventory for distribution. Substantially, all of the Company's inventory consists of compact discs, and video game hardware and software, which are not substandard from a functional standpoint. Typically, the Company's music suppliers offer return privileges for excess inventory quantities. Video game hardware and software are generally purchased as a one-way sale. Inventory reserves are provided for the risk that exists related to the carrying value of non-returnable slow moving or excess inventory that may exceed market value, although the effect of markdowns is minimized since the Company's music vendors generally offer some level of return allowances and price protection. On a quarterly basis, management reviews the Company's carrying value of inventory from a lower of cost or market perspective and makes any necessary carrying value adjustments. When management determines the salability of inventory has diminished, markdowns are recorded at that time. Factors considered in the determination of markdowns include current and anticipated demand, customer preferences, the ability to make returns to vendors for credit, age of merchandise, timing of last purchase, open purchase order status, anticipated sell-off, seasonality and industry trends. While the Company believes the assumptions it uses to estimate the net realizable value of its inventory is reasonable, the use of different assumptions or estimates could produce different results and the amounts realized upon the ultimate sale of the inventory may differ materially from that recorded in the current period. Routinely the estimates used in these factors are reasonable when compared to actual results, and variances have typically not been significant. The Company also conducts physical inventory counts on a quarterly basis.

Long-Lived Assets At the end of each fiscal year, or as business conditions warrant, the Company performs an impairment test for goodwill. This test relies on assumptions for growth and discount rate to create multiple sensitivity scenarios. These scenarios are averaged to arrive at a fair value of goodwill, which is compared to the carrying value. The growth assumption is based on forecasted operating income (which approximates cash flows) and an assumed growth rate through perpetuity for years greater than five. The discount rate is a blend of the Company's incremental borrowing rate and the Company's weighted average cost of capital at the measurement date. The goodwill impairment analyses performed by the Company as of May 3, 2008 resulted in fair values that did not exceed the carrying values of its Handleman UK and Crave reporting units. Reasonable changes in any of the assumptions underlying these estimates would increase the fair values, but would not change the impairment results. Furthermore, the Company's carrying value for Handleman UK and Crave, after application of the goodwill impairment charges, does not purport to reflect the fair market value of these entities.

At the end of each year or as business conditions warrant, the Company evaluates the carrying value of long-lived assets for potential impairment by considering several factors, including management's plans for future operations, recent operating results, market trends and other economic facts relating to the

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operation to which the assets apply. Recoverability of these assets is measured by a comparison of the carrying amount of such assets to the future undiscounted net cash flows expected to be generated by the assets. If such assets are deemed to be impaired as a result of this measurement, the impairment that would be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets. The fair value is estimated based on what the Company believes a willing third party would pay to acquire the assets. When determining future cash flow estimates, the Company considers historical results adjusted to reflect current and anticipated operating conditions. Estimating future cash flows requires significant judgment by the Company in such areas as future economic conditions, industry-specific conditions, product pricing and necessary capital expenditures. The use of different assumptions or estimates for future cash flows could produce different impairment amounts (or none at all) for long-lived assets. The long-lived asset impairment analyses performed as of May 3, 2008, resulted in carrying values that exceeded the estimated fair value for the U.S., Handleman UK and certain corporate assets.

A third-party valuation was prepared for the Crave and REPS intangible assets and management determined that these assets were not impaired because the undiscounted cash flows exceeded their carrying amounts. Accordingly, no impairment charge was recorded during fiscal 2008 nor was any impairment charge previously recorded in fiscal 2007.

As a result of these goodwill and long-lived impairment analyses, the Company recorded significant impairment charges during the fourth quarter of fiscal 2008. See Notes 4 and 6 of Notes to Consolidated Financial Statements for additional information related to these charges. No significant impairment charges were recorded in fiscal 2007 as a result of the annual impairment testing at the end of that year.

Comparison of Fiscal 2008 with Fiscal 2007

Unless otherwise noted, the following discussion relates only to results from continuing operations, which includes Handleman UK, Crave, REPS and corporate.

Consolidated revenues from continuing operations for fiscal 2008 were \$494.6 million, compared to \$558.4 million for fiscal 2007. Revenues in the category management and distribution operations segment decreased to \$219.5 million in this fiscal year from \$322.7 million during the same period last year. This decrease was primarily due to the discontinuance of the ASDA music supply arrangement in the UK in early fiscal 2008 resulting in a decrease in revenues of \$210.7 million. This decrease was offset in part, by revenues from the fee-for-services model, which had an increase of \$49.7 million, chiefly related to a new arrangement to distribute and service entertainment product for Tesco in the UK, which began in the first quarter of fiscal 2008. The distribution and servicing of the greeting cards business in the UK also had an increase in revenues of \$32.1 million during fiscal 2008 predominantly due to a full year of revenues in fiscal 2008 (the greeting cards business began in the latter part of fiscal 2007). The remainder of the offset was primarily due to an increase in revenues of \$15.2 million in the UK from non-ASDA category management customers and a \$7.7 million reduction in future returns reserve requirements in the UK.

Revenues in the video game operations segment were \$259.6 million in fiscal 2008, compared to \$219.7 million in fiscal 2007. This increase was primarily due to (i) increased exclusive distribution revenues of \$18.4 million driven by the initiative in the current fiscal year to secure additional exclusive distribution arrangements related to video game software products and the success of those titles, (ii) a \$15.1 million improvement in shipments of hardware bundles that combine a video game console with software titles and/or game accessories due to the popularity of the Wii, PS2 and PS3 video game hardware platforms, and (iii) increased revenues related to internally developed video game software of \$8.1 million.

Consolidated direct product costs from continuing operations as a percentage of revenues was 83.1% for fiscal 2008, compared to 90.7% for fiscal 2007. This decrease in consolidated direct product costs as a percentage of revenues was substantially driven by decreases in both the

category management and

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distribution operations segment, and the video game operations segment. Direct product costs as a percentage of revenues in the category management and distribution segment decreased to 79.6% from 91.9% last year. This decrease was primarily due to fee-for-services and greeting cards revenues in the UK, which began in fiscal 2008 and the latter part of fiscal 2007, respectively; these businesses carry lower direct product costs as a percentage of revenues compared to direct product costs for the music category management business. Fee-for-services revenues and greeting cards revenues contributed 7.3 and 2.7 percentage points to the lower direct product costs as a percentage of revenues, respectively. The decrease was also a result of lower UK inventory reserves this year, primarily driven by lower markdown costs recorded in fiscal 2008 in the amount of \$9.8 million predominately related to the discontinuance of the music distribution arrangement with ASDA in the UK; this reduction in reserves contributed 2.7 percentage points to the lower direct product costs as a percentage of revenues. Direct product costs as a percentage of revenues in the video game operations segment decreased to 87.8% from 92.1% last year. This favorable change was predominately due to increased sales from exclusive distribution and internally developed video game software titles, both of which carry lower overall costs as a percentage of revenues. Consolidated direct product costs for fiscal 2008 and 2007 included costs associated with acquiring and preparing inventory for distribution of \$3.1 million and \$5.5 million, respectively.

Consolidated selling, general and administrative (SG&A) expenses from continuing operations were \$168.6 million, or 34.1% of revenues, for fiscal 2008, compared to \$173.9 million, or 31.1% of revenues, for fiscal 2007. This dollar decrease was principally due to lower corporate and REPS (the all other segment) SG&A expenses, partially offset by an increase in category management and distribution operations segment SG&A expenses. Corporate SG&A expenses decreased to \$65.9 million in fiscal 2008 from \$76.1 million in fiscal 2007. This decrease was primarily related to a reduction in stock-based compensation expense of \$4.4 million mainly resulting from a decrease in the price of the Company's common stock, a reduction in outside information technology costs of \$4.4 million predominantly due to cost savings initiatives, a reduction in certain other corporate expenses of \$3.9 million related to the Company's various cost cutting plans, a reduction in outside consulting costs of \$1.4 million, and \$1.0 million in foreign currency exchange gains related to intercompany accounts receivable and accounts payable balances. These corporate reductions were partially offset by the write off of a loan receivable of \$3.2 million related to the Company's equity investment and increased bank fees of \$2.8 million related to the Company's loan agreement entered into on April 30, 2007. REPS SG&A expenses decreased to \$20.6 million for fiscal 2008 from \$25.0 million in fiscal 2007 primarily due to the implementation of cost cutting initiatives. Category management and distribution operations segment SG&A expenses increased to \$57.1 million in fiscal 2008 from \$47.8 million in fiscal 2007. This increase was due to higher SG&A expenses in the UK of \$9.3 million. The fee-for-services business arrangement with Tesco in the UK added \$17.2 million in SG&A expenses this fiscal year, as well as higher SG&A expenses related to the greeting cards business with ASDA of \$7.3 million resulting from a full year of business activity this fiscal year (the greeting card business began in the latter part of fiscal 2007). These increases in UK SG&A expenses were partially offset by lower SG&A expenses in the UK related to the discontinuance of the ASDA music and video category management business in the amount of \$15.2 million. SG&A expenses for the video game operations segment of \$26.2 million for fiscal 2008 approximated the SG&A expenses of \$26.1 million for fiscal 2007.

Impairment of goodwill was \$30.0 million in fiscal 2008, compared to no goodwill impairment in fiscal 2007. The Company performed its annual goodwill impairment tests as of the fourth quarter of fiscal 2008 and determined that the fair value of the Crave and Handleman UK subsidiaries did not exceed their carrying values. As a result, the goodwill was deemed impaired and the Company recorded goodwill impairment charges in the fourth quarter of fiscal 2008 of \$26.6 million related to Crave and \$3.4 million related to Handleman UK. See Note 6 of Notes to Consolidated Financial Statements for additional information related to the impairment of goodwill.

Impairment of subsidiary assets was \$17.2 million in fiscal 2008, compared to no impairment of subsidiary assets in fiscal 2007. The Company performed its impairment testing of long-lived assets as of the fourth quarter of fiscal 2008. Based on the Company's new outlook, its decision in the fourth quarter of fiscal 2008 to exit the music business in North America, and projected forecasts of cash flows, the Company determined that certain fixed assets in the U.S. (including corporate) and UK were impaired and recorded

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impairment charges totaling \$15.8 million during the fourth quarter of fiscal 2008. In addition, the Company recorded an impairment charge of \$1.4 million during the third quarter of fiscal 2008 as a result of Handleman UK and ASDA agreeing to discontinue the greeting cards business in the UK. See Note 4 of Notes to Consolidated Financial Statements for additional information related to the impairment of subsidiary assets.

Loss before interest expense, investment (loss) income and income taxes (operating loss) from continuing operations for fiscal 2008 was \$132.4 million, compared to an operating loss of \$121.9 million for fiscal 2007.

Interest expense from continuing operations for fiscal 2008 decreased to \$3.0 million from \$4.9 million for fiscal 2007. This decrease was mainly due to the increase in operating income in fiscal 2008 for Crave and Handleman UK, cash generated from the discontinuance of the ASDA music and video business in the UK and corporate cost cutting initiatives, all of which resulted in lower working capital requirements and therefore, lower borrowings, which in turn decreased the year-over-year interest expense. However, interest expense for discontinued operations was \$11.7 million for fiscal 2008, compared to \$3.1 million for fiscal 2007. This increase in interest expense was due to (i) borrowings under the Company's new credit agreements, which carry materially higher interest rates than those incurred under its previous credit facility, which terminated on April 30, 2007; and (ii) higher working capital requirements for the U.S. and Canada. In addition, interest expense from discontinued operations for fiscal 2008 included fees associated with the unused portion of its credit facility, as well as, prepayment premiums on the early payment of term debt. There were no comparable fees in fiscal 2007.

Investment loss for fiscal 2008 was \$1.9 million, compared to investment income of \$1.5 million for fiscal 2007. The fiscal 2008 investment loss is comprised of an impairment charge related to the Company's minority interest in an equity investment totaling \$3.8 million. This was partially offset by investment income of \$1.0 million related to the gain on the sale of an investment in PRN, a company that provides in-store media networks; and interest income and SERP market value adjustments totaling \$0.6 million and \$0.3 million, respectively. The fiscal 2007 investment income is primarily comprised of SERP market value adjustments and interest income totaling \$0.9 million and \$0.5 million, respectively.

The effective income tax rates from continuing operations for fiscal 2008 and 2007 were 7.8% and 20.2%, respectively. In fiscal 2008 a full valuation allowance was recorded on the Company's deferred tax assets. The income tax benefit in continuing operations reflects the recognition of a U.S. tax benefit, which will be utilized to offset the income tax expense recorded on U.S. taxable income in discontinued operations. Additionally, although the Company recorded a full valuation allowance in fiscal 2008, the deferred tax liability in existence as of the end of fiscal 2007 reduced the impact on income tax expense in fiscal 2008 to the extent of this deferred tax liability balance. The income tax benefit in fiscal 2007 mainly resulted from tax benefits recognized on the operating loss incurred in fiscal 2007, partially offset by (i) a valuation allowance in the amount of \$11.5 million recorded on deferred tax assets primarily related to net operating losses in the UK, which the Company felt that it may not realize, (ii) valuation allowances of \$3.8 million placed on foreign tax credits during the fourth quarter of fiscal 2007, (iii) income tax expense recorded in the amount of \$1.4 million related to the withholding of foreign taxes on accumulated undistributed earnings of foreign subsidiaries no longer considered permanently reinvested, and (iv) \$1.4 million in additional tax expense related to non-deductible stock-based compensation expense.

For fiscal 2008, the Company had a net loss from continuing operations of \$126.6 million, or \$6.22 per diluted share, compared to a net loss of \$100.0 million, or \$4.96 per diluted share, for fiscal 2007.

Other

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Accounts receivable at May 3, 2008 was \$62.5 million, compared to \$236.1 million at April 28, 2007. This decrease was mainly due to the reclassification of accounts receivable to Assets held for sale in the amount of \$94.4 million resulting from the Company's decision to exit the music business in North America, a \$57.2 million decline in the UK accounts receivable balance related to the discontinuance of the ASDA music and video category management business, as well as a \$19.4 million decrease in the U.S. accounts receivable balance mainly attributable to the overall year over year reduction in sales volume.

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Merchandise inventories decreased to \$29.4 million at May 3, 2008 from \$115.5 million at April 28, 2007. This decrease was principally due to the reclassification of merchandise inventories to Assets held for sale in the amount of \$37.8 million resulting from the Company's decision to exit the music business in North America, an overall reduction in U.S. merchandise inventories in the amount of \$23.9 million resulting from ongoing efforts to minimize inventory levels and a decrease in UK merchandise inventories of \$23.6 million due to the discontinuance of the ASDA music and video business.

Other current assets decreased to \$10.2 million at May 3, 2008 from \$17.7 million at April 28, 2007. This decrease was primarily due to lower income taxes receivable of \$7.5 million.

Assets held for sale totaled \$139.9 million at May 3, 2008 while no balance existed at April 28, 2007. This increase was due to the Company's decision to exit the music business in North America. In accordance with accounting guidance, the U.S. and Canadian assets were reclassified as assets held for sale as of May 3, 2008. See Note 3 of Notes to Consolidated Financial Statements for a detailed description of this line item.

Property and equipment, net decreased to \$28.9 million at May 3, 2008 from \$65.1 million at April 28, 2007. This decrease was predominantly due to the \$16.0 million impairment of fixed assets in the U.S. related to the Company's decision to exit the music business in North America, depreciation expense in excess of fixed asset additions totaling \$10.1 million, the \$7.6 million reclassification of U.S. and Canadian assets to Assets held for sale, the \$1.4 million impairment of UK fixed assets related to greeting cards and \$1.3 million impairment of UK assets for the potential sale to Tesco. See Notes 2 and 3 of Notes to Consolidated Financial Statements for a detailed discussion related to these items.

Goodwill, net at May 3, 2008 was \$6.9 million, compared to \$36.9 million at April 28, 2007. This decrease was due to the impairment of goodwill related to Crave and Handleman UK in the amounts of \$26.6 million and \$3.4 million, respectively. See Note 6 of Notes to Consolidated Financial Statements for a detailed discussion of these impairment charges.

Other assets, net decreased to \$14.8 million at May 3, 2008 from \$20.2 million at April 28, 2007. The decrease resulted from settlement payments made during this fiscal year from the Company's Supplemental Executive Retirement Plan, which contributed \$5.5 million to the change in Other assets, net; the Company's write-off of its \$4.1 million minority interest in an equity investment; and a \$1.9 million reduction in bank fees, which were written-off as a result of amendments to the Company's credit agreements entered into on April 30, 2007. These decreases were partially offset by an increase in deferred tax assets of \$4.8 million and an increase in prepaid pension costs of \$1.3 million.

Debt, current portion at May 3, 2008 totaled \$63.7 million, compared to \$106.9 million at April 28, 2007. This reduction was mainly driven by the cash generated from the discontinuance of the ASDA music and video business, which was used to reduce borrowings, as well as the Company's efforts to minimize overall working capital requirements.

Accounts payable was \$31.0 million at May 3, 2008, compared to \$159.4 million at April 28, 2007. This decrease was primarily due to the reclassification of accounts payable to Liabilities held for sale in the amount of \$56.8 million resulting from the Company's decision to exit the music business in North America; a \$28.1 million decrease in the UK accounts payable balance related to the discontinuance of the ASDA music supply arrangement, as previously discussed; a decrease in the Crave accounts payable balance of \$16.2 million due to cash in advance payment terms for a greater portion of its inventory purchases; a reduction in U.S. accounts payable of \$12.8 million primarily driven by the Company's efforts to minimize inventory levels and a reduction in corporate accounts payable of \$7.6 million primarily driven by lower bank fees.

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Accrued and other liabilities was \$23.5 million at May 3, 2008, compared to \$31.2 million at April 28, 2007. This decrease was primarily due to the reclassification of accrued and other liabilities to Liabilities held for sale in the amount of \$5.5 million resulting from the Company's decision to exit the music business in North America, lower payroll related accruals of \$3.8 million and lower accrued legal expense of \$1.1 million. The decrease was partially offset by higher income tax payables of \$2.1 million.

Liabilities held for sale totaled \$62.3 million at May 3, 2008 while no balance existed at April 28, 2007. This increase was due to the Company's decision to exit the music business in North America. In accordance with accounting guidance, the U.S. and Canadian liabilities were reclassified as held for sale as of May 3, 2008. See Note 3 of Notes to Consolidated Financial Statements for a detailed discussion related to this line item.

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The Company did not repurchase any shares of its common stock during fiscal 2008 or fiscal 2007. The Company has repurchased 2,044,000 shares, or 63% of the shares authorized under the current 15% share repurchase program authorized by the Board of Directors. The credit agreements restrict the Company from repurchasing its common stock. At this time, the Company has no plans to resume stock repurchases. See Note 8 of Notes to Consolidated Financial Statements for additional information related to these credit agreements.

The Company is not currently involved in any legal proceedings that are material or for which it does not believe it has adequate reserves. Any other legal proceedings in which the Company is involved are 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 establishes reserves for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

Liquidity and Capital Resources

On April 30, 2007, Handleman Company and certain of its subsidiaries entered into two, five-year credit agreements that constituted a \$250 million multi-tranche credit facility. The credit agreements are with Silver Point Finance, LLC and General Electric Capital Corporation. Company borrowings under the agreements are limited by the collateral value of certain assets less reserves with a maximum of \$223,306,000 as of May 3, 2008. Absent this multi-year credit facility, the Company would have violated its debt covenants under its previous credit agreements. Also, on April 30, 2007, Handleman Company terminated the amended and restated credit agreements dated November 22, 2005 with its lenders and repaid all amounts outstanding under those agreements. The collateral value of certain assets less reserves as of May 3, 2008 was \$76,318,000. A borrowing base certificate, which details the value of collateral assets, is required daily from the Company to support all debt outstanding.

Subsequent to May 3, 2008, the Company entered into a Sixth, Seventh, Eighth, Ninth and Tenth Amendment to its credit agreements. The Tenth Amendment, among other provisions, waived an event of default that existed at May 3, 2008 that related to the amount of capital expenditures, license advances, exclusive distribution advances and software development costs allowed during the period of January 1, 2008 to May 31, 2008. The Company intends to sell its significant assets, which include Crave, Handleman Canada, REPS and Handleman UK. If the Company is not able to complete those sales transactions by October 31, 2008, then the Company projects that it will not comply with a Tenth Amendment covenant that requires a \$70 million minimum asset coverage on and after October 31, 2008. The Company would seek to amend its credit agreement to prevent an event of default, but cannot make any assurances that its lender would agree to an amendment. See Note 8 of Notes to Consolidated Financial Statements for additional information related to these two credit agreements.

As previously discussed, the Board of Directors of the Company approved, in the fourth quarter of fiscal 2008, the discontinuance of the music business in North America. Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company's day-to-day business activities provided the Company is able to sell its remaining assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's liquidity would be dependent upon further amendments to its credit agreements or securing alternative funding. If these actions are unsuccessful, then the Company's ability to continue as a going concern could be in doubt.

The Company had borrowings of \$63.7 million and \$106.9 million outstanding as of May 3, 2008 and April 28, 2007, respectively, both of which were classified as current liabilities at each of these balance sheet dates.

As of May 3, 2008, the Company had excess availability under its credit agreements to borrow an additional \$12.6 million. After the last holiday season, as anticipated, the Company experienced a significant reduction in its collateral assets, primarily due to its collection of accounts

receivable balances and an overall reduction in inventory levels, as well as a significant increase in its cash position. This

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reduction in working capital led to the Company's request for a fifth amendment. This amendment, which is described in Note 8 of Notes to Consolidated Financial Statements, also required the Company to pre-pay \$20.0 million of its Term A Loan debt on March 4, 2008. The amount was based on the Company's cash balances as of that date. Subsequent prepayments of term debt in the amount of \$9.2 million were also made between March 5, 2008 and May 3, 2008. A prepayment premium associated with these early debt repayments in the amount of \$2.5 million was incurred and was recorded in the fourth quarter of fiscal 2008 in discontinued operations in the Company's Consolidated Statements of Operations.

On February 7, 2006, the Company entered into an interest rate swap agreement for a notional amount of \$75.0 million in order to reduce variable interest rate exposure. On February 16, 2007, the Company sold the interest rate swap agreement and recorded a related gain of \$101,000 in the fourth quarter of fiscal 2007 that was amortized through April 28, 2007, the expected remaining term of its borrowings under the 2007 Credit Agreement.

For the fiscal year ended April 28, 2007, a total of \$0.24 per share or \$4.8 million in cash dividends was paid to shareholders. The Company did not pay cash dividends during fiscal 2008.

Working capital at May 3, 2008 was \$62.5 million, compared to \$90.3 million at April 28, 2007. The working capital ratio was 1.3 to 1 and 1.4 to 1 at May 3, 2008 and April 28, 2007, respectively.

Net cash provided from operating activities included in the Consolidated Statements of Cash Flows increased to \$56.3 million for fiscal 2008 from \$22.6 million for fiscal 2007. The increase in cash flows from operating activities was primarily related to year-over-year reductions in accounts receivable, inventory and other operating assets/liabilities of \$49.9 million, \$37.8 million and \$18.3 million respectively; these increases were partially offset by a year-over-year reduction in accounts payable of \$75.7 million.

Net cash used by investing activities was \$22.1 million for fiscal 2008, compared to \$38.3 million for fiscal 2007. The decrease in cash flows used by investing activities was mainly the result of reduced spending on property and equipment of \$20.1 million and other cash investments of \$2.2 million; this reduction was partially offset by increased spending by Crave on license advances and acquired rights of \$7.4 million. The Company also received proceeds in fiscal 2008 related to the sale of investments of \$1.2 million.

Net cash used by financing activities was \$50.8 million for fiscal 2008, compared to net cash provided from financing activities of \$23.3 million for fiscal 2007. This decrease in cash flows from financing activities was predominately due to an increase of net debt repayments of \$63.0 million, a decrease of \$8.2 million in checks issued in excess of cash balances, which were classified as a financing activity in the prior fiscal year; under the Company's new credit agreements, bank overdrafts are not honored by the bank if sufficient funds do not exist to cover payment of the overdrafts; therefore, checks issued in excess of cash balances, when in existence, are classified as an operating activity in fiscal 2008. Checks issued in excess of cash balances were \$3.4 million at May 3, 2008. Additionally, the decrease in cash flows from financing activities was due to an increase of \$7.8 million in financing related fees. These net uses of cash were offset, in part, by a year over year decline in cash dividends paid of \$4.8 million.

The Company had no significant off-balance sheet arrangements as of May 3, 2008.

New Accounting Pronouncements

SFAS No. 141(R)

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 (revised 2007), Business Combinations. SFAS No. 141(R) reiterates that business combinations must be accounted for using the acquisition method. The definition of business combination is expanded to include transactions where an acquirer gains control by contract alone or without exchange of consideration. SFAS No. 141(R) requires the measurement and recognition of a business combination on the acquisition date and requires acquisition-date fair value measurement of identifiable assets acquired, liabilities assumed, and noncontrolling interests held in the acquiree, which eliminates the current cost-based purchase method. This Statement also requires an acquirer to recognize goodwill as of the acquisition date, measured as a residual of the consideration paid plus the fair value of any

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noncontrollable interest in the acquiree at the acquisition date over the fair value of the identifiable net assets acquired. SFAS No. 141(R) is effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period after December 15, 2008. The Company will adopt this Statement as necessary.

SFAS No. 157

In September 2006, SFAS No. 157, *Fair Value Measurements*, was issued by the FASB. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements; however, this pronouncement does not require any new fair value measurements. The effective date for SFAS No. 157 has been delayed by the FASB for nonfinancial assets and nonfinancial liabilities; the Company will adopt this portion of the Statement for the fiscal year beginning May 3, 2009. SFAS No. 157 is effective for the Company for the fiscal year beginning May 4, 2008 for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*. SFAS No. 159 allows companies to irrevocably elect to recognize most financial assets and financial liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses will be reported in earnings at each reporting date. The cumulative effect of re-measuring such instruments to fair value at adoption is accounted for as an adjustment to the beginning balance of retained earnings. SFAS No. 159 will be effective for the Company's fiscal year beginning May 4, 2008, and is not expected to have a significant impact on the Company's consolidated financial statements.

SFAS No. 160

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*, an amendment of ARB No. 51. SFAS No. 160 identifies a new term *noncontrolling interests* to replace what were previously called *minority interests*. This Statement clarifies that noncontrolling interests should be classified as equity. Changes in a parent's ownership interest whereby the parent still retains control of a subsidiary will also be accounted for as an equity transaction. If a change in a parent's ownership results in a loss of control of a subsidiary, the retained equity interest will be re-measured at fair value as of the deconsolidation date and any gain or loss would be recognized in net income. The Statement is currently not applicable to the Company; the provisions of this Statement will be adopted as necessary.

SFAS No. 161

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133. SFAS No. 161 requires enhanced disclosures about derivative and hedging activities with the intent to provide a greater understanding of how and why derivative instruments are used, how they are accounted for and how they affect the financial statements. SFAS No. 161 will be effective for the Company's fourth quarter of fiscal 2009 beginning February 1, 2009. The Company is currently evaluating the impact of this pronouncement on its reporting disclosures.

FIN No. 48

In June 2006, Financial Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, was issued by the FASB. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest (that will be classified in the Company s financial statements as

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interest expense, consistent with the Company's current accounting policy) and penalties, accounting in interim periods, disclosure and transition. Upon adoption of FIN No. 48 as of April 29, 2007, the Company increased its existing income tax reserves by \$1,562,000, largely due to foreign and state income tax matters. The increase was recorded as a cumulative effect adjustment to the opening balance of retained earnings. As of May 3, 2008, the Company had \$3,745,000 of unrecognized tax benefits.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

	2008
Balance at April 29, 2007	\$ 2,798
Increase tax positions in prior periods	1,472
Increase tax positions in current period	52
Decrease tax positions in prior periods	(543)
Settlements	(67)
Lapse of statute of limitations	
Foreign currency translation adjustment	33
Balance at May 3, 2008	\$ 3,745

If recognized, approximately \$3,407,000 would be recorded as a component of income tax expense and the additional \$338,000 would be recorded as interest and penalties. The unrecognized tax benefits increased by \$947,000 in fiscal 2008. This increase was predominantly due to an unrecognized tax benefit recorded in the second quarter of fiscal 2008 in the amount of \$639,000. The increase in unrecognized tax benefit in the second quarter of fiscal 2008 resulted from the reevaluation of facts and circumstances related to a tax uncertainty identified during the adoption of FIN No. 48 in the first quarter of this fiscal year. Upon reevaluation, management determined that a reserve amount was appropriate on this tax uncertainty and accordingly, additional income tax expense of \$804,000 was recorded in the second quarter of fiscal 2008. Management also determined that this amount did not materially impact the financial results for any individual quarter or year-to-date period of this fiscal year.

With the adoption of FIN No. 48, the Company will continue to include interest expense and penalties related to income tax contingencies in income before income taxes in its Consolidated Statements of Operations.

In many instances, the Company's uncertain positions are related to tax years that remain subject to examination by the relevant tax authorities. The following table summarizes these open tax years by major jurisdiction as of May 3, 2008:

Jurisdiction	Open Tax Year	Examination
	in Progress	not yet Initiated
United States *	N/A	2006 2007
Canada *	2000 2005	2006 2007
United Kingdom	N/A	2004 2007

* Includes federal as well as state or provincial jurisdictions, as applicable.

Based on the outcome of these examinations, it is reasonably possible that the related unrecognized tax benefits for tax positions taken regarding previously filed tax returns will materially change from those recorded as liabilities for uncertain tax positions in the Company's financial statements. In addition, the outcome of these examinations may impact the valuation of certain deferred tax assets (such as net operating losses and credit carryforwards) in future periods. Based on the number of tax years currently under audit by the relevant taxing authorities, the Company anticipates that some of these audits may be finalized in the foreseeable future.

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During the next 12 months, the Company expects to settle a United States federal tax audit, a Canadian federal tax audit and a state tax audit. The settlement of these audits could reduce the unrecognized tax benefits by approximately \$1,500,000.

FSP FIN No. 48-1

In May 2007, the FASB issued FASB Staff Position (FSP) FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48. FSP FIN No. 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN No. 48-1 is effective retroactively to April 28, 2007. The adoption of this standard did not have a significant impact on the Company's consolidated financial position or results of operations.

SEC Final Rule Release No. 33-8876

In December 2007, the Securities and Exchange Commission (SEC) issued Final Rule Release No. 33-8876, Smaller Reporting Company Regulatory Relief and Simplification. The SEC eliminated the category of filers defined as small business issuers and defined a new category called smaller reporting companies. This Final Rule also expanded the number of companies eligible for the SEC's scaled disclosures for smaller reporting companies. Under these amended rules, the scaled disclosures apply to reporting companies with less than \$75 million in public float or less than \$50 million in revenue if they do not have a calculable public float. For existing companies, eligibility for the smaller reporting company status is based on the last business day of the company's most recent second fiscal quarter. The Company qualified as a Smaller Reporting Company as of October 27, 2007, the end of its most recent second fiscal quarter, and has adopted the scaled disclosures in this annual report on Form 10-K.

SEC Staff Accounting Bulletin No. 108

In September 2006, Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements, was issued by the SEC. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement misstatements, the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements. The use of this method can cause the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB No. 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach, since it requires quantification of errors under both the iron curtain and the roll-over methods. SAB No. 108 permits public companies to initially apply its provisions either by (i) restating prior financial statements as if the dual approach had always been used, or (ii) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities with an offsetting adjustment recorded to the opening balance of retained earnings. Use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment; including how and when the errors arose. The Company applied the provisions of SAB No. 108 using the cumulative effect transition method in connection with the preparation of its annual financial statements for the year ending April 28, 2007.

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The following table summarizes the effects (up to April 30, 2006) of applying the guidance in SAB No. 108 (in thousands of dollars):

	<u>Period in Which the Misstatement Originated</u> ⁽¹⁾			<u>Adjustment Recorded as of April 30, 2006</u>
	<u>Cumulative Prior to May 2, 2004</u>	<u>Fiscal Year Ended April 30, 2005</u>	<u>Fiscal Year Ended April 29, 2006</u>	
Accrued property taxes ⁽²⁾	\$ (1,123)	\$ (86)	\$ (575)	\$ (1,784)
Deferred tax assets ^(2, 3, 4)	(865)	(528)	(372)	(1,765)
Foreign currency translation adjustment ⁽³⁾	139	37	64	240
Retained earnings ⁽⁵⁾	<u>\$ (1,849)</u>	<u>\$ (577)</u>	<u>\$ (883)</u>	<u>\$ (3,309)</u>

- 1) The Company quantified these errors under the rollover method and concluded that they were immaterial individually and in the aggregate.
- 2) Historically, the Company was not correctly matching the recording of property tax expense with the period covered by the property tax invoice from the governing authority. As a result, the Company's accrued property taxes were understated by \$1.8 million (cumulatively) in years prior to fiscal 2007. The Company recorded an increase in accrued property taxes of \$1.8 million and an increase in deferred tax assets of \$0.6 million as of April 30, 2006 with a corresponding reduction in retained earnings of \$1.2 million.
- 3) The Company determined that unpaid interest expense related to Handleman UK should be treated as a non-deductible item for tax purposes (due to the thin capitalization rules in the UK), as opposed to its historical treatment as a future tax deduction. Accordingly, the Company recorded a reduction of \$2.4 million in deferred tax assets and \$0.2 million in foreign currency translation adjustment as of April 30, 2006 with a corresponding reduction in retained earnings of \$2.2 million.
- 4) Deferred tax assets were overstated by a total of \$1.8 million, net. As discussed in (2) above, the property tax issue resulted in a related deferred tax asset understatement of \$0.6 million and the UK interest expense discussed in (3) above resulted in a related deferred tax asset overstatement of \$2.4 million.
- 5) Represents the net overstatement of net income for the indicated periods resulting from the aforementioned misstatements and the net reduction to retained earnings recorded as of April 30, 2006 to record the initial application of SAB No. 108.

Other Information

The Company has no significant investments that are accounted for under the equity method in accordance with accounting principles generally accepted in the United States of America. Accordingly, there are no liabilities associated with investments accounted for under the equity method that would be considered material to the Company.

The Company's financial statements have reported amounts based on historical costs, which represent dollars of varying purchasing power and do not measure the effects of inflation. If the financial statements had been restated for inflation, net income would have been lower because depreciation expense would have to be increased to reflect the most current costs. Management does not believe that inflation within the economies in which the Company conducts business has had a material effect on the Company's results of operations.

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On November 27, 2007, the Board of Directors appointed Mr. Albert A. Koch as Handleman's President and Chief Executive Officer through Handleman's engagement of AP Services, LLC ("APS"). AP Services is affiliated with AlixPartners, a financial advisory and consulting firm, where Mr. Koch is a Vice Chairman, Managing Director and Partner. In addition to an hourly rate and time commitment for services, Handleman's original agreement called for it to pay AP Services a success fee that is equal to 5% of the increase in shareholder market capitalization from the inception of the agreement through the payment due date upon the completion of the engagement. On May 29, 2008, the Company and APS amended their original agreement. The Amendment provides that in lieu of the success fee previously agreed to by Handleman and APS, Handleman will pay APS a success fee based on 5% (five percent) of the fair value of cash and/or other assets that is distributed to shareholders if such a distribution is approved by the Company's Board of Directors. The success fee shall be paid in cash, concurrent with the date or dates that distributions are made to Handleman Company's shareholders. In addition to Mr. Koch, the Managing Director of Handleman UK and one of Handleman's Vice Presidents of Finance are also employees of Alix Partners that were retained by Handleman Company after Mr. Koch's

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appointment. This additional staffing was approved in advance of their joining Handleman by the CEO Governing Committee, which is a three-person Committee of the Board that was formed to oversee the AlixPartners engagement. All invoices from AlixPartners to the Company are reviewed and approved by a member of the CEO Governing Committee prior to their payment. In accordance with accounting guidance, this relationship is viewed as a related party transaction since the APS consultants may control or significantly influence the management and operating policies of the Company.

The Company has not engaged in any other related party transactions, which would have had a material effect on the Company's financial position, results of operations or cash flows.

* * * * *

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 because of factors affecting any of a number of critical objectives, including, without limitation, receiving governmental approval to sell the assets and operations of the Company's Canadian subsidiary to Anderson, the ability to transition the U.S. music customers other than Wal-Mart to other vendors smoothly, the ability to realize a final agreement to sell the UK operations to Tesco and successfully settle other UK assets and liabilities, maintaining satisfactory working relationships with our lenders, customers and vendors, retaining key personnel, satisfactory resolution of any outstanding claims or claims which may arise, finding and capitalizing on opportunities to maximize the value of the Company's non-music operations, 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.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements and supplementary data are filed as a part of this report:

Reports of Independent Registered Public Accounting Firms

Consolidated Balance Sheets as of May 3, 2008 and April 28, 2007

Consolidated Statements of Operations For the Years Ended May 3, 2008 and April 28, 2007

Consolidated Statements of Shareholders' Equity For the Years Ended May 3, 2008 and April 28, 2007

Consolidated Statements of Cash Flows For the Years Ended May 3, 2008 and April 28, 2007

Notes to Consolidated Financial Statements

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Report Of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Handleman Company

We have audited the accompanying consolidated balance sheet of Handleman Company and subsidiaries (the Company) as of May 3, 2008, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended. Our audit of the basic financial statements included the financial statement schedule listed in the index appearing under Item 15 (a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Handleman Company and subsidiaries as of May 3, 2008, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2, the Company incurred a net loss of \$96,785,000 during the year ended May 3, 2008 and has been unable to obtain additional financing to satisfy its operating and capital requirements through May 2, 2009. These factors, among others, as discussed in Note 2 to the consolidated financial statements, raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ GRANT THORNTON LLP
Southfield, Michigan
August 11, 2008

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Handleman Company:

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Handleman Company and its subsidiaries at April 28, 2007, and the results of their operations and their cash flows for the year ended April 28, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein for the year ended April 28, 2007 when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 11 and Note 10 to the consolidated financial statements, Handleman Company changed the manner in which it accounts for share-based compensation and the manner in which it accounts for defined benefit pension plans in fiscal 2007.

/s/PricewaterhouseCoopers LLP

Detroit, Michigan

June 29, 2007, except for the effects of discontinued operations discussed in Note 3 and the change in the composition of reportable segments discussed in Note 13 to the consolidated financial statements, as to which the date is August 11, 2008.

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HANDLEMAN COMPANY

CONSOLIDATED BALANCE SHEETS

AS OF MAY 3, 2008 and APRIL 28, 2007

(in thousands of dollars except share data)

	<u>2008</u>	<u>2007</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,043	\$ 18,457
Accounts receivable, less allowances of \$2,602 in 2008 and \$12,797 in 2007	62,479	236,069
Merchandise inventories	29,404	115,535
Other current assets	10,221	17,713
Assets held for sale	139,943	
Total current assets	243,090	387,774
Property and equipment, net	28,870	65,128
Goodwill, net	6,903	36,938
Intangible assets, net	35,062	36,433
Other assets, net	14,779	20,178
Total assets	\$ 328,704	\$ 546,451
LIABILITIES		
Current liabilities:		
Debt, current portion	\$ 63,706	\$ 106,897
Accounts payable	31,023	159,444
Accrued and other liabilities	23,548	31,163
Liabilities held for sale	62,298	
Total current liabilities	180,575	297,504
Other liabilities	6,456	9,402
Commitments and contingencies (Note 12)		
Total liabilities	187,031	306,906
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; 20,464,000 and 20,291,000 shares issued and outstanding at May 3, 2008 and April 28, 2007, respectively	205	203
Additional paid-in capital	788	
Accumulated other comprehensive income	17,099	17,414
Retained earnings	123,581	221,928
Total shareholders' equity	141,673	239,545

Total liabilities and shareholders' equity	\$ 328,704	\$ 546,451
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The accompanying notes are an integral part of the consolidated financial statements.

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE FISCAL YEARS ENDED MAY 3, 2008 and APRIL 28, 2007

(in thousands of dollars except per share data)

	<u>2008</u>	<u>2007</u>
Revenues	\$ 494,570	\$ 558,363
Costs and expenses:		
Direct product costs	(411,120)	(506,352)
Selling, general and administrative expenses	(168,615)	(173,914)
Impairment of goodwill	(30,035)	
Impairment of subsidiary assets	(17,197)	
Operating loss	(132,397)	(121,903)
Interest expense	(2,978)	(4,870)
Investment (loss) income	(1,913)	1,475
Loss from continuing operations before income taxes	(137,288)	(125,298)
Income tax benefit	10,725	25,279
Loss from continuing operations	(126,563)	(100,019)
Discontinued operations (Note 3):		
Income from operations of discontinued subsidiaries	41,165	73,672
Income tax expense	(11,387)	(27,081)
Income from discontinued operations	29,778	46,591
Net loss	\$ (96,785)	\$ (53,428)
(Loss) income per share:		
Continuing operations - basic	\$ (6.22)	\$ (4.96)
Continuing operations - diluted	\$ (6.22)	\$ (4.96)
Discontinued operations - basic	\$ 1.46	\$ 2.31
Discontinued operations - diluted	\$ 1.46	\$ 2.31
Net loss - basic	\$ (4.76)	\$ (2.65)
Net loss - diluted	\$ (4.76)	\$ (2.65)
Weighted average number of shares outstanding during the period		
Basic	20,341	20,149

Diluted	<u>20,341</u>	<u>20,149</u>
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The accompanying notes are an integral part of the consolidated financial statements.

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

FOR THE FISCAL YEARS ENDED MAY 3, 2008 and APRIL 28, 2007

(in thousands of dollars)

	Common Stock		Accumulated Other Comprehensive Income (Loss)					Retained Earnings	Total Share- holders' Equity
	Shares Issued	Amount	Foreign Currency Translation Adjustment	Employee Benefit Related	Interest Rate Swap	Unearned Compensation	Additional Paid-in Capital		
April 29, 2006, previously reported	19,990	\$ 200	\$ 16,131	\$ (248)	\$ 184	\$ (4,816)	\$	\$ 285,538	\$ 296,989
Cumulative effect, net of tax, for adoption of SAB No. 108								(3,309)	(3,309)
April 29, 2006, restated	19,990	200	16,131	(248)	184	(4,816)		282,229	293,680
Net loss								(53,428)	(53,428)
Adjustment for foreign currency translation			6,523						6,523
Minimum pension liability adjustment, net of tax of \$35				66					66
Interest rate swap, net of tax of (\$101)					(184)				(184)
Comprehensive loss, net of tax									(47,023)
Adoption of SFAS No. 158 net of tax of (\$2,824)				(5,058)					(5,058)
Stock-based compensation:									
Performance shares	214	2				3,484	(2,176)		1,310
Stock options						812	(82)		730
Restricted stock and other	87	1				520	231		752
Reclassification of additional paid-in-capital							2,027	(2,027)	
Cash dividends, \$0.24 per share								(4,846)	(4,846)
April 28, 2007, previously reported	20,291	203	22,654	(5,240)				221,928	239,545
Cumulative effect of adoption of FIN No. 48								(1,562)	(1,562)
April 28, 2007, restated	20,291	203	22,654	(5,240)				220,366	237,983
Net loss								(96,785)	(96,785)
Adjustment for foreign currency translation, net of tax of \$2,301			(1,213)						(1,213)
Employee benefit plan related adjustment, net of tax of \$(484)				898					898
Comprehensive loss, net of tax									(97,100)

Stock-based compensation:									
Performance shares/units	130	2					567		569
Stock options							(127)		(127)
Restricted stock and other	43						348		348
May 3, 2008	20,464	\$ 205	\$ 21,441	\$ (4,342)	\$	\$	\$ 788	\$ 123,581	\$ 141,673

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 FISCAL YEARS ENDED MAY 3, 2008 and APRIL 28, 2007

(in thousands of dollars)

	<u>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Net loss	\$ (96,785)	\$ (53,428)
Adjustments to reconcile net loss to net cash provided from operating activities:		
Depreciation	15,844	15,136
Amortization of definite-lived intangible assets	7,961	9,221
Recoupment of development costs/licensed rights	11,120	7,324
Amortization of financing related fees	3,070	
Loss on extinguishment of debt	3,068	
Impairment of equity investments	3,805	
Impairment of subsidiary assets and inventory markdowns	22,802	9,734
Impairment of goodwill	30,035	
Gain on sale of investment	(957)	
Unrealized investment income	(215)	(427)
Loss on disposal of property and equipment	770	817
Deferred income taxes		5,513
Stock-based compensation	670	2,710
Retirement plans curtailment/settlement charges	148	1,375
Changes in operating assets and liabilities:		
Decrease in accounts receivable	78,906	28,964
Decrease in merchandise inventories	44,661	6,843
Decrease (increase) in other operating assets	6,579	(6,160)
(Decrease) increase in accounts payable	(74,491)	1,229
Decrease in other operating liabilities	(708)	(6,220)
Total adjustments	153,068	76,059
Net cash provided from operating activities	56,283	22,631
Cash flows from investing activities:		
Additions to property and equipment	(6,702)	(26,824)
License advances and acquired rights	(16,734)	(9,301)
Proceeds from disposition of properties and equipment	150	4
Proceeds from sale of investment	1,217	
Cash investment in REPS LLC		(1,052)
Other equity investments		(1,137)
Net cash used by investing activities	(22,069)	(38,310)
Cash flows from financing activities:		
Issuances of debt	4,139,371	5,333,755
Repayments of debt	(4,182,574)	(5,313,981)
Financing related fees	(7,755)	

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Checks issued in excess of cash balances		8,249
Cash dividends		(4,846)
Cash proceeds from stock-based compensation plans	120	82
	<u> </u>	<u> </u>
Net cash (used by) provided from financing activities	(50,838)	23,259
	<u> </u>	<u> </u>
Effect of exchange rate changes on cash	(790)	531
Net (decrease) increase in cash and cash equivalents	(17,414)	8,111
Cash and cash equivalents at beginning of year	18,457	10,346
	<u> </u>	<u> </u>
Cash and cash equivalents at end of year	\$ 1,043	\$ 18,457
	<u> </u>	<u> </u>

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unless otherwise noted, the following Notes to Consolidated Financial Statements relate only to results from continuing operations.

1. Accounting Policies

Business

During fiscal 2008, Handleman Company had the following reporting segments: category management and distribution operations, video game operations and all other. As a category manager and distributor of product, the Company created value for its customers by leveraging its core competencies of logistics services, field services and intellectual services. During fiscal 2008, the Company predominately provided full category management services for prerecorded music product to leading retail chains in the United States (U.S.), United Kingdom (UK) and Canada. The Company's Board of Directors approved the exiting of the music category management and distribution operations in the U.S. and Canada during the fourth quarter of fiscal 2008. In accordance with accounting guidance, the U.S. and Canadian operations have been classified as discontinued operations for financial reporting purposes for all periods presented. The video game operations are related to Crave Entertainment Group, Inc. (Crave) and the all other segment primarily represents REPS LLC (REPS).

Fiscal Year

The Company's fiscal year ends on the Saturday closest to April 30. The fiscal year ended May 3, 2008 (fiscal 2008) consisted of 53 weeks and the fiscal year ended April 28, 2007 (fiscal 2007) consisted of 52 weeks.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all subsidiaries where the Company has voting control. All intercompany accounts and transactions have been eliminated. All subsidiary companies are wholly owned. The Company does not have any significant equity investments other than in companies in which it has voting control.

The Company has intercompany transactions between its U.S. category management and distribution operations and REPS related to revenues and expenses resulting from REPS providing field service for the U.S. music business. As these revenues and expenses will not be on-going as a result of the Company exiting the U.S. music business, costs and associated eliminations have been classified as discontinued operations in the Company's Consolidated Statements of Operations for all periods presented.

Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Foreign Currency Translation

The Company's foreign subsidiaries utilize the local currency as their functional currency. Therefore, the Company follows the guidance outlined in Statement of Financial Accounting Standards (SFAS) No. 52, Foreign Currency Translation, issued by the Financial Accounting Standards Board (FASB) to convert the balance sheets and statements of operations of its foreign

Table of Contents**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued**

subsidiaries to United States dollars. The Company uses an average exchange rate for the period, based on published daily rates, to convert foreign operational transactions to United States dollars. Assets and liabilities of foreign subsidiaries are converted to United States dollars using the prevailing published exchange rate on the last business day of the fiscal period. Common stock and additional paid in capital are converted at historical exchange rates. Resulting translation adjustments are included as a component of Accumulated other comprehensive income in the Company's Consolidated Balance Sheets. Net transaction gains included in Selling, general and administrative expenses from continuing operations in the Company's Consolidated Statements of Operations were \$1,029,000 and \$832,000 for the years ended May 3, 2008 and April 28, 2007, respectively.

Financial Instruments

The Company has evaluated the fair value of those assets and liabilities identified as financial instruments under SFAS No. 107, Disclosures about Fair Value of Financial Instruments. The Company estimates that fair values generally approximated carrying values at May 3, 2008 and April 28, 2007. Fair values have been determined through information obtained from market sources and management estimates.

Cash Equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Accounts Receivable

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

	May 3, 2008	April 28, 2007
	<u> </u>	<u> </u>
Trade accounts receivable	\$ 65,081	\$ 248,866
Less allowances for:		
Gross profit impact of estimated future returns	(440)	(8,719)
Doubtful accounts	(2,162)	(4,078)
	<u> </u>	<u> </u>
Accounts receivable, net	<u>\$ 62,479</u>	<u>\$ 236,069</u>

Inventory Valuation

Merchandise inventories are recorded at the lower of cost (average cost method) or market. The Company accounts for inventories using the full cost method which includes costs associated with acquiring and preparing inventory for distribution. Costs associated with acquiring and preparing inventory for distribution of \$3,138,000 and \$5,547,000 were incurred during the fiscal years ended May 3, 2008 and April 28, 2007, respectively, and are classified as a component of Direct product costs from continuing operations in the Company's Consolidated Statements of Operations. Merchandise inventories as of May 3, 2008 and April 28, 2007 included \$269,000 and \$1,962,000, respectively, of such costs.

The Company's inventory consists substantially of compact discs and video game hardware and software, which are not substandard from a functional standpoint. Typically, the Company's music suppliers offer return privileges for excess inventory quantities. Video game hardware and software is generally purchased as a one-way sale. Therefore, inventory reserves are provided for the risk

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

that exists related to the carrying value of non-returnable slow moving inventory that may exceed market value, although the effect of markdowns is minimized since the Company's music vendors generally offer some level of return allowances and price protection.

Long-Lived Assets

The Company accounts for long-lived assets in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This Statement applies to long-lived assets other than goodwill, and prescribes a probability-weighted cash flow estimation approach to evaluate the recoverability of the carrying amount of long-lived assets such as property, plant and equipment. See Note 4 of Notes to Consolidated Financial Statements for information related to long-lived asset impairment charges recorded in fiscal 2008.

Common Stock Repurchases

The Company is authorized to repurchase shares of its common stock pursuant to authorizations approved by its Board of Directors. Upon repurchase, the Company immediately retires the shares and, as a result, records a reduction in the number of common shares outstanding along with a reduction to additional paid-in-capital (representing the excess of the purchase price over the par value of the shares repurchased) in the period of repurchase/retirement. These transactions generally result in a negative balance in additional paid-in-capital. In the event of an active repurchase program, the negative balance in additional paid-in-capital is subsequently reclassified to retained earnings. The effect of these share repurchase transactions on common shares and shareholders' equity is included in the Company's Consolidated Statements of Shareholders Equity for all periods presented. Under the terms of the Company's credit agreements, the Company is restricted from repurchasing shares of its common stock. See Note 8 of Notes to Consolidated Financial Statements for additional information related to the Company's debt agreements.

Recognition of Revenue and Future Returns

Revenues are recognized upon delivery of product to customers (FOB destination). As a category manager of music product and distributor of video game product, the Company coordinates freight service for product purchased by its customers with the assumption of risk effectively remaining with the Company until its customers receive the product. Customer inspection of merchandise is not a condition of the sale. The Company also manages product returns that include both salable and non-salable product, as well as damaged merchandise, and provides credit for such customer product returns. The Company reduces revenues and direct product costs for estimated future returns at the time of revenue recognition. The estimate for future returns includes both salable and non-salable product. On a quarterly basis, the Company reviews the estimates for future returns and records adjustments as necessary.

Direct Product Costs

As a distributor of music and video game product, the Company is primarily a reseller of finished goods. Accordingly, substantially all the Company's direct product costs relate to its purchase price from suppliers for finished products shipped from the Company to customers. The

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Company computes direct product costs at an item specific level based on the lower of cost (average cost method) or market at the time of product shipment to customers. Direct product costs also include costs associated with acquiring and preparing inventory for distribution, as well as inventory reserves, supplier discounts and residual advertising related items.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Selling, General and Administrative Expenses

The major components of the Company's selling, general and administrative expenses included in its Consolidated Statements of Operations are as follows:

labor expense, which includes field sales, warehouse, corporate office labor and stock-based compensation expense, along with associated payroll taxes and fringe benefits;

freight expense related to product shipments to customers;

outside information technology related service expenses;

depreciation expense, which includes depreciation of Company-owned display fixtures located in customers' retail stores;

travel expense;

supplies expense;

outside consulting expense;

amortization expense of intangible assets;

rent expense; and

repairs and maintenance expense.

Shipping and Handling (Freight Expense)

The Company generally does not bill customers for shipping and handling costs incurred. Shipping and handling costs associated with shipments to and returns from customers are paid by the Company and included in Selling, general and administrative expenses from continuing operations in the Consolidated Statements of Operations. Customer related shipping and handling costs included in selling, general and administrative expenses from continuing operations were \$14,771,000 and \$6,680,000 for fiscal years 2008 and 2007, respectively.

Income Taxes

The provision for income taxes is based on reported income before income taxes. Deferred income taxes are provided for the effect of temporary differences between the amounts of assets and liabilities recognized for financial reporting purposes and amounts recognized for income tax purposes. Valuation allowances are recognized to reduce deferred tax assets when there is a higher probability the assets will not be realized. In assessing the likelihood of realization, consideration is given to estimates of future taxable income, the character of income needed to realize future benefits and all available evidence.

Value-added taxes are presented in the Company's Consolidated Statements of Operations on a net-basis, that is, they are excluded from revenues.

Earnings Per Share

The Company computes diluted earnings per share from net income in accordance with SFAS No. 128, Earnings Per Share. A reconciliation of the weighted average shares used in the calculation of basic and diluted shares is as follows (in thousands):

	<u>May 3, 2008</u>	<u>April 28, 2007</u>
Weighted average shares during the period - basic	20,341	20,149
Additional shares from assumed exercise of stock-based compensation		
Weighted average shares adjusted for assumed exercise of stock options - diluted	<u>20,341</u>	<u>20,149</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

No additional shares related to stock options issued by the Company were included in the computation of diluted weighted average shares as a result of the net loss for fiscal years 2008 and 2007.

New Accounting Pronouncements

SFAS No. 141(R)

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*. SFAS No. 141(R) reiterates that business combinations must be accounted for using the acquisition method. The definition of business combination is expanded to include transactions where an acquirer gains control by contract alone or without exchange of consideration. SFAS No. 141(R) requires the measurement and recognition of a business combination on the acquisition date and requires acquisition-date fair value measurement of identifiable assets acquired, liabilities assumed, and noncontrolling interests held in the acquiree, which eliminates the current cost-based purchase method. This Statement also requires an acquirer to recognize goodwill as of the acquisition date, measured as a residual of the consideration paid plus the fair value of any noncontrollable interest in the acquiree at the acquisition date over the fair value of the identifiable net assets acquired. SFAS No. 141(R) is effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period after December 15, 2008. The Company will adopt this Statement as necessary.

SFAS No. 157

In September 2006, SFAS No. 157, *Fair Value Measurements*, was issued by the FASB. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements; however, this pronouncement does not require any new fair value measurements. The effective date for SFAS No. 157 has been delayed by the FASB for nonfinancial assets and nonfinancial liabilities; the Company will adopt this portion of the Statement for the fiscal year beginning May 3, 2009. SFAS No. 157 is effective for the Company for the fiscal year beginning May 4, 2008 for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115*. SFAS No. 159 allows companies to irrevocably elect to recognize most financial assets and financial liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses will be reported in earnings at each reporting date. The cumulative effect of re-measuring such instruments to fair value at adoption is accounted for as an adjustment to the beginning balance of retained earnings. SFAS No. 159 will be effective for the Company's fiscal year beginning May 4, 2008, and is not expected to have a significant impact on the Company's consolidated financial statements.

SFAS No. 160

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51. SFAS No. 160 identifies a new term noncontrolling interests to replace what were previously called minority interests. This Statement clarifies that noncontrolling interests should be classified as equity. Changes in a parent's ownership interest whereby the parent still retains control of a subsidiary will also be accounted for as an equity transaction. If a change in a parent's ownership results in a loss of control of a subsidiary, the retained equity interest will be re-measured at fair value as of the deconsolidation date and any gain or loss would be recognized in net income. The Statement is currently not applicable to the Company; the provisions of this Statement will be adopted as necessary.

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SFAS No. 161

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133. SFAS No. 161 requires enhanced disclosures about derivative and hedging activities with the intent to provide a greater understanding of how and why derivative instruments are used, how they are accounted for and how they affect the financial statements. SFAS No. 161 will be effective for the Company's fourth quarter of fiscal 2009 beginning February 1, 2009. The Company is currently evaluating the impact of this pronouncement on its reporting disclosures.

FIN No. 48

In June 2006, Financial Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, was issued by the FASB. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest (that will be classified in the Company's financial statements as interest expense, consistent with the Company's current accounting policy) and penalties, accounting in interim periods, disclosure and transition. Upon adoption of FIN No. 48 as of April 29, 2007, the Company increased its existing income tax reserves by \$1,562,000, largely due to foreign and state income tax matters. The increase was recorded as a cumulative effect adjustment to the opening balance of retained earnings. As of May 3, 2008, the Company had \$3,745,000 of unrecognized tax benefits.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands of dollars):

	2008
Balance at April 29, 2007	\$ 2,798
Increase tax positions in prior periods	1,472
Increase tax positions in current period	52
Decrease tax positions in prior periods	(543)
Settlements	(67)
Lapse of statute of limitations	
Foreign currency translation adjustment	33
Balance at May 3, 2008	<u>\$ 3,745</u>

If recognized, approximately \$3,407,000 would be recorded as a component of income tax expense and the additional \$338,000 would be recorded as interest and penalties. The unrecognized tax benefits increased by \$947,000 in fiscal 2008. This increase was predominantly due to an unrecognized tax benefit recorded in the second quarter of fiscal 2008 in the amount of \$639,000. The increase in unrecognized tax benefit in the second quarter of fiscal 2008 resulted from the reevaluation of facts and circumstances related to a tax uncertainty identified during the adoption of FIN No. 48 in the first quarter of this fiscal year. Upon reevaluation, management determined that a reserve amount was appropriate on this tax uncertainty and accordingly, additional income tax expense of \$804,000 was recorded in the second quarter of fiscal 2008.

Management also determined that this amount did not materially impact the financial results for any individual quarter or year-to-date period of this fiscal year.

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With the adoption of FIN No. 48, the Company will continue to include interest expense and penalties related to income tax contingencies in income before income taxes in its Consolidated Statements of Operations.

In many instances, the Company's uncertain positions are related to tax years that remain subject to examination by the relevant tax authorities. The following table summarizes these open tax years by major jurisdiction as of May 3, 2008:

Jurisdiction	Open Tax Year Examination in Progress	Examination not yet Initiated
United States *	N/A	2006 2007
Canada *	2000 2005	2006 2007
United Kingdom	N/A	2004 2007

* Includes federal as well as state or provincial jurisdictions, as applicable.

Based on the outcome of these examinations, it is reasonably possible that the related unrecognized tax benefits for tax positions taken regarding previously filed tax returns will materially change from those recorded as liabilities for uncertain tax positions in the Company's financial statements. In addition, the outcome of these examinations may impact the valuation of certain deferred tax assets (such as net operating losses and credit carryforwards) in future periods. Based on the number of tax years currently under audit by the relevant taxing authorities, the Company anticipates that some of these audits may be finalized in the foreseeable future.

During the next 12 months, the Company expects to settle a United States federal tax audit, a Canadian federal tax audit and a state tax audit. The settlement of these audits could reduce the unrecognized tax benefits by approximately \$1,500,000.

FSP FIN No. 48-1

In May 2007, the FASB issued FASB Staff Position (FSP) FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48. FSP FIN No. 48-1 provides guidance on how to determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN No. 48-1 is effective retroactively to April 28, 2007. The adoption of this standard did not have a significant impact on the Company's consolidated financial position or results of operations.

SEC Final Rule Release No. 33-8876

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In December 2007, the Securities and Exchange Commission (SEC) issued Final Rule Release No. 33-8876, Smaller Reporting Company Regulatory Relief and Simplification. The SEC eliminated the category of filers defined as small business issuers and defined a new category called smaller reporting companies. This Final Rule also expanded the number of companies eligible for the SEC s scaled disclosures for smaller reporting companies. Under these amended rules, the scaled disclosures apply to reporting companies with less than \$75 million in public float or less than \$50 million in revenue if they do not have a calculable public float. For existing companies, eligibility for the smaller reporting company status is based on the last business day of the company s most recent second fiscal quarter. The Company qualified as a Smaller Reporting Company as of October 27, 2007, the end of its most recent second fiscal quarter, and adopted the scaled disclosures in this annual report on Form 10-K.

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SEC Staff Accounting Bulletin No. 108

In September 2006, Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements," was issued by the SEC. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement misstatements, the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements. The use of this method can cause the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB No. 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a "dual approach," since it requires quantification of errors under both the iron curtain and the roll-over methods. SAB No. 108 permits public companies to initially apply its provisions either by (i) restating prior financial statements as if the "dual approach" had always been used, or (ii) recording the cumulative effect of initially applying the "dual approach" as adjustments to the carrying values of assets and liabilities with an offsetting adjustment recorded to the opening balance of retained earnings. Use of the "cumulative effect" transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment, including how and when the errors arose. The Company applied the provisions of SAB No. 108 using the cumulative effect transition method in connection with the preparation of its annual financial statements for the year ending April 28, 2007.

The following table summarizes the effects (up to April 30, 2006) of applying the guidance in SAB No. 108 (in thousands of dollars):

	Period in Which the Misstatement Originated ⁽¹⁾			Adjustment Recorded as of April 30, 2006
	Cumulative Prior to May 2, 2004	Fiscal Year Ended April 30, 2005	Fiscal Year Ended April 29, 2006	
Accrued property taxes ⁽²⁾	\$ (1,123)	\$ (86)	\$ (575)	\$ (1,784)
Deferred tax assets ^(2, 3, 4)	(865)	(528)	(372)	(1,765)
Foreign currency translation adjustment ⁽³⁾	139	37	64	240
Retained earnings ⁽⁵⁾	\$ (1,849)	\$ (577)	\$ (883)	\$ (3,309)

¹⁾ The Company quantified these errors under the rollover method and concluded that they were immaterial individually and in the aggregate.

²⁾ Historically, the Company was not correctly matching the recording of property tax expense with the period covered by the property tax invoice from the governing authority. As a result, the Company's accrued property taxes were understated by \$1.8 million (cumulatively) in years prior to fiscal 2007. The Company recorded an increase in accrued property taxes of \$1.8 million and an increase in deferred tax assets of \$0.6 million as of April 30, 2006 with a corresponding reduction in retained earnings of \$1.2 million.

³⁾ The Company determined that unpaid interest expense related to Handleman UK should be treated as a non-deductible item for tax purposes (due to the thin capitalization rules in the UK), as opposed to its historical treatment as a future tax deduction. Accordingly, the

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Company recorded a reduction of \$2.4 million in deferred tax assets and \$0.2 million in foreign currency translation adjustment as of April 30, 2006 with a corresponding reduction in retained earnings of \$2.2 million.

- 4) Deferred tax assets were overstated by a total of \$1.8 million, net. As discussed in (2) above, the property tax issue resulted in a related deferred tax asset understatement of \$0.6 million and the UK interest expense discussed in (3) above resulted in a related deferred tax asset overstatement of \$2.4 million.

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- 5) Represents the net overstatement of net income for the indicated periods resulting from the aforementioned misstatements and the net reduction to retained earnings recorded as of April 30, 2006 to record the initial application of SAB No. 108.

2. Financial Position

The Company has incurred losses of \$96.8 million and \$53.4 million in fiscal years 2008 and 2007, respectively. Industry wide music sales have been declining at double-digit rates over the past few years, impacted by digital distribution, downloading and piracy. As a result, many mass retailers have reduced the amount of floor space dedicated to physical music product. The Company implemented cost cutting initiatives during the last two years in response to these waning music sales, but has been unable to return to profitability. The Company determined that there were not enough further cost reduction opportunities to offset margin reductions from the continuing decline in sales volumes. On June 2, 2008, the Company announced its decision to exit the music business in North America, which was approved by the Company's Board of Directors in April 2008. The Company's decision to exit the music business in North America was further impacted by reluctance from its customers to maintain relationships with multiple music distributors in a declining market, uncertainty whether vendor terms would allow the Company to service its customers during the upcoming holiday season and uncertainty whether the Company's credit agreements would provide sufficient liquidity to fund operations through fiscal 2009.

Handleman Company projects that it will have sufficient liquidity to operate until the wind down of the music business in North America is complete, which is expected to occur early in the second quarter of fiscal 2009. The Company is also exploring opportunities related to its other business activities including Crave, REPS and Handleman UK. The Company believes that cash provided from operations and asset sales could provide sufficient liquidity to fund the Company's day-to-day operations provided that the Company is able to sell its remaining assets at anticipated selling prices and within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's liquidity would be dependent on further amendments to its credit agreements, or securing alternative financing. If the Company is unable to do so, then its ability to continue as a going concern would be in doubt.

If the Company is able to generate cash proceeds in excess of what is needed to satisfy all of the Company's obligations, the Company is considering the possibility of distributing any such proceeds to shareholders rather than pursue reinvestment opportunities. Whether there will be any excess cash proceeds for distribution to shareholders is subject to a number of material risks and uncertainties that may prevent any such distribution from occurring. Accordingly, while the Company believes that a cash distribution is possible, actual results may differ from current estimates, perhaps materially.

Exiting the Music Business in North America

During the fourth quarter ended May 3, 2008, the Company committed to a plan to exit the North American music category management and distribution operations. Pursuant to this decision, Handleman Company entered into separate arrangements with Anderson Merchandisers L.P. (Anderson) related to its U.S. and Canadian operations.

The Company announced on June 2, 2008 that it entered into a definitive Asset Purchase Agreement (APA) with Anderson to purchase a portion of the U.S. music inventory and all of the store display fixtures related to its Wal-Mart business in the U.S. The APA was effective on June 2,

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2008. Pursuant to this agreement, an initial purchase of U.S. music inventory was delivered to Anderson, FOB shipping point, from the Company's Indianapolis, Indiana automated distribution

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center. An additional inventory purchase by Anderson is expected to be completed on or about August 29, 2008. On June 2, 2008, the Company ceased providing music category management and distribution services to Wal-Mart in the U.S.

The purchase price paid by Anderson for the initial U.S. music inventory was equal to Handleman's supplier invoice cost. The purchase price for the additional U.S. music inventory in August will be equal to Handleman's supplier invoice cost less \$0.31 per unit and less any supplier return handling fees. The total inventory purchase price to be paid by Anderson will not exceed \$21,500,000. The purchase price paid by Anderson for the retail display fixtures was \$3,629,000, which was equal to the net book value of the fixtures as of June 2, 2008. Anderson also paid Handleman \$175,000 for transition services and \$5,000,000 for pick, pack and ship costs, warehousing costs and billing and management costs incurred by Handleman in connection with the closing. Anderson has agreed to pay \$4,000,000 if Handleman identifies and sells or transitions to Anderson any other Handleman business that adds value to the U.S. music transaction. (Handleman has signed a definitive agreement to sell the assets and the operations of its Canadian subsidiary to Anderson). The Company secured the consent of its lenders prior to the execution of both the U.S. and Canadian transactions. All of the proceeds from the U.S. sale were used to pay Handleman's lenders and reduce outstanding loan balances. To date, the APA has generated approximately \$19,795,000 in cash in the first quarter of fiscal 2009.

Handleman will be working with its other U.S. music customers to assist them in achieving a smooth transition to other music suppliers by the end of August 2008. As of July 31, 2008, a material portion of such transition has occurred. Following the transition of the last customer, Handleman will have no on-going music business in the U.S.

July 2008, the Company signed a definitive agreement to sell all of the music inventory, fixed assets and operations of Handleman's Canadian subsidiary, inclusive of customer relationships, to Anderson. The agreement is structured such that Anderson will purchase all of these assets at carrying value as of the closing date plus \$1,000,000. Completion of this transaction is expected to occur shortly after receipt of Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009.

Crave Entertainment and REPS LLC

During the fourth quarter of fiscal 2008, the Company announced that it retained the investment banking firm W.Y. Campbell & Company for the purpose of exploring possible strategic options for Crave. In June 2008, an Offering Memorandum was completed and the Company began actively marketing Crave for sale at that time. In July 2008, the Company retained W.Y. Campbell & Company to explore strategic options for REPS, as well. An Offering Memorandum for REPS was completed in late July 2008 and the Company began actively marketing REPS in early August 2008.

Handleman United Kingdom

Handleman UK began providing distribution, replenishment and store merchandising services to Tesco Stores Limited (Tesco) in support of its entertainment businesses specifically music, video and video games at the beginning of fiscal 2008. Under this arrangement, Tesco retained title to the inventory, which was housed in and distributed from a Handleman UK distribution facility. During the first quarter of fiscal 2009, the Company began discussions and has reached an agreement in principle with Tesco to sell certain assets and assume all of the operations related to the Tesco category management and distribution operations, as well as to transfer certain of the Company's intellectual properties to Tesco. It

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is expected that if a purchase agreement is reached, to the satisfaction of both parties, that a closing will occur during the second quarter of fiscal 2009. The completion of this purchase agreement will transition all related assets and services from Handleman UK to Tesco.

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The purchase price to be paid by Tesco is approximately \$18,549,000, and relates to all of the fixed assets located in the Company's Tesco-dedicated distribution center in the UK and certain licensed and proprietary computer software held by the Company's corporate subsidiary. Following its discontinuance of business with Tesco, as well as ASDA, as discussed in Note 5 of Notes to Consolidated Financial Statements, Handleman UK will have no on-going operations.

Amendments to Debt Agreements

During the first quarter of fiscal 2009, the Company and its lenders entered into Sixth, Seventh, Eighth and Ninth Amendments to its credit agreements, and early in the second quarter of Fiscal 2009, the Company entered into a Tenth Amendment to its credit agreements. See Note 8 of Notes to Consolidated Financial Statements for detailed discussions of these amendments.

3. Disposal of Long-Lived Assets*Assets Held for Sale*

During the fourth quarter of fiscal 2008, management committed to a plan, that was approved by the Company's Board of Directors in April 2008, to exit the North American music business and entered into negotiations with Anderson for the sale of its U.S. and Canadian assets and operations. Therefore, the Company classified the assets and liabilities of its U.S. and Canadian music operations as held for sale in its Consolidated Balance Sheet as of May 3, 2008, in accordance with the guidance provided in SFAS No. 144. All of the assets and liabilities held for sale were previously included in the category management and distribution operations segment.

The table below summarizes the major categories of assets and liabilities held for sale at May 3, 2008 (in thousands of dollars):

Assets Held for Sale	Total
Accounts receivable	\$ 94,420
Merchandise inventories	37,803
Property and equipment, net	7,635
Other assets	85
Total assets held for sale	\$ 139,943
Liabilities Held for Sale	
Accounts payable	\$ 56,839

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Accrued and other liabilities	5,459
Total liabilities held for sale	\$ 62,298

The assets of Handleman UK, Crave and REPS are classified as held and used as of May 3, 2008 because all of the criteria in SFAS No. 144 related to long-lived assets to be disposed of by sale were not met. As of May 3, 2008, the Company did not have an active program in place to locate a buyer for these businesses and these asset groups were not being actively marketed for sale.

The Company began actively marketing the assets of Handleman UK by initiating conversations with Tesco in May 2008, during the Company's first quarter of fiscal 2009. Those discussions have progressed and management believes the parties will execute an asset purchase agreement early in the second quarter of fiscal 2009. In accordance with SFAS No. 144, in the first quarter of fiscal

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2009 the Company will classify the Handleman UK assets and liabilities as held for sale and the results of operations for the Handleman UK business will be reported in discontinued operations.

The Company engaged an investment banking firm in the fourth quarter of fiscal 2008 to explore strategic options for Crave. An Offering Memorandum was completed in June 2008 and the Company decided, upon Board approval, to begin actively marketing Crave for sale at that time. In accordance with SFAS No. 144, in the first quarter of fiscal 2009 the Company will classify the Crave assets and liabilities as held for sale and the results of operations for the Crave business will be reported in discontinued operations. There is a reasonable likelihood that upon the sale of Crave, a loss will be incurred because the carrying value of the entity will not be recovered.

During the first quarter of fiscal 2009, the Company retained the same investment banking firm to pursue strategic options related to REPS, as well; an Offering Memorandum was drafted during the first quarter of fiscal 2009 and marketing efforts for REPS will begin in the second quarter of fiscal 2009. In accordance with SFAS No. 144, REPS assets and liabilities will be classified as held and used and its results of operations will be reported in continuing operations as of the end of the first quarter of fiscal 2009. There is a reasonable likelihood that upon the sale of REPS, a loss will be incurred because the carrying value of the entity will not be recovered.

Discontinued Operations

The results of operations for the U.S. and Canadian music category management and distribution businesses are reported in discontinued operations in the Company's Consolidated Statements of Operations for all periods presented in accordance with the guidance in SFAS No. 144. After completion of these sales transactions and the wind down of the remaining business, the operations and cash flows of these business units will be eliminated from the ongoing operations of the Company and the Company will not have any continuing involvement in the operations of the U.S. or Canadian businesses.

Upon completion of the U.S. asset purchase agreement on June 2, 2008, the buyer assumed all category management and distribution operations related to the Company's U.S. music business with Wal-Mart. Wal-Mart represented approximately 74% of the Company's U.S. revenues in fiscal 2008. The Company's remaining non-Wal-Mart category management and distribution customers are expected to transition to other suppliers by the end of August 2008. Upon completion of the Canadian asset purchase agreement, all of the Canadian music category management and distribution operations will transition to the buyer. The closing of this transaction is expected to occur shortly after receipt of Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009.

The table below summarizes the discontinued operations included in the Company's Consolidated Statements of Operations, all of which were previously included in the category management and distribution operations reporting segment, for the fiscal years ended May 3, 2008 and April 28, 2007 (in thousands of dollars):

	<u>Fiscal 2008</u>	<u>Fiscal 2007</u>
Revenues	\$ 664,652	\$ 766,119

Pre-tax income from operations

\$ 41,165 \$ 73,672

4. Impairment and Other Charges

Impairment Charges

In light of the change in the Company's future outlook, the Company reviewed its long-lived assets for potential impairment as of the end of fiscal 2008. In April 2008, the Company's Board of Directors approved that the Company exit the music distribution business in North America and enter into an agreement in principle with Anderson for select U.S. music inventory and all of the store fixtures related to the Wal-Mart business. During the first quarter of fiscal 2009, the Company

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also began discussions with Tesco, and reached an agreement in principle to sell certain assets and assume all of the operations related to its UK category management and distribution business related to Tesco. Based on the revised Company outlook and the projected cash flows for these business units, impairment analyses were performed in accordance with the guidance in SFAS No. 144, and as a result, certain assets were deemed impaired; accordingly, impairment charges of \$15,765,000 were recorded in the fourth quarter of fiscal 2008. These charges primarily related to certain Handleman corporate proprietary and licensed computer software to be transferred to Tesco at the close of the asset purchase agreement with Tesco and Handleman UK's machinery and equipment and related assets that were used exclusively for the storage and distribution of Tesco inventory to Tesco stores under their current business arrangement. These impairment charges were included in Impairment of subsidiary assets in the Company's Consolidated Statements of Operations.

In addition, an impairment charge related to U.S. machinery and equipment in the Indianapolis, Indiana distribution center, and leasehold improvements on that facility, was recorded in the amount of \$1,483,000 and is included in income from operations of discontinued subsidiaries in the Company's Consolidated Statements of Operations.

During the third quarter of fiscal 2008, Handleman UK and its customer ASDA determined that their business relationship related to the greeting cards business, which began in October 2006, would terminate in May 2008. Management determined that events leading up to and resulting in this separation represented a triggering event during the third quarter of fiscal 2008. In accordance with SFAS No. 144, the Company recorded a fixed asset impairment charge of \$1,432,000 primarily related to Handleman UK's machinery and equipment and related assets that were used exclusively for this product line. This impairment charge was recorded in the third quarter of fiscal 2008 and is included in Impairment of subsidiary assets in the Company's Consolidated Statements of Operations.

The following table summarizes the impairment charges recorded during fiscal 2008 by reporting segment and included in the Company's Consolidated Statements of Operations (in thousands of dollars):

	Category Management and Distribution Operations	Corporate
	<u> </u>	<u> </u>
Computer software - corporate	\$	\$ 14,490
UK machinery and equipment - Tesco		
business	1,275	
UK machinery and equipment		
greeting cards business	1,432	
	<u> </u>	<u> </u>
Total impairment charges included in		
continuing operations	\$ 2,707	\$ 14,490
	<u> </u>	<u> </u>
U.S. machinery and equipment - U.S.	\$ 1,483	\$

music business

Total impairment charge included in discontinued operations

\$ 1,483

\$

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Other Charges

The Company recorded an inventory markdown in the amount of \$2,200,000, representing the Company's best estimate of the adjustment necessary to mark the U.S. inventory down to net realizable value based on the Company's decision in the fourth quarter of fiscal 2008 to exit the music business in North America. The charge was recorded in the fourth quarter of fiscal 2008 and included in income from operations of discontinued subsidiaries in the Company's Consolidated Statements of Operations. The Company believes the inventory markdowns are adequate; however, the markdowns are subject to change as the Company completes the liquidation of the remaining inventory. The Company anticipates that the liquidation of the remaining inventory will be completed early in fiscal 2009.

The Company estimates that one-time costs related to its decision to exit the music business in North America will approximate \$14,000,000. These costs will be recorded in accordance with the guidance provided in SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. Severance costs were not accrued in the fourth quarter of fiscal 2008 because the Company was still developing the benefit termination plans for employees and because the communication to employees had not yet occurred as of May 3, 2008. All other one-time exit costs will be recorded as incurred in fiscal 2009.

During the first quarter of fiscal 2008, the Company announced that Handleman UK and ASDA decided not to continue their music supply arrangement effective August 2007. Pursuant to that decision, during fiscal 2008 Handleman UK developed and executed a plan to liquidate music inventory. As a result, and as previously discussed, management recorded an inventory markdown in the amount of \$9,000,000 in the fourth quarter of fiscal 2007. Management determined that an additional inventory markdown in the amount of \$1,922,000 was required in the fourth quarter of fiscal 2008. This amount was included in Direct product costs in the Company's Consolidated Statements of Operations.

In the UK, there is a statutory obligation for companies to pay severance, upon termination, to employees who will neither be transferred to a new organization (if applicable) under the Transfer of Undertakings (Protection of Employment) regulations, nor be retained by the existing company in some other capacity. This statutory requirement is the equivalent of a benefit plan and is subject to the guidance in SFAS No. 112, Employers Accounting for Postemployment Benefits, an amendment of FASB Statements No. 5 and 43, because there is a mutual understanding between the employee and the company. The Company expects that substantially all of the employees in the UK will transition with the operations to Tesco upon completion of the asset purchase agreement. Accordingly, no severance costs have been accrued in fiscal 2008 related to the asset purchase agreement with Tesco.

5. ASDA Supply Arrangements

Greeting Cards

During the third quarter of fiscal 2008, Handleman UK determined, in conjunction with its customer (ASDA), that their business relationship related to the greeting cards business, which began in October 2006, would terminate in May 2008. This decision was mainly due to the customer's desire to work directly with the greeting cards vendor to service its retail stores. Upon cessation of this greeting cards business relationship, ASDA was no longer a customer of Handleman UK. Greeting card sales to ASDA represented \$71,401,000 of the Company's consolidated revenues for fiscal 2008 and \$39,324,000 of consolidated revenues for fiscal 2007.

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Management determined that events leading up to and resulting in this separation represented a triggering event during the third quarter of fiscal 2008. As discussed in Note 4 of Notes to Consolidated Financial Statements, in accordance with SFAS No. 144, the Company recorded a fixed asset impairment charge of \$1,432,000 primarily related to the Company's warehouse facility and related assets that were used exclusively for this product line because the carrying value of the asset group associated with the greeting card business exceeded its fair value. This amount was recorded in the third quarter of fiscal 2008 and was included in Impairment of subsidiary assets in the Company's Consolidated Statements of Operations. In the greeting cards business model, Handleman UK did not own the greeting card product until the product was shipped from its facility. Accordingly, no inventory markdown to liquidation value was required. In the UK, there is a statutory obligation for companies to pay severance, upon termination, to employees who will neither be transferred to a new organization (if applicable) under the Transfer of Undertakings (Protection of Employment) regulations, nor be retained by the existing company in some other capacity. This statutory requirement is the equivalent of a benefit plan and is subject to the guidance in SFAS No. 112, because there is a mutual understanding between the employee and the company. The Company transitioned certain employees to other UK activities. Severance costs of \$120,000 have been accrued in the fourth quarter of fiscal 2008 related to the termination of this greeting cards business. These costs were charged to Selling, general and administrative expenses in the Company's Consolidated Statements of Operations.

The Company estimates that one-time costs related to the termination of this greeting cards business will approximate \$600,000. In accordance with SFAS No. 146, exit costs associated with this termination will be recorded as incurred. In the fourth quarter of fiscal 2008, the Company incurred \$423,000 in one-time costs related to the termination of the greeting card business, of which \$247,000 related to merchandise penalties and inventory shrinkage; these costs were charged to Direct product costs in the Company's Consolidated Statements of Operations. The remaining \$176,000 related to vehicle termination fees and was charged to Selling, general and administrative expenses in the Company's Consolidated Statements of Operations.

Music

On May 24, 2007, the Company announced that Handleman UK and ASDA decided not to continue their music supply arrangement. Under this arrangement, Handleman UK provided category management and distribution of music CDs and, to a limited extent, DVDs to ASDA stores. The decision not to continue the music supply arrangement was due to the inability of Handleman UK and ASDA to reach terms that were mutually beneficial. Music and DVD sales to ASDA represented \$57,339,000 of the Company's consolidated revenues for the first four months of fiscal 2008 (through the agreed upon termination date) and \$268,000,000 of the Company's consolidated revenues during fiscal 2007. Handleman UK provided music category management and distribution services to ASDA through August 2007.

Management determined that events leading up to and resulting in this separation represented a triggering event during the fourth quarter of fiscal 2007. Accordingly, the Company recorded an inventory markdown in the amount of \$9,000,000 in the fourth quarter of fiscal 2007, representing the Company's best estimate of the adjustment necessary to mark inventory down to liquidation value. The Company recorded an additional \$1,922,000 in the fourth quarter of fiscal 2008. These amounts were included in Direct product costs in the Company's fiscal 2007 and 2008 Consolidated Statements of Operations, respectively. The Company believes these inventory markdowns are adequate; however, the markdowns are subject to change as the Company completes the liquidation of the remaining inventory. The Company anticipates that the liquidation of the remaining inventory will be completed early in fiscal 2009.

In addition, the Company recorded an impairment charge of \$734,000 related to fixed assets, because the carrying value of the asset group associated with the music category management and

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distribution activities exceeded its fair value. This impairment charge was also recorded in the fourth quarter of fiscal 2007 in accordance with SFAS No. 144, and was included in Selling, general and administrative expenses in the Company's fiscal 2007 Consolidated Statements of Operations.

The Company estimates, although it cannot make any assurances, that additional one-time costs related to the termination of its music supply agreement are substantially complete and no significant additional costs are expected to be incurred in fiscal 2009. In accordance with SFAS No. 146, exit costs associated with this termination have been recorded as incurred. During fiscal 2008, the Company incurred \$2,674,000 in one-time costs related to the discontinuance of the ASDA business. These costs included \$1,079,000 related to warehouse and storage costs incurred to liquidate inventory; \$850,000 related to inventory liquidation retail outlets; \$655,000 related to third-party consulting costs; and \$90,000 related to vehicle contract termination costs. These amounts were included in Selling, general and administrative expenses in the Company's Consolidated Statements of Operations. In accordance with UK Transfer of Undertakings (Protection of Employment) regulations, the Company accrued severance costs of \$253,000 during fiscal 2008. These amounts were included in Selling, general and administrative expenses in the Company's Consolidated Statements of Operations.

6. Goodwill and Intangible Assets

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 in the fourth quarter of each fiscal year or as business conditions warrant a review. 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 a discounted cash flow methodology.

The Company performed its annual goodwill impairment tests during the fourth quarter of fiscal 2008. A third-party valuation was obtained to determine the fair value of the Crave and REPS entities using projected cash flows prepared by the Company; management determined that the fair value of Crave did not exceed its carrying value and, as a result, all of the Crave goodwill was deemed impaired. This impairment for Crave was mainly due to future cash flows being negatively impacted by Crave's strategy to increase expenditures related to its software development business, specifically to increase its investments in exclusive distribution arrangements. The valuation for REPS resulted in no goodwill impairment. In accordance with SFAS No. 142, the Company recorded a goodwill impairment charge of \$26,629,000 related to Crave in the fourth quarter of fiscal 2008. The charge was included in Impairment of goodwill in the Company's Consolidated Statements of Operations.

During the third quarter of fiscal 2008, Handleman UK determined in conjunction with its customer ASDA, that their business relationship related to the greeting cards business, would terminate effective May 2008. Due to the discontinuance of this business in the UK, an impairment test of goodwill related to the Handleman UK reporting unit was performed in the third quarter of this fiscal year. As a result of this test, no goodwill impairment charge was recorded in the third quarter of fiscal 2008.

The Company also performed its annual goodwill impairment test related to Handleman UK as of the fourth quarter of fiscal 2008. Based on the Company's decision in the first quarter of fiscal 2009 to begin discussions with Tesco for the possible sale of the Tesco-related UK operations,

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the projected cash flows of that entity changed significantly from the assumptions used in the third quarter. Using the new assumptions for cash flow and fair value for Handleman UK, management

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determined that all of the Handleman UK goodwill was impaired, based on the guidance provided in SFAS No. 142. The Company recorded a goodwill impairment charge of \$3,406,000 in the fourth quarter of fiscal 2008. This charge was included in Impairment of goodwill in the Company's Consolidated Statements of Operations.

The following table summarizes the changes in the Company's goodwill by reporting segment for the fiscal year ended May 3, 2008 (in thousands of dollars):

	Category Management and Distribution Operations	Video Games	All Other
	<u> </u>	<u> </u>	<u> </u>
Balance as of April 28, 2007	\$ 3,406	\$ 26,629	\$ 6,903
Impairment charges	(3,406)	(26,629)	
	<u> </u>	<u> </u>	<u> </u>
Balance as of May 3, 2008	<u>\$</u>	<u>\$</u>	<u>\$ 6,903</u>

Intangible Assets

The intangible assets predominately relate to the acquisitions of Crave and REPS. The Company performs annual impairment analyses, or as business conditions warrant a review, comparing the carrying value of its intangible assets with the future economic benefit of these assets. Based on such analyses, the Company adjusts, as necessary, the value of its intangible assets. The Company performed its annual impairment tests in the fourth quarter of fiscal 2008. A third-party valuation was prepared in accordance with SFAS No. 144 for the Crave and REPS intangible assets and management determined that these assets were not impaired. Accordingly, no impairment charge was recorded during fiscal 2008 nor was any impairment charge previously recorded in fiscal 2007.

Internally Developed Video Game Software

Crave, through one of its subsidiary companies, publishes video game titles under the Crave brand name. These titles support Sony, Nintendo and/or Microsoft video game platforms and are distributed by Crave. As a result, Crave incurs obligations to contracted video game software developers and, in some cases, obligations to intellectual property right holders.

Under its software development agreements, payments are typically based on the achievement of defined milestones, which vary by agreement. Such milestones include payments due at the signing of the agreements, design and/or technical achievements and delivery of completed product; these advances are typically not refundable. These developed games are the property of Crave. 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, which

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requires that these costs are capitalized once technological feasibility of a product is established and such costs are determined to be recoverable. Under this guidance, technological feasibility should be evaluated on a product-by-product basis. Payments prior to technological feasibility, or amounts otherwise related to software development that are not capitalized, should be charged immediately to research and development expense. Crave generally engages independent software developers experienced with the current video game platforms developed by the manufacturers. Due to the experience of the software developers and the established game platform technology, technological feasibility is already proven prior to the beginning of, or occurs very early in, the development cycle. Therefore, Crave typically does not incur any research and development costs. The Company did not incur any research and

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development costs for the fiscal years ended May 3, 2008 or April 28, 2007, because technological feasibility related to the development of video game titles was established prior to the start of game development.

Software development payments are classified as Intangible assets, net in the Company's Consolidated Balance Sheets. Commencing upon product release, these payments are amortized as royalty expense based upon the ratio of current revenues to total projected revenues, generally over a period of 18 months, and included in Direct product costs in the Company's Consolidated Statements of Operations. The Company performs quarterly analyses, comparing the carrying value of its software development costs with the expected sales performance of the specific products for which the costs relate. Management's judgments and estimates are utilized in the ongoing assessment of the recoverability of these advances. Based on such analyses, the Company adjusts, when necessary, the value of its software development costs.

Certain software development agreements may require Crave to make additional payments based on pre-defined sales volumes. Subject to these terms, once all advance payments to developers have been expensed, additional payments to developers may be required. These additional payments are accrued as royalties and included in Accrued and other liabilities in the Company's Consolidated Balance Sheets.

Under Crave's intellectual property licensing agreements, payments are made to licensors in exchange for the rights to utilize intellectual properties owned by the licensors (e.g. popular animated characters, including all designs, themes and story lines) that may be used in the development of video game software. Payments to licensors allow Crave the limited right to use these intellectual properties, and at no time does Crave take ownership of these intellectual properties. Advances under these licensing agreements typically occur at the signing of the agreements and are not refundable. License advance payments are classified as Intangible assets, net in the Company's Consolidated Balance Sheets. Commencing upon product release, these payments are amortized as royalty expense based upon the ratio of current revenues to total projected revenues, generally over a period of 18 months, and included in Direct product costs in the Company's Consolidated Statements of Operations. The Company performs quarterly analyses comparing the carrying value of its license advances with the expected sales performance of the specific products to which the costs relate. Management's judgments and estimates are utilized in the ongoing assessment of the recoverability of these advances. Based on such analyses, the Company adjusts, when necessary, the value of its license advances. Certain intellectual property licensing agreements may require Crave to make additional payments based on sales volumes. Subject to these terms, once all advance payments to licensors have been expensed, additional payments to licensors may be required. These additional payments are accrued as royalties and are included in Accrued and other liabilities in the Company's Consolidated Balance Sheets.

Purchased Video Game Software

Crave also purchases video game software from other software developers that support Sony, Nintendo and Microsoft video game platforms. As a distributor, Crave occasionally enters into exclusive distribution agreements with these video game suppliers. Under these exclusive distribution agreements, Crave has the right to sole distribution of the agreed upon video software games. The agreements vary by supplier, and may obligate Crave to pay minimum distribution fees or purchase a specified number of units over a designated period of time. Payments under these exclusive distribution agreements are usually made at the time the agreements are signed, at the time of manufacturing, or in some instances, at the time of product receipt by Crave. These exclusive distribution advances are classified as Intangible assets, net in the Company's Consolidated Balance Sheets and are amortized as royalty expense based upon sales of product purchased from these suppliers, and included in Direct product costs in the Company's Consolidated Statements of Operations. Under certain of these exclusive distribution agreements,

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additional payments to these suppliers may be required if pre-defined minimum purchase volumes are exceeded. These additional payments are also classified as Intangible assets, net in the Company's Consolidated Balance Sheets. Management's judgments and estimates are utilized in the ongoing assessment of the recoverability of these advances.

The Company's future minimum payment commitments related to all of these agreements, as discussed above, are \$9,697,000 as of May 3, 2008. Accrued royalties as of May 3, 2008 and April 28, 2007 totaled \$673,000 and \$482,000, respectively.

The following information relates to intangible assets subject to amortization as of May 3, 2008 and April 28, 2007 (in thousands of dollars):

Amortized Intangible Assets	May 3, 2008		April 28, 2007	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Trademark	\$ 7,900	\$ 3,550	\$ 7,900	\$ 2,182
Customer relationships	28,100	12,350	28,100	7,547
Non-compete agreements	4,770	3,466	3,970	1,849
Software development costs and distribution/license advances	35,522	21,864	18,785	10,744
Total	\$ 76,292	\$ 41,230	\$ 58,755	\$ 22,322

Amortized Intangible Assets	May 3, 2008		April 28, 2007	
	Net Amount	Weighted Average Amortization Period	Net Amount	Weighted Average Amortization Period
Trademark	\$ 4,350	180 mos.	\$ 5,718	180 mos.
Customer relationships	15,750	227 mos.	20,553	227 mos.
Non-compete agreements	1,304	37 mos.	2,121	41 mos.
Software development costs and distribution/license advances	13,658	18 mos.	8,041	17 mos.
Total	\$ 35,062	113 mos.	\$ 36,433	141 mos.

Royalty expense related specifically to software development costs and licensed rights included in Recoupment of development costs/licensed rights in the Company's Consolidated Statements of Cash Flows is as follows (in thousands of dollars):

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<u>Royalty Expense</u>	<u>May 3, 2008</u>	<u>April 28, 2007</u>
Software development costs, including write down to net realizable value of \$568 for fiscal year 2008 and \$2,628 for fiscal 2007	\$ 5,560	\$ 6,118
Exclusive distribution rights, including write down to net realizable value of \$15 for fiscal year 2008	4,775	
Licensed intellectual property rights, including write down to net realizable value of \$62 for fiscal year 2008 and \$373 for fiscal year 2007	785	1,206
Total	\$ 11,120	\$ 7,324

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The Company's aggregate amortization expense for fiscal 2008 and fiscal 2007 totaled \$18,908,000 and \$16,206,000, respectively. The Company estimates future aggregate amortization expense as follows (in thousands of dollars):

Fiscal Years	Amounts
2009	\$ 15,115
2010	8,289
2011	2,771
2012	2,083
2013	1,622
Thereafter	5,182
Total	\$ 35,062

7. Property and Equipment

Property and equipment consists of the following (in thousands of dollars):

	2008	2007
Land	\$ 640	\$ 640
Buildings and improvements	13,245	13,245
Display fixtures	1	28,821
Computer hardware and software	21,641	66,111
Equipment, furniture and other	24,711	56,863
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