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HANDLEMAN CO /MI/
Form 10-Q
September 16, 2003
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the first quarter ended August 2, 2003

Commission File Number 1-7923

Handleman Company

(Exact name of registrant as specified in its charter)

Michigan

38-1242806

(State or other jurisdiction of
incorporation or organization)

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

500 Kirts Boulevard, Troy, Michigan

48084-4142

Area Code 248 362-4400

(Address of principal executive offices)

(Zip code)

(Registrant's telephone number)

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

YES X NO

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

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YES X NO

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

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

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HANDLEMAN COMPANY

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

HANDLEMAN COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)
(in thousands of dollars except per share data)

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

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

Table of Contents**HANDLEMAN COMPANY****CONSOLIDATED BALANCE SHEETS****(in thousands of dollars except share data)**

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

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

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

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

(UNAUDITED)

(in thousands of dollars)

Three Months (13 Weeks) Ended August 2, 2003

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

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

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(in thousands of dollars)

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

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

1. In the opinion of management, the accompanying consolidated balance sheets and consolidated statements of income, shareholders' equity and cash flows contain all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position of the Company as of August 2, 2003, and the results of operations and changes in cash flows for the three months then ended. Because of the seasonal nature of the Company's business, sales and earnings results for the three months ended August 2, 2003 are not necessarily indicative of what the results will be for the full year. The consolidated balance sheet as of May 3, 2003, included in this Form 10-Q, was derived from the audited consolidated financial statements of the Company included in the Company's 2003 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended May 3, 2003, including the discussion of the Company's critical accounting policies.
2. The accompanying consolidated financial statements for the three months ended July 27, 2002 have been restated to recognize revenues upon customer receipt rather than at the time of shipment to reflect when risk of ownership is effectively transferred to the Company's customers. In addition, the Company has revised the accounting for two vendor contracts negotiated by a subsidiary of the Company during fiscal 2001. The Company has also reclassified costs associated with acquiring and preparing inventory for distribution from selling, general and administrative expenses to direct product costs for the three months ended July 27, 2002, to conform to the presentation adopted in the fourth quarter of fiscal 2003. As a result of the aforementioned, the Company has restated its financial statements for the three months ended July 27, 2002.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

| <u>Period</u> | <u>Amount</u> |
|-----------------------------------|---------------|
| Three months ended August 2, 2003 | \$ 4,222 |
| Three months ended July 27, 2002 | 4,449 |

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

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

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

- In May 2003, SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, was issued by the Financial Accounting Standards Board. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments based on whether such financial instruments embody an obligation of the issuer. The Company is evaluating the impact of this Statement and does not expect that SFAS No. 150 will have a significant effect on the consolidated financial position and results of operations of the Company.
- The Company operates in two business segments: Handleman Entertainment Resources (H.E.R.) is a category manager and distributor of prerecorded music to mass merchants, principally in North America and the United Kingdom; and North Coast Entertainment (NCE), through its Anchor Bay Entertainment division, is responsible for the Company's proprietary operations, which markets video titles on DVD and VHS formats.

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

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

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

| Three Months Ended August 2, 2003: | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
|---|---------------|------------|--------------|
| Revenues, external customers | \$ 205,070 | \$ 19,100 | \$ 224,170 |
| Intersegment revenues | | | |
| Segment income | 1,521 | 1,600 | 3,121 |
| Total assets | 448,206 | 78,075 | 526,281 |
| Capital expenditures | 1,765 | 49 | 1,814 |
| | | | |
| Three Months Ended July 27, 2002, Restated: | <u>H.E.R.</u> | <u>NCE</u> | <u>Total</u> |
| Revenues, external customers | \$ 252,097 | \$ 24,988 | \$ 277,085 |
| Intersegment revenues | | 4,231 | 4,231 |
| Segment income | 4,137 | 166 | 4,303 |
| Total assets | 467,649 | 154,586 | 622,235 |
| Capital expenditures | 1,888 | 261 | 2,149 |

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

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

8. Comprehensive income is net income plus certain other items recorded directly to shareholders' equity. Comprehensive income, net of tax was \$2.0 million for the first quarter ended August 2, 2003, compared to \$6.4 million, restated, for the first quarter ended July 27, 2002.
9. A reconciliation of the weighted average shares used in the calculation of basic and diluted shares is as follows (in thousands):

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

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Item 2.

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

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

Revenues for the first quarter of fiscal 2004, which ended August 2, 2003, were \$224.3 million, compared to \$277.2 million for the first quarter of fiscal 2003, which ended July 27, 2002. Net income for the first quarter of fiscal 2004 was \$1.7 million, or \$.07 per diluted share, compared to \$2.7 million, or \$.10 per diluted share for the first quarter of fiscal 2003.

The Company has two business segments: Handleman Entertainment Resources (H.E.R.) and North Coast Entertainment (NCE). H.E.R. consists of music category management and distribution operations principally in North America and the United Kingdom (UK). NCE, through its Anchor Bay Entertainment division, encompasses the Company's proprietary operations, which markets video titles on DVD and VHS formats.

H.E.R. revenues declined to \$205.1 million for the first quarter of fiscal 2004 from \$252.1 million for the first quarter of fiscal 2003, a decrease of 19%. The decrease in H.E.R. revenues for the first quarter of this year was primarily due to lower net sales within the H.E.R. United States (U.S.) operation, which was impacted by fewer stores serviced, accounting for \$19.6 million of the decrease. The remaining decrease in H.E.R. revenues was mainly a result of the weakness in overall music industry sales.

NCE revenues for the first quarter of this fiscal year were \$19.1 million, compared to \$29.2 million for the first quarter of last fiscal year, a decrease of 35%. The lower revenues for the first quarter of this year were due to the absence of Madacy Entertainment revenues of \$14.4 million, resulting from the sale of that entity during the Company's fiscal 2003 third quarter, partially offset by increased sales within the Anchor Bay Entertainment unit.

Consolidated direct product costs as a percentage of revenues was 77.5% for the first quarter ended August 2, 2003, compared to 79.1% for the first quarter ended July 27, 2002. The decrease in direct product costs as a percentage of revenues was primarily driven by lower direct product costs within the H.E.R. business segment. Within H.E.R., the U.S. operation accounted for approximately 82% of the improvement in direct product costs as a percentage of revenues, primarily due to a change in sales mix for the first quarter of this fiscal year versus the comparable prior year period. The remaining improvement in H.E.R. direct product costs as a percentage of revenues resulted from lower direct product costs in the UK, principally due to the ongoing negotiation of more favorable vendor terms. Consolidated direct product costs for the first quarters ended August 2, 2003 and July 27, 2002 included costs associated with

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acquiring and preparing inventory for distribution in the amounts of \$2.4 million and \$2.7 million, respectively.

Consolidated SG&A expenses were \$47.0 million or 20.9% of revenues for the first quarter of this fiscal year, compared to \$53.2 million, or 19.2% of revenues for the first quarter of last fiscal year. This decrease in SG&A expenses of \$6.2 million was driven by the absence of Madacy Entertainment, which incurred \$3.8 million in SG&A expenses in the first quarter last year, and a decrease in SG&A expenses of \$2.5 million at the Company's e-commerce subsidiary, resulting from the refocusing of that subsidiary in the third quarter of last fiscal year to better align its operations with the Company's core competencies of distribution and category management.

Consolidated income before interest, income taxes and minority interest (operating income) for the first quarter of fiscal 2004 decreased to \$3.6 million from \$4.7 million for the first quarter of fiscal 2003.

H.E.R. operating income for the first quarter of fiscal 2004 was \$1.5 million, down from \$4.1 million for the first quarter of fiscal 2003. The lower H.E.R. operating income was predominately due to a decrease in its U.S. operating income of \$7.6 million over the same period last year, primarily due to the lower sales volume resulting from fewer stores serviced and the weakness in overall music industry sales. The lower U.S. operating income was partially offset by a reduction in the operating loss of \$2.5 million at the Company's e-commerce subsidiary due to the refocusing of that subsidiary as discussed above, and an improvement in operating income within the H.E.R. UK operation of \$1.9 million, chiefly due to lower direct product costs as a percentage of revenues resulting from the ongoing negotiation of more favorable vendor terms.

NCE operating income for the first quarter of fiscal 2003 was \$1.6 million, compared to operating income of \$0.2 million for the comparable period of last fiscal year. The increase in NCE operating income was predominately due to improved operating performance within the Anchor Bay U.S. business unit, primarily driven by higher sales volume in the first quarter of this fiscal year.

Interest income, net for the first quarter of fiscal 2004 was \$0.2 million, compared to interest expense, net of \$0.4 million for the first quarter of fiscal 2003. The improvement was due to lower borrowing levels in the first quarter of this year, compared to the same period of last year.

The effective income tax rate for the first quarter of this fiscal year was 54.2%, compared to 41.7% for the first quarter of last fiscal year. The higher effective rate this year was attributable to providing a valuation reserve against a tax benefit on certain operating losses.

During the first quarter of this fiscal year, the Company repurchased 891,900 shares of its common stock at an average price of \$16.61 per share.

Accounts receivable at August 2, 2003 was \$169.8 million, compared to \$202.0 million at May 3, 2003. The decrease was due to lower sales volume in the first quarter of fiscal 2004, compared to the fourth quarter of fiscal 2003.

Merchandise inventories at August 2, 2003 was \$142.9 million, compared to \$120.0 million at May 3, 2003. The increase in merchandise inventories was primarily due to accelerated

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inventory purchases made to take advantage of favorable terms offered by the Company's vendors, as well as increased inventory purchases to support the higher sales level anticipated in the second quarter of fiscal 2004.

Accounts payable at August 2, 2003 totaled \$152.3 million, compared to \$159.7 million at May 3, 2003. The decrease in accounts payable was chiefly due to the timing of payments to vendors.

Accrued and other liabilities decreased to \$29.5 million at August 2, 2003, from \$40.6 million at May 3, 2003. The decrease was primarily attributable to a decrease in accrued compensation related items.

Cash provided from operating activities was \$2.5 million for the first quarter of this fiscal year, compared to \$20.5 million for the same quarter of last fiscal year. The decrease in cash flows from operating activities was primarily related to unfavorable year-over-year changes in accounts receivable, merchandise inventories and other operating assets balances of \$17.2 million, \$14.2 million and \$5.9 million, respectively, partially offset by a favorable year-over-year change in accounts payable balances of \$19.4 million. Net cash used by investing activities decreased to \$5.4 million for the first quarter of fiscal 2004 from \$14.2 million for the comparable prior year period. The decrease in net cash used by investing activities was principally due to additional investments in subsidiaries of \$5.8 million made in the first quarter of last fiscal year, and a lower investment in acquired rights of \$2.7 million over the same period last fiscal year. Cash used by financing activities was \$12.2 million for the first quarter of this fiscal year, compared to \$20.7 million for the first quarter of last fiscal year. The year-over-year decrease in net cash used by financing activities of \$8.5 million was mainly attributable to lower overall borrowing levels, generating cash in the amount of \$23.3, partially offset by increased repurchases of the Company's common stock of \$13.3 million over the same period last year.

The Company has an unsecured \$170 million line of credit, arranged with a consortium of banks. This agreement expires in August 2005. Management believes that the revolving credit agreement, along with cash provided from operations, will provide sufficient liquidity to fund the Company's day-to-day operations, including seasonal increases in working capital, as well as repurchases of common stock under the Company's stock repurchase program. The Company had no borrowings against its line of credit during the first quarter ended August 2, 2003. The Company also has a senior note agreement with a group of insurance companies. The remaining balance on the senior note agreement is \$7.1 million and is payable in equal annual installments through fiscal 2005.

Reference should be made to Note 6 of the Notes to Consolidated Financial Statements, in this Form 10-Q, for new accounting pronouncements adopted in fiscal 2004, and those currently being evaluated by the Company.

The Company continues to expect revenues during fiscal 2004 to increase slightly from the prior fiscal year, which included sales from both Madacy Entertainment and over 300 stores closed by one of the Company's customers in January 2003. This revenue growth is dependent upon several factors including the success of new releases during the upcoming holiday season; the Company's ability to grow sales to existing and new customers; the competitive nature of retail pricing and pricing policies of the Company's suppliers; competition from DVD sales, computer games and other forms of software entertainment; music product piracy; and the overall health of the economy, the retail sector and the music industry. The

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Company expects direct product costs as a percentage of revenues for fiscal 2004 to be comparable to those of fiscal 2003. The Company also expects to continue to gain operating efficiencies in fiscal 2004, and thus reduce SG&A expenses slightly from the prior fiscal year. The Company expects a more normalized tax rate in the 37-38% range for fiscal 2004. As a result, the Company believes that fully diluted earnings per share will increase for fiscal 2004 and fall within the range of \$1.80 to \$1.88 per share. The Company plans to continue to repurchase shares of its common stock under its share repurchase program during the remainder of fiscal 2004.

* * * * *

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

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Item 4.

CONTROLS AND PROCEDURES

An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e)) of the Securities Exchange Act of 1934 (the Act) as of August 2, 2003 was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures, as currently in effect, are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the first fiscal quarter ended August 2, 2003, that have materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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

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PART II OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

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

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

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

(b) Reports on Form 8-K

During the quarter ended August 2, 2003, the Company filed the following Current Reports on Form 8-K:

(1) On June 11, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting registrant's results for the fourth quarter and fiscal year ended May 3, 2003.

(2) On June 30, 2003, the Company filed a Current Report on Form 8-K for the purpose of filing a press release reporting a complaint filed by Kmart Corporation, a customer of the registrant.

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

HANDLEMAN COMPANY

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Date: September 16, 2003

By: /s/ Stephen Strome

STEPHEN STROME
Chairman of the Board and

Chief Executive Officer

Date: September 16, 2003

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

THOMAS C. BRAUM, JR.
Senior Vice President and

Chief Financial Officer

(Principal Financial Officer)