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HANDLEMAN CO /MI/
Form 10-K
July 24, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended April 28, 2001 Commission File No. 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

(Address of principal executive offices)

(Zip Code)

248-362-4400

(Registrant's telephone number, including area code)

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

| Title of each class | Name of each exchange which registered |
|------------------------------|--|
| ----- | ----- |
| COMMON STOCK \$.01 PAR VALUE | NEW YORK STOCK EXCHANGE |

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

NONE

(Title of Class)

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 X NO _____

State the aggregate market value of the voting stock held by non-affiliates of the registrant. The aggregate market value shall be computed by reference to the price at which the stock was sold, or the average bid and asked prices of such stock, as of a specified date within 60 days prior to the date of filing. The aggregate market value as of June 29, 2001 was \$424,813,000.

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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 June 29, 2001 was 26,682,285.

Item 14(a) 3. on page 40 describes the exhibits filed with the Securities and Exchange Commission.

Certain sections of the definitive Proxy Statement to be filed for the 2001 Annual Meeting of Shareholders are incorporated by reference into Part III.

PART 1

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.

DESCRIPTION OF BUSINESS:

Handleman Company is comprised of two operating segments: Handleman Entertainment Resources (H.E.R.) and North Coast Entertainment (NCE).

H.E.R. is a category manager and distributor of prerecorded music to mass merchants in the United States, United Kingdom, Canada, Mexico and Brazil. As a category manager, H.E.R. manages a broad assortment of titles required to optimize sales in retail stores and provides direct-to-store shipments, marketing of the selections, in-store merchandising and product exchange.

NCE has three companies in its portfolio. Anchor Bay Entertainment, an independent home video label, markets a collection of titles that range from horror to exercise to children's classics. Madacy Entertainment, an independent record label, markets music and video products with a catalog spanning all genres. The itsy bitsy Entertainment Company is a provider of early childhood entertainment, both on and off the screen, for the youngest of children and their caregivers.

The accounting policies of the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements, "Accounting Policies." Segment data includes intersegment revenues, as well as a charge allocating all 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.

See Note 2 of Notes to Consolidated Financial Statements for additional information regarding segment activities.

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The following table sets forth net sales, and the percentage contribution to consolidated revenues, for the Company's two business segments for the fiscal years ended April 28, 2001 ("Fiscal 2001"), April 29, 2000 ("Fiscal 2000") and May 1, 1999 ("Fiscal 1999").

Years Ende

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(dollar amounts in

| | April 28, 2001 (52 weeks) | April 29, 2000 (52 weeks) |
|--|------------------------------|------------------------------|
| Handleman Entertainment Resources | \$1,064.0 | \$1,011.3 |
| % of Total | 89.2 | 88.9 |
| North Coast Entertainment | 142.7 | 142.0 |
| % of Total | 12.0 | 12.5 |
| Eliminations, principally NCE sales to H.E.R., net of corporate rental income | (13.7) | (15.7) |
| % of Total | (1.2) | (1.4) |
| Exited activities/(1)/ | -- | -- |
| % of Total | ----- | ----- |
| TOTAL | \$1,193.0 ===== | \$1,137.6 ===== |

(1) Exited activities represent, within H.E.R., sales of the exited video, book and software product lines and sales in Argentina where the operations were sold in the fourth quarter of fiscal 1999, and within NCE, sales at Sofsource, which was sold during the first quarter of fiscal 1999.

Handleman Entertainment Resources

As category manager and distributor of pre-recorded music, H.E.R. manages the selection, acquisition, delivery, display and return of music product for unrelated mass merchant chain stores. The following discussion pertains to these category management activities of H.E.R. which comprises approximately 89% of the Company's sales.

The Company's vendors and customers use the services of H.E.R. for a variety of reasons:

- . Music is a local and national business requiring that products selected for each individual store meet the demand of consumers who frequent each store.
- . Store service - the Company's field sales force visits each mass merchant store to implement a variety of merchandising responsibilities, including verifying that product has been placed on display, ensuring that the department is neatly merchandised and that top-hit product is available, setting up point of purchase displays, reordering product with low inventory levels or required for local events, and ensuring that new release product is displayed as close to the release date as possible.
- . Direct store shipment - the Company bypasses mass merchant distribution centers and ships directly to thousands of retail locations.
- . Numerous small quantity shipments - to tailor each store inventory to changing consumer demand in each store, the Company must make frequent shipments of less than case lot quantities to each store.

The Company distributes throughout vast geographic regions and adapts selections

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to local tastes via a coordination of national and local purchasing responsibility, both monitored by inventory control programs. In fiscal 2001, approximately 93% of H.E.R.'s sales were in the U.S. and Canada.

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Vendors

The Company purchases from many different vendors. The volume of purchases from individual vendors fluctuates from year to year based upon the salability of selections being offered by such vendors. Though a small number of major, financially sound vendors account for a high percentage of purchases, product must be selected from a variety of additional vendors in order to maintain an adequate selection for consumers. The Company must closely monitor its inventory exposure and accounts payable balances with smaller vendors which may not have the financial resources to honor their return commitments.

Since the public's taste for the products the Company supplies is broad and varied, H.E.R. is required to maintain sufficient inventories to satisfy diverse tastes. The Company minimizes the effect of obsolescence through planned purchasing methods and computerized inventory controls. Since substantially all vendors from which the Company purchases product offers some level of return allowances and price protection, the Company's exposure to markdown risk is limited unless vendors are unable to fulfill their return obligations or non-salable product purchases exceed vendor return limitations. Vendors offer a variety of return programs, ranging from 100% returns to zero return allowance. Other vendors offer incentive and penalty arrangements to restrict returns. Accordingly, the Company may possess in its inventories non-salable product that can only be returned to vendors with cost penalties or may be non-returnable until the Company can comply with the provisions of the vendor's return policies.

H.E.R. generally does not have distribution contracts with manufacturers or suppliers; consequently, its relationships with them may be discontinued at any time by such manufacturers or suppliers, or by H.E.R.

Customers

The customers of H.E.R. utilize H.E.R.'s services for a variety of reasons. Products must be selected from a multitude of vendors offering numerous titles, different formats (e.g., compact discs, cassettes) and different payment and return arrangements. In addition, mass merchants utilize category managers due to the complexity of managing the numerous SKUs required per department, the variability of salable items among individual stores of a mass merchant chain, the wide array of programs offered by the multitude of vendors, the "hits" nature of the business and the high risk of inventory obsolescence. By utilizing H.E.R., customers avoid substantially all of the risks inherent in product selection and the risk of inventory obsolescence.

The Company must anticipate consumer demand for individual titles. In order to maximize sales, the Company must be able to immediately react to "breakout" titles, while simultaneously minimizing inventory exposure for artists or titles which do not sell.

H.E.R. also offers customers a variety of "value-added" services:

Store Service: Sales representatives visit individual retail stores and meet

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with store management to discuss upcoming promotions, special merchandising efforts, department changes, current programs, or breaking releases which will increase sales. They also monitor inventory levels, check merchandise displays and install point-of-purchase advertising materials.

Advertising: H.E.R. supplies point-of-purchase materials and assists customers in preparing radio, television and print advertisements.

Fixturing: H.E.R. provides specially designed fixtures that emphasize product visibility and accessibility.

Freight: H.E.R. coordinates delivery of product to each store.

Product Exchange: H.E.R. protects its continuing customers against product markdowns by offering the privilege of exchanging slower-selling product for newer product.

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The nature of the Company's business lends itself to computerized ordering, distribution and store inventory management techniques. The Company is able to tailor the inventories of individual stores to reflect the customer profile of each store and to adjust inventory levels, product mix and selections according to seasonal and current selling trends.

Using proprietary processes and systems to forecast consumer demand, Handleman determines the selections to be offered in its customers' retail stores, and ships these selections to the stores from one of its distribution centers. Slow-selling items are removed from the stores by the Company and are recycled for redistribution to other stores, or for return to the manufacturers. Returns from customer stores occur for a variety of reasons, including new releases which did not achieve their expected sales potential, advertised product to be returned after the promotion has ended, regularly scheduled realignment pick-ups and customer directed returns. The Company (for financial reporting purposes) reduces gross sales and direct product costs for estimated future returns at the time the merchandise is shipped to customer stores.

During the fiscal year ended April 28, 2001, one customer, Wal-Mart, accounted for approximately 44% of the Company's consolidated sales, while a second customer, Kmart, accounted for approximately 35%. Handleman generally does not have contracts with its customers, and such relationships may be changed or discontinued at any time by the customers or Handleman; the discontinuance of, or a significant unfavorable change in, the relationships with either of the two largest customers would have a materially adverse effect upon the Company's future sales and earnings.

Operations

H.E.R. distributes products from facilities in the U.S., Canada, Mexico and the United Kingdom. Besides economies of scale and through-put considerations in determining the number of facilities it operates, the Company must also consider 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 authorized "street dates" is an important driver of both retail sales and customer satisfaction.

Within its facilities, H.E.R. operates return centers, including use of automated return processing equipment in the United States and Canada, to expedite the processing of customer returns. In order to minimize inventory

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investment, customer returns must be sorted and identified for either redistribution or return to vendors as expeditiously as possible. An item returned from one store may be required for shipment to another store. Therefore, timely recycling prevents purchasing duplicate product for a store whose order could be filled from returns from other stores.

H.E.R. has implemented high-technology automated distribution equipment in Indianapolis, Indiana; Sparks, Nevada; and Toronto, Canada; and is in the process of implementing automated distribution equipment in Warrington, United Kingdom.

H.E.R. also utilizes a proprietary inventory management system ("PRISM"). PRISM automates and integrates the functions of ordering product, receiving, warehousing, order fulfillment, ticket printing and perpetual inventory maintenance. PRISM also provides the basis to develop title specific billing to allow the Company to better serve its customers.

Other Developments

On February 1, 2001, the Company began category management, distribution and service to 241 ASDA stores in the United Kingdom. The Company anticipates, going forward, that Handleman UK will add over \$100 million to sales on an annual basis.

In November 2000, H.E.R. launched Handleman Online ("HOL") to enhance its position in music category management by extending its capabilities to internet driven markets. HOL provides both traditional and online retailers with an array of e-commerce related products and services. HOL offers customers outsourced inventory management and shipment of entertainment related products to consumer's homes or to their local stores. Handleman Online also offers an outsourced online webstore solution branded for each retailer that can either be

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offered as a stand-alone webstore or transparently integrated into the retailer's existing online environment. In addition, HOL offers its kiosk products to enhance in-store shopping with preview capabilities as well as allowing consumers to purchase from a deeper catalog of music titles. HOL revenues in fiscal 2001 were not material, nor are such revenues anticipated to be material in fiscal 2002. The Company, however, will continue to invest in HOL in fiscal 2002 to position itself for future opportunities within internet driven markets.

North Coast Entertainment

NCE, a subsidiary of Handleman Company, includes the Company's proprietary product operations. NCE is the umbrella company for subsidiaries which acquire exclusive licensing and distribution rights for home entertainment properties including music and video products. Such items are manufactured and then distributed directly to distributors or retailers. In fiscal 2001, approximately 99% of NCE's sales were in the U.S. and Canada. Many NCE products are categorized as budget, with many retailing for under \$10. Such products are designed to provide high margins to the retailer at prices that generate impulse sales.

NCE provides the following opportunities:

- . NCE enables the Company to take a more active, and more profitable, role in

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the production of home entertainment products. This enhances the Company's profit potential.

- . NCE provides the Company with a wide array of product development and licensing opportunities for music products. This enables H.E.R. to offer a broader range of more profitable products to its customers.
- . NCE gives the Company access to new distribution channels, new markets and new customers. For example, the Company can cross-sell music and video to new or existing customers through any NCE subsidiary sales organization.

NCE's current portfolio is comprised of the following entities:

- . Anchor Bay Entertainment ("ABE") is an independent home video label. In addition to acquiring films for home entertainment distribution, ABE markets a wide variety of products including the award-winning children's series, Thomas the Tank Engine. Thomas has been a member of the ABE family for nearly a decade. ABE also has a solid stable of fitness products including the chart-topping Crunch series and most recently, the popular Yoga for Dummies based on the successful For Dummies book franchise. ABE is

perhaps most noted for being one of the best marketers within the horror genre and has the rights for Halloween and The Evil Dead series.

- . Madacy Entertainment Group ("Madacy") is an independent recording label which markets a range of music and video products with a catalog spanning all genres. Madacy is the largest independently distributed label in North America for the fifth consecutive year as published by Billboard Magazine.

It provides licensing services and distributes music, video, DVD and customer entertainment premiums through its offices located in North America and Europe. Madacy operates nine market-driven divisions namely Madacy Special Products, Madacy Special Markets, Madacy Label Group, Madacy Kids, Madacy Latino, Madacy Christian, Madacy Entertainment Interactive, Madacy Sports Music and Madacy Home Video. The Madacy Label Group, launched in 1999, distributes albums for other labels and produces music for its own labels including Relentless Records (Contemporary Rock and Pop), Relentless Nashville (Country), Bongo Boy Records (World Music, Reggae) and Suite 102 Music (Easy Listening, Jazz). Madacy Entertainment Group provides a variety of marketing services to their clients including the creation and production of advertising, custom packaging, manufacturing of audio, video and DVD, the development of promotional campaigns, branding consultancy, strategic media buying and planning, field marketing, sports marketing and internet marketing.

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- . The itsy bitsy Entertainment Company ("TibECo"), is a provider of early childhood entertainment, both on and off the screen, for the youngest of children and their caregivers. TibECo holds exclusive rights to license a number of popular entertainment properties including Teletubbies, created by Ragdoll Ltd., and the classic children's brand, Eloise. TibECo consists of an on-screen division responsible for producing, selling and distributing its media products as well as an off-screen division, which oversees its licensing, marketing, retail and promotion efforts. In addition, TibECo includes a consumer products division, which creates and distributes its own children's merchandise under the Hooray! brand name.

NCE's management will continue to focus on growing the business through licensing, acquiring or producing new products, as well as via new markets, new customers, geographical growth, growth within the home entertainment category

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and selective acquisitions and joint ventures.

Competition

Handleman is primarily a category manager of music products. The business of the Company is highly competitive as to both price and alternative supply arrangements. Besides competition among the Company's mass merchant customers, the Company's customers compete with alternative sources from which consumers could purchase the same product, such as (1) specialty retail outlets, (2) electronic specialty stores, (3) record clubs, and (4) internet direct sales, including direct to home shipment and direct downloading through a consumer's home computer. Also, new methods of in-home delivery of entertainment software products are continually being introduced. The Company competes directly 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 mass merchants have "vertically integrated" so as to provide their own category management. Some of these companies, however, also purchase from independent category managers.

The Company believes that the distribution of home entertainment software will remain highly competitive. The Company believes that customer service and continual progress in operational efficiencies are the keys to growth and profitability in this competitive environment.

* * * * *

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

The Company's sales and earnings are of a seasonal nature. Note 9, Quarterly Financial Summary (unaudited), on page 37 under Item 8, discloses quarterly results which indicate the seasonality of the Company's business.

The Company has approximately 2,700 employees. As of April 28, 2001, none were unionized.

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Item 2.

PROPERTIES

As of April 28, 2001, the Company's H.E.R. segment occupied leased warehouses located in Indianapolis, Indiana; Reno, Nevada; Toronto, Ontario; Warrington, United Kingdom and Mexico City, Mexico. H.E.R. also occupies nine leased satellite sales offices located in the states of Maryland, Michigan, Missouri, California, Georgia, Illinois and New York, as well as the Canadian provinces of Alberta and Quebec. The vacant Company-owned warehouse in Tampa, Florida, which has a net book value of approximately \$2.0 million, is in the process of being sold. Sale proceeds are estimated to approximate net book value.

The Company's NCE unit leases one warehouse located in Quebec, Canada. NCE also occupies leased office space within the United States in the states of Michigan, California, New Jersey, New York, Tennessee and Minnesota, as well as in Canada, Germany and the United Kingdom.

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The Company owns its 130,000 square feet corporate office building located in Troy, Michigan, of which approximately 31,000 square feet are leased to an outside lessee.

Item 3. LEGAL PROCEEDINGS

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

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

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PART II

Item 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

The Company's common stock is traded on the New York Stock Exchange under the symbol of "HDL."

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

| Quarter | Fiscal Year Ended | | | |
|---------|-------------------|---------|----------------|---------|
| | April 28, 2001 | | April 29, 2000 | |
| | Low | High | Low | High |
| First | \$8.75 | \$12.88 | \$10.75 | \$14.50 |
| Second | 9.81 | 13.44 | 9.38 | 16.38 |
| Third | 6.44 | 10.75 | 9.75 | 17.00 |
| Fourth | 8.57 | 11.60 | 8.50 | 12.88 |

As of June 29, 2001, the Company had 3,120 shareholders of record.

The Company has not declared or paid dividends during the two fiscal years presented herein.

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Item 6.

SELECTED FINANCIAL DATA
HANDLEMAN COMPANY
FIVE-YEAR REVIEW

(amounts in thousands except per share data and ratios)

| | 2001 | % | 2000 | % | 1999 | % |
|---|-------------|-------|-------------|-------|-------------|-------|
| | ---- | - | ---- | - | ---- | - |
| SUMMARY OF OPERATIONS: | | | | | | |
| Revenues | \$1,192,979 | 100.0 | \$1,137,605 | 100.0 | \$1,058,553 | 100.0 |
| Gross profit, after direct product costs | 296,170 | 24.8 | 288,776 | 25.4 | 266,870 | 25.2 |
| Selling, general & administrative expenses | 224,406 | 18.8 | 219,625 | 19.3 | 211,682 | 20.0 |
| Depreciation and amortization: included in selling, general & administrative expenses | 20,949 | 1.8 | 20,109 | 1.8 | 20,488 | 1.9 |
| Repositioning and related charges | -- | | -- | | 96,362 | 9.1 |
| Interest expense, net | 2,632 | .2 | 3,178 | .3 | 8,088 | .8 |
| Income (loss) before income taxes and minority interest | 69,132 | 5.8 | 65,973 | 5.8 | (49,262) | 4.7 |
| Income tax expense (benefit) | 26,379 | 2.2 | 26,255 | 2.3 | (16,449) | 1.6 |
| Net income (loss) | 42,031 | 3.5 | 38,648 | 3.4 | (35,052) | 3.3 |
| Dividends | -- | | -- | | -- | |
| Weighted average number of shares outstanding | | | | | | |
| -- basic | 27,318 | | 29,425 | | 31,568 | |
| -- diluted | 27,458 | | 29,692 | | 31,818 | |
| PER SHARE DATA: | | | | | | |
| Earnings (loss) per share--basic | \$ 1.54 | | \$ 1.31 | | \$ (1.11) | |
| --diluted | 1.53 | | 1.30 | | (1.11) | |
| BALANCE SHEET DATA: | | | | | | |
| Merchandise inventories | \$ 113,348 | | \$ 100,298 | | \$ 102,589 | |
| Total assets | 590,667 | | 519,683 | | 487,856 | |
| Debt, current | 14,571 | | 14,571 | | 18,571 | |
| Debt, non-current | 53,014 | | 33,986 | | 39,857 | |
| Working capital | 162,867 | | 129,721 | | 152,721 | |
| Shareholders' equity | 253,228 | | 223,282 | | 225,686 | |
| FINANCIAL RATIOS: | | | | | | |
| Working capital ratio (Current assets/current liabilities) | 1.6 | | 1.5 | | 1.7 | |
| Inventory turns (Direct product costs/average inventories throughout year) | 6.8 | | 6.6 | | 5.5 | |
| Debt to total capitalization ratio (Debt, non-current/debt, non-current plus shareholders' equity) | 17.3% | | 13.2% | | 15.0% | |
| Return on assets (Net income/average assets) | 7.6% | | 7.7% | | * | |
| Return on beginning shareholders' equity (Net income/beginning shareholders' equity) | 18.8 % | | 17.1% | | * | |

* - Not meaningful

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** - Amount for fiscal 1999 is net of \$31,000 gain on sale of subsidiary.

Note: The Company's fiscal year ends on the Saturday closest to April 30th. Fiscal years 2001, 2000, 1999 and 1998 consisted of 52 weeks, whereas fiscal 1997 consisted of 53 weeks. Management believes the inclusion of one additional week in fiscal 1997 did not have a material effect on results of operations for fiscal 1997.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

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. NCE encompasses the Company's proprietary operations, which include music and video products, as well as licensing operations. All references herein to NCE exclude Sofsource, which was sold during the first quarter of fiscal 1999. Business segment sales discussed herein include intercompany sales which are eliminated in consolidation.

The following table sets forth net sales, and the percentage contribution to consolidated revenues, for the Company's two business segments for the fiscal years ended April 28, 2001, April 29, 2000 and May 1, 1999.

| | Year End (dollar amounts) | |
|--|------------------------------|---------------------------|
| | April 28, 2001 (52 weeks) | April 29 (52 weeks) |
| Handleman Entertainment Resources | \$1,064.0 | \$1,018.0 |
| % of Total | 89.2 | 89.2 |
| North Coast Entertainment | 142.7 | 142.7 |
| % of Total | 12.0 | 12.0 |
| Eliminations, principally NCE sales to H.E.R., net of corporate rental income | (13.7) | (13.7) |
| % of Total | (1.2) | (1.2) |
| Exited Activities / (1) / | -- | -- |
| % of Total | ----- | ----- |
| TOTAL | \$1,193.0 ===== | \$1,193.0 ===== |

/(1)/ Exited activities represent, within H.E.R., sales of the exited video, book and software product lines and sales in Argentina where the operations were sold in the fourth quarter of fiscal 1999, and, within NCE, sales at Sofsource which was sold during the first quarter of fiscal

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1999.

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Comparison of Fiscal 2001 with Fiscal 2000

For the fiscal year ended April 28, 2001 ("fiscal 2001"), revenues increased 5% to \$1.19 billion from \$1.14 billion for the fiscal year ended April 29, 2000 ("fiscal 2000"). Net income for fiscal 2001 was \$42.0 million or \$1.53 per diluted share, compared to net income of \$38.6 million or \$1.30 per diluted share for fiscal 2000.

H.E.R. net sales increased 5% to \$1.06 billion for fiscal 2001 from \$1.01 billion for fiscal 2000. Over 60% of the increase in net sales was attributable to H.E.R.'s United Kingdom ("UK") operations where the Company gained the ASDA chain as a new customer in February 2001, and substantially all of the remaining increase was attributable to improved sales in the United States throughout the year.

NCE net sales for fiscal 2001 were \$142.7 million, essentially the same as \$142.0 million for fiscal 2000. Increased sales of approximately \$12.5 million in the Anchor Bay Entertainment unit were offset by sales declines at the Madacy Entertainment Group and The itsy bitsy Entertainment Company ("TibECo") units.

Direct product costs as a percentage of revenues was 75.2% for the year ended April 28, 2001, compared to 74.6% for the year ended April 29, 2000. The slight increase was due to higher costs as a percentage of revenues within the NCE segment.

Selling, general and administrative ("SG&A") expenses for fiscal 2001 were \$224.4 million or 18.8% of revenues, compared to \$219.6 million or 19.3% of revenues for fiscal 2000. SG&A expenses at NCE approximated prior year levels, whereas H.E.R. expenses increased due to the increase in H.E.R. sales; however, as a percentage of sales, SG&A expenses at H.E.R. declined year over year.

Income before interest, income taxes and minority interest ("operating income") for fiscal 2001 increased to \$71.8 million from \$69.2 million in fiscal 2000. H.E.R. operating income rose 21% to \$66.1 million in fiscal 2001 from \$54.8 million in fiscal 2000. The increase in H.E.R. operating income was primarily attributable to North American operations. NCE operating income was \$4.3 million in fiscal 2001, compared with \$14.2 million in fiscal 2000. This decrease was due to a higher operating loss at TibECo, as well as reduced operating income at Madacy Entertainment Group. The Company's expectation is that NCE operating income will improve in fiscal 2002 to levels more comparable to fiscal 2000 operating income.

Net interest expense was \$2.6 million for fiscal 2001, compared to \$3.2 million for fiscal 2000. The decrease in interest expense was attributable to lower borrowing levels.

Minority interest recognized in the statement of income represents the minority shareholders' portion of the income or loss for less than wholly-owned subsidiaries. Minority interest expense was \$.7 million for fiscal 2001, compared to \$1.1 million for fiscal 2000.

The effective income tax rate for fiscal 2001 of 38.2% was lower than the fiscal 2000 tax rate of 39.8%. The decrease in the rate from last year was primarily due to tax benefits resulting from tax planning initiatives. The effective rate for fiscal 2001 was higher than expected due to higher losses at TibECo where no tax benefit on these losses was recognized because TibECo was an unconsolidated

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subsidiary for income tax purposes for fiscal 2001. The Company expects its effective tax rate for fiscal 2002 to approximate its rate for fiscal 2001.

Accounts receivable, net was \$265.3 million at April 28, 2001, compared to \$234.0 million at April 29, 2000. This increase was due to the higher sales level in the fourth quarter of fiscal 2001, compared to the fourth quarter of fiscal 2000.

Other assets, net was \$101.8 million at April 28, 2001, compared to \$90.0 million at April 29, 2000. This increase was primarily attributable to the cost of license advances and acquired rights.

The increase in other current liabilities to \$44.8 million at April 28, 2001 from \$31.2 million at April 29, 2000 was chiefly due to increases in accrued royalties and the timing of income tax payments.

Debt, non-current was \$53.0 million at April 28, 2001, compared to \$34.0 million at April 29, 2000. This change was caused by additional borrowings under the Company's revolving line of credit and the inclusion of the Handleman UK revolving line of credit borrowings.

During fiscal 2001, the Company repurchased 1,230,880 shares of its common stock at a cost of \$12 million, leaving 26,540,000 shares outstanding as of April 28, 2001. The current stock repurchase program was approved

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by the Board of Directors in December 2000 and allows the Company to repurchase up to 10% of its outstanding common stock as of that date. Under the current authorization, which has no expiration date, the Company can repurchase in fiscal year 2002 or later approximately 2,100,000 additional shares.

Comparison of Fiscal 2000 with Fiscal 1999

For the fiscal year ended April 29, 2000 ("fiscal 2000"), revenues increased 7% to \$1.14 billion from \$1.06 billion for the fiscal year ended May 1, 1999 ("fiscal 1999"). This increase in revenues was primarily the result of increased music sales at H.E.R. Fiscal 1999 revenues included \$48.7 million attributable to product lines and activities exited pursuant to the repositioning program discussed later herein.

Net income for fiscal 2000 was \$38.6 million or \$1.30 per diluted share, compared to a net loss of \$(35.1) million or \$(1.11) per share for fiscal 1999. The Company's fiscal 1999 results included pre-tax repositioning and related charges of \$127.4 million and a pre-tax gain on the sale of a subsidiary (Sofsource) of \$31 million.

H.E.R. net sales increased 14% to \$1.01 billion for fiscal 2000 from \$888.4 million for fiscal 1999. This increase in net sales was principally due to strong music sales by H.E.R.'s customers. Management believes this was mainly due to the Company's mass merchant customers outperforming, in regards to music sales, other music retailers as a group, as well as exceeding the overall music industry growth rate.

NCE net sales for fiscal 2000 were \$142.0 million, compared to \$139.0 million for fiscal 1999.

Direct product costs as a percentage of revenues was 74.6% for fiscal 2000, compared to 74.8% for fiscal 1999. The slight decrease in direct product costs

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as a percentage of revenues was primarily attributable to the inclusion of higher direct product costs related to product lines exited during fiscal 1999, which had a dampening effect on the prior year's gross profit margin percentage.

In the first quarter of fiscal 1999, the Company's Board of Directors approved a repositioning program which resulted in a \$110 million charge during that quarter, representing asset adjustments and cost accruals directly related to the repositioning program. A component of the \$110 million charge was a \$31.6 million provision for merchandise inventory write-downs required to liquidate inventory through non-traditional channels as a result of the Company exiting certain product lines (video, book and software) and no longer servicing certain customers. The table below displays the proforma presentation of operations for the fiscal years ended April 29, 2000 and May 1, 1999 as if the inventory write-downs had been included in direct product costs (dollar amounts in millions):

| | Fiscal Year Ended | | |
|---|--|-------------------------------------|----------------------------------|
| | April 29, 2000 As Reported and Proforma ----- | May 1, 1999 As Reported ----- | May 1, 1999 Proforma ----- |
| Revenues | \$1,137.6 | \$1,058.6 | \$1,058.6 |
| Direct product costs | 848.8 | 791.7 | 823.3 |
| Repositioning and related costs | -- | 127.4 | 95.8 |
| Direct product costs as a percentage of revenues | 74.6% | 74.8% | 77.8% |

Selling, general and administrative ("SG&A") expenses for fiscal 2000 were \$219.6 million or 19.3% of revenues, compared to \$211.7 million or 20.0% of revenues for fiscal 1999. H.E.R. SG&A expenses for fiscal 2000 approximated fiscal 1999 levels. NCE SG&A expenses increased 18% for fiscal 2000, compared to the prior fiscal year, primarily due to incremental expenses incurred for investments in future revenue producing projects.

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Income before interest, income taxes, minority interest, repositioning and related charges and gain on sale of subsidiary ("operating income") for fiscal 2000 increased to \$69.2 million from \$55.2 million for fiscal 1999. H.E.R. operating income increased 52% to \$54.8 million for fiscal 2000 from \$36.1 million for fiscal 1999. This increase was attributable to the higher sales level. NCE operating income was \$14.2 million for fiscal 2000, compared to \$20.0 million for fiscal 1999. The decrease in NCE operating income was principally related to increased SG&A expenses.

Net interest expense for fiscal 2000 was \$3.2 million, compared to \$8.1 million for fiscal 1999. This decrease in net interest expense was attributable to lower borrowing levels.

Minority interest recognized in the statement of income represents the minority shareholders' portion of the income or loss for less than wholly-owned subsidiaries. Minority interest expense was \$1.1 million for fiscal 2000, compared to \$2.2 million for fiscal 1999.

Accounts receivable, net was \$234.0 million at April 29, 2000, compared to

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\$218.0 million at May 1, 1999. This increase was primarily due to the higher level of sales in the fourth quarter of fiscal 2000, compared to the fourth quarter of fiscal 1999.

The decrease in other current assets to \$16.0 million at April 29, 2000 from \$21.6 million at May 1, 1999 was mainly attributable to the collection of income taxes receivable related to a net operating loss carryback arising from the repositioning charges in fiscal 1999.

Other assets, net was \$90.0 million at April 29, 2000, compared to \$64.9 million at May 1, 1999. This increase was primarily attributable to the cost of license advances and acquired rights of \$30.0 million.

Accounts payable increased to \$202.3 million at April 29, 2000 from \$156.3 million at May 1, 1999. This increase was principally the result of the timing of payments to vendors and increased merchandise purchases during the fourth quarter of fiscal 2000, compared to the fourth quarter of the prior fiscal year.

Accrued and other liabilities decreased to \$31.2 million at April 29, 2000 from \$41.9 million at May 1, 1999. This decrease was chiefly due to decreases in accrued royalties and other payroll related items.

Other liabilities were \$14.3 million at April 29, 2000, compared to \$5.5 million at May 1, 1999. This increase was primarily the result of an increase in deferred revenues, which related to cash received for future revenue recognition on certain new investments at TibECo.

The following comments relate to the Company's repositioning program.

On June 2, 1998, the Company's Board of Directors approved a repositioning program designed to focus the Company on its core music distribution business. The major components of the program were:

- . Exit the H.E.R. video, book and software distribution and service operations;
- . Reduce the number of customers serviced in the music distribution business within H.E.R.; and
- . Sell Sofsource, the Company's software publishing subsidiary.

The operational repositioning activities, including employee severance programs, were completed during fiscal 1999.

The repositioning program resulted in a \$110 million charge to earnings in the first quarter of fiscal 1999, representing asset adjustments and cost accruals directly related to the repositioning program, other than those costs actually incurred and charged to earnings in fiscal 1998 and certain costs that were incurred in the last three quarters of fiscal 1999 that were required to be expensed as incurred.

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A summary of the components of the \$127.4 million (pre-tax) repositioning and related charge recognized in fiscal 1999 is as follows (in millions):

| First Quarter ----- | Second Quarter ----- | Third Quarter ----- | F Q |
|---------------------------|----------------------------|---------------------------|--------|
|---------------------------|----------------------------|---------------------------|--------|

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| | | | |
|---|---------|-------|-------|
| Adjustments of assets to net realizable value | \$ 84.5 | | |
| Intangibles write-off | 13.0 | | |
| Other repositioning related costs | 12.5 | 7.0 | 6.9 |
| | ----- | ---- | ---- |
| Total | \$110.0 | \$7.0 | \$6.9 |
| | ===== | ===== | ===== |

Adjustments of assets to net realizable value included adjustments to reflect the estimated recovery amount of assets disposed of during fiscal 1999 that were directly related to exited businesses or customers no longer serviced. The components of the provision were, principally, inventory of \$31.6 million and property and equipment of \$11.8 million, as well as certain adjustments to the carrying value of receivables of \$27.2 million, payables of \$4.1 million and investments of \$9.2 million. Intangibles related to either businesses exited, or customers no longer serviced, were included in the intangibles write-off. Other repositioning related costs recorded in the first quarter of fiscal 1999 were principally employee severance costs of \$3.5 million, advisory fees of \$3.0 million, debt restructuring costs of \$2.0 million and inventory handling costs of \$2.0 million. Other repositioning related costs recognized in subsequent quarters were primarily employee stay bonus costs and advisory fees, which were not accruable as part of the initial repositioning charge, and therefore, were expensed as incurred.

The amount of each element of the overall repositioning charge was determined based upon the actual cost of the asset and management estimates of recoverability. In the case of receivables, the fact that certain accounts would be settled with customer product returns rather than cash, which resulted in a reversal of gross margin, was taken into consideration, as well as liquidation value of the inventory returned since ongoing relationships with certain vendors no longer existed and, therefore, return authorizations would be difficult to obtain. In the case of property and equipment, which was principally display fixtures in customer stores, the charge represented the net book value of such abandoned display fixtures.

There were no adjustments necessary to the original estimated repositioning provision of \$110 million recognized in the first quarter of fiscal 1999.

The repositioning program resulted in a reduction of approximately 1,000 positions (approximately 30% of the Company's total workforce). This reduction occurred predominantly in the H.E.R. division. For the most part, the reductions were in the following areas: field sales representatives; distribution facility employees; and the corporate headquarters. Employee severance amounts were determined based upon an employee's length of service, salary grade level and compensation. Total employee severance paid in fiscal 2000 and fiscal 1999 in connection with the repositioning program was approximately \$.3 and \$3.5 million, respectively.

LIQUIDITY AND CAPITAL RESOURCES

Working capital at April 28, 2001 was \$162.9 million, compared to \$129.7 million at April 29, 2000. The working capital ratio was 1.6 to 1 at April 28, 2001, compared to 1.5 to 1 at April 29, 2000.

Property and equipment consist primarily of display fixtures, computer hardware and software, warehouse equipment and facilities. The Company also acquires or

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licenses video and music products which it markets. Purchases of these assets are expected to be funded primarily by cash flow from operations.

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The Company has an unsecured, five-year, \$150,000,000 credit agreement, as amended, with a consortium of banks that expires in September 2002. \$25,000,000 was outstanding under the credit agreement as of April 28, 2001. The Company also has \$25,285,000 outstanding as of April 28, 2001 under a senior note agreement with a group of insurance companies, of which \$14,571,000 matures in fiscal 2002. See Note 5 of Notes to Consolidated Financial Statements for additional information regarding the senior notes, including scheduled maturities.

Two subsidiary companies have uncommitted credit facilities with certain banks. The Company has guaranteed repayment of amounts borrowed under each facility and is required to maintain availability under its \$150,000,000 unsecured credit agreement in an amount equal to total borrowings under the guaranteed lines of credit. As of April 28, 2001, TibECo had \$8,700,000 outstanding on its \$8,750,000 facility and the Company's UK subsidiary had \$8,600,000 outstanding on its \$11,500,000 facility.

Net cash provided from operating activities included in the Consolidated Statement of Cash Flows decreased to \$43,893,000 for fiscal 2001 from \$107,476,000 for fiscal 2000. This decrease was attributable to an increase during fiscal 2001 in the investment in working capital.

Net cash used by investing activities was \$44,718,000 for fiscal 2001, compared to net cash used by investing activities of \$56,448,000 for fiscal 2000.

Net cash provided from financing activities was \$6,943,000 for 2001, compared to \$50,923,000 used by financing activities for fiscal 2000. This change was principally due to fewer shares of common stock being repurchased in fiscal 2001 compared to fiscal 2000, and additional borrowings under the Company's revolving credit agreements in fiscal 2001.

Management believes that the credit agreement, and the senior note agreement, will provide sufficient amounts to fund day-to-day operations and higher peak seasonal demands. For further information, reference should be made to Note 5 of Notes to Consolidated Financial Statements.

OTHER INFORMATION

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.

Inflation within the economies in which the Company does business has not had a material effect on the Company's results of operations.

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* * * * *

Information in this document contains forward-looking statements that are not

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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, 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 the new businesses, customer requirements, continuation of satisfactory relationships with existing customers and suppliers, effects of electronic commerce, relationships with the Company's lenders, pricing and competitive pressures, certain global and regional economic conditions, and other factors discussed in this Form 10-K and those detailed from time to time in the Company's other 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.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

Report of Independent Accountants

Consolidated Balance Sheet at April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Income - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Shareholders' Equity - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Cash Flows - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Notes to Consolidated Financial Statements

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Report of Independent Accountants

To the Board of Directors and Shareholders of
Handleman Company:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholders' equity, and of cash flows present fairly, in all material respects, the financial position of Handleman Company and subsidiaries (the "Company") at April 28, 2001, April 29, 2000 and May 1, 1999, and the results of their operations and their cash flows for each of the three years in the period ended April 28, 2001, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in Item 14(a) 2 of this Annual Report on Form 10-K presents fairly, in all material respects, the information set forth therein 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

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statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which 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 audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

Detroit, Michigan
June 5, 2001

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HANDLEMAN COMPANY
CONSOLIDATED BALANCE SHEET
YEARS ENDED APRIL 28, 2001, APRIL 29, 2000 AND MAY 1, 1999
(amounts in thousands except share data)

| ASSETS | 2001 | 2000 |
|--|------------|------------|
| ----- | ---- | ---- |
| Current assets: | | |
| Cash and cash equivalents | \$ 33,628 | \$ 33,628 |
| Accounts receivable, less allowance of \$16,336 in 2001, \$17,383 in 2000 and \$13,760 in 1999 for gross profit impact of estimated future returns | 265,280 | 265,280 |
| Merchandise inventories | 113,348 | 113,348 |
| Other current assets | 19,720 | 19,720 |
| | ----- | ----- |
| Total current assets | 431,976 | 431,976 |
| Property and equipment, net | 56,887 | 56,887 |
| Other assets, net | 101,804 | 101,804 |
| | ----- | ----- |
| Total assets | \$ 590,667 | \$ 590,667 |
| | ===== | ===== |
| | | |
| LIABILITIES | | |
| ----- | | |
| Current liabilities: | | |
| Accounts payable | \$ 209,766 | \$ 209,766 |
| Debt, current portion | 14,571 | 14,571 |
| Accrued and other liabilities | 44,772 | 44,772 |
| | ----- | ----- |
| Total current liabilities | 269,109 | 269,109 |
| Debt, non-current | 53,014 | 53,014 |
| Other liabilities | 15,316 | 15,316 |
| | | |
| SHAREHOLDERS' EQUITY | | |
| ----- | | |

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| | | |
|--|------------|-------|
| Preferred stock, par value \$1.00; 1,000,000 shares authorized; none issued | -- | |
| Common stock, \$.01 par value; 60,000,000 shares authorized: 26,540,000, 27,691,000 and 31,049,000 shares issued in 2001, 2000 and 1999, respectively | 265 | |
| Paid-in capital | -- | |
| Foreign currency translation adjustment | (7,479) | |
| Unearned compensation | (63) | |
| Retained earnings | 260,505 | |
| | ----- | ----- |
| Total shareholders' equity | 253,228 | |
| | ----- | ----- |
| Total liabilities and shareholders' equity | \$ 590,667 | \$ |
| | ===== | ===== |

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

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF INCOME
YEARS ENDED APRIL 28, 2001, APRIL 29, 2000 AND MAY 1, 1999
(amounts in thousands except per share data)

| | 2001 ---- | 2000 ---- |
|--|--------------|--------------|
| Revenues | \$ 1,192,979 | \$ 1,137,6 |
| Costs and expenses: | | |
| Direct product costs | 896,809 | 848,8 |
| Selling, general and administrative expenses | 224,406 | 219,6 |
| Interest expense, net | 2,632 | 3,1 |
| Repositioning and related charges | -- | |
| Gain on sale of subsidiary | -- | |
| | ----- | ----- |
| Income (loss) before income taxes and minority interest | 69,132 | 65,9 |
| Income tax (expense) benefit | (26,379) | (26,2 |
| Minority interest | (722) | (1,0 |
| | ----- | ----- |
| Net income (loss) | \$ 42,031 | \$ 38,6 |
| | ===== | ===== |
| Earnings (loss) per common share | | |
| Basic | \$ 1.54 | \$ 1. |
| | ===== | ===== |
| Diluted | 1.53 | 1. |
| | ===== | ===== |

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Weighted average number of common shares
outstanding during the year

| | | |
|---------|--------|-------|
| Basic | 27,318 | 29,4 |
| | ===== | ===== |
| Diluted | 27,458 | 29,6 |
| | ===== | ===== |

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

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
YEARS ENDED APRIL 28, 2001, APRIL 29, 2000 AND MAY 1, 1999
(amounts in thousands)

| | Common Stock | | | Foreign Currency | |
|--|------------------|--------|--------------------|---------------------------|---------------------|
| | Shares Issued | Amount | Paid-In Capital | Translation Adjustment | Unrea Com sat |
| | ----- | ----- | ----- | ----- | ----- |
| May 2, 1998 | 31,977 | \$ 320 | \$ 20,710 | \$ (7,600) | \$ |
| Net loss | | | | | |
| Adjustment for foreign currency translation | | | | 2,380 | |
| Comprehensive loss, net of tax | | | | | |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 368 | 4 | 4,290 | | (1 |
| Common stock repurchased | (1,742) | (18) | (20,991) | | |
| Additional investment in The itsy bitsy Entertainment Company, Inc. | 446 | 4 | 2,819 | | |
| | ----- | ----- | ----- | ----- | ----- |
| May 1, 1999 | 31,049 | 310 | 6,828 | (5,220) | (1 |
| Net income | | | | | |
| Adjustment for foreign currency translation | | | | (1,229) | |
| Comprehensive income, net of tax | | | | | |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 181 | 2 | 1,559 | | 1 |
| Common stock repurchased | (3,539) | (35) | (8,387) | | |
| | ----- | ----- | ----- | ----- | ----- |
| April 29, 2000 | 27,691 | 277 | -- | (6,449) | |

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| | | | | | |
|--|---------|--------|-------|------------|-------|
| Net income | | | | | |
| Adjustment for foreign currency translation | | | | (1,030) | |
| Comprehensive income, net of tax | | | | | |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 80 | | | | |
| Common stock repurchased | (1,231) | (12) | | | |
| | ----- | ----- | ----- | ----- | ----- |
| April 28, 2001 | 26,540 | \$ 265 | -- | \$ (7,479) | \$ |
| | ===== | ===== | ===== | ===== | ===== |

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

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF CASH FLOWS
YEARS ENDED APRIL 28, 2001, APRIL 29, 2000 AND MAY 1, 1999
(amounts in thousands)

| | 2001 | |
|---|-----------|----|
| | ----- | |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 42,031 | \$ |
| | ----- | |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: | | |
| Depreciation | 16,004 | |
| Amortization of acquisition costs | 4,945 | |
| Recoupment of license advances | 12,992 | |
| Loss on disposal of property and equipment | 844 | |
| Repositioning charge | -- | |
| Gain on sale of subsidiary | -- | |
| Loss on sale of book business | -- | |
| (Increase) decrease in accounts receivable | (31,275) | |
| (Increase) decrease in merchandise inventories | (13,050) | |
| (Increase) decrease in other operating assets | (10,608) | |
| Increase (decrease) in accounts payable | 7,427 | |
| Increase (decrease) in other operating liabilities | 14,583 | |
| | ----- | |
| Total adjustments | 1,862 | |
| | ----- | |
| Net cash provided from operating activities | 43,893 | |
| | ----- | |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (26,503) | |
| Proceeds from disposition of property and equipment | 4,750 | |
| License advances and acquired rights | (22,965) | |
| Cash investment in Lifetime Entertainment Limited | -- | |
| Cash investment in The itsy bitsy Entertainment | -- | |

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| | |
|---|-------------|
| Company, Inc. | -- |
| Proceeds from sale of subsidiary | -- |
| Proceeds from sale of book business and other | -- |
| | ----- |
| Net cash provided from (used by) investing activities | (44,718) |
| | ----- |
| Cash flows from financing activities: | |
| Issuances of debt | 1,262,171 |
| Repayments of debt | (1,243,143) |
| Repurchase of common stock | (12,055) |
| Other changes in shareholders' equity, net | (30) |
| | ----- |
| Net cash provided from (used by) financing activities | 6,943 |
| | ----- |
| Net increase in cash and cash equivalents | 6,118 |
| Cash and cash equivalents at beginning of year | 27,510 |
| | ----- |
| Cash and cash equivalents at end of year | \$ 33,628 |
| | ===== |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies:

Business

The Company is comprised of two business segments. Handleman Entertainment Resources is a category manager and distributor of prerecorded music to mass merchants, principally in North America. North Coast Entertainment is responsible for the Company's proprietary operations, which include music and video products, as well as licensing operations. (see "Segment Information" note)

Fiscal Year

The Company's fiscal year ends on the Saturday closest to April 30th. Fiscal years 2001, 2000 and 1999 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. Minority interest recognized in the statement of income represents the minority shareholders' portion of the income (loss) for less than wholly-owned subsidiaries. The minority interest share of the net assets of these subsidiaries of \$4,187,000, \$5,000,000 and \$5,244,000 as of April 28, 2001, April 29, 2000 and May 1, 1999, respectively, is included in other liabilities in the accompanying consolidated balance sheet. The Company does not have any material equity

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investments other than in companies in which they have voting control.

Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 utilizes the policies outlined in Statement of Financial Accounting Standards No. 52, "Foreign Currency Translation," to convert the balance sheet and operations of its foreign subsidiaries to United States dollars. Net transaction gains (losses) included in the statement of income were \$(123,000), \$383,000 and \$(162,000) for the years ended April 28, 2001, April 29, 2000 and May 1, 1999, respectively.

Recognition of Revenue and Future Returns

Revenues are recognized upon shipment of the merchandise. The Company reduces gross sales and direct product costs for estimated future returns at the time the merchandise is sold. Staff Accounting Bulletin No. 101 issued by the Securities and Exchange Commission regarding revenue recognition did not have an impact on the Company's revenue recognition policy when the Bulletin became effective in fiscal 2001.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Inventory Valuation

Merchandise inventories are recorded at the lower of cost (first-in, first-out 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 \$11,086,000, \$11,178,000 and \$10,980,000 were incurred during the years ended April 28, 2001, April 29, 2000 and May 1, 1999, respectively. Merchandise inventories as of April 28, 2001, April 29, 2000 and May 1, 1999 included \$855,000, \$843,000 and \$892,000, respectively, of such costs.

Property and Equipment

Property and equipment are recorded at cost. Upon retirement or disposal, the asset cost and related accumulated depreciation are eliminated from the respective accounts and the resulting gain or loss is included in the consolidated statement of income for the period. Repair costs are charged to expense as incurred.

Depreciation

Depreciation is computed using primarily the straight-line method based on the following estimated useful lives:

| | |
|--------------------------------|------------|
| Display fixtures | 5 years |
| Computer hardware and software | 3-5 years |
| Equipment, furniture and other | 3-10 years |

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Buildings and improvements

10-40 years

License Advances and Acquired Rights

The Company, principally in its proprietary product business, acquires video and audio licenses or rights giving it the exclusive privilege to manufacture and distribute such products. The cost of license advances and acquired rights are included in other assets in the consolidated balance sheet and are amortized based upon the sales volume method over a period which is the lesser of the term of the agreement or the products' estimated useful life. The effective lives of the licenses and rights tend to range from three to five years. As of April 28, 2001, April 29, 2000 and May 1, 1999, licenses and acquired rights, net of amortization, amounted to \$74,181,000, \$61,390,000 and \$31,654,000, respectively.

Intangible Assets

Intangible assets consist primarily of the excess of consideration paid over the estimated fair values of net assets of businesses acquired. Such amounts included in other assets in the consolidated balance sheet as of April 28, 2001, April 29, 2000 and May 1, 1999 are \$19,719,000, \$24,575,000 and \$24,624,000, which are net of amortization of \$15,756,000, \$10,900,000 and \$7,894,000, respectively. These assets are amortized using the straight-line method over periods ranging from four to 15 years. As of April 28, 2001, the weighted average period remaining to be amortized is approximately six years.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Long-Lived Assets

At each balance sheet date, management evaluates the carrying value and remaining estimated lives of long-lived assets, including intangible assets, for potential impairment by considering several factors, including management's plans for future operations, recent operating results, market trends and other economic factors relating to the 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 were 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 asset exceeds the fair value of the asset as determined on a discounted basis.

Cash Equivalents

The Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Cash and cash equivalents are net of issued and outstanding checks in excess of disbursing bank account balances, which checks are routinely funded on a daily basis from the Company's main bank account with another bank.

Financial Instruments

The Company has evaluated the fair value of those assets and liabilities identified as financial instruments under Statement of Financial Accounting Standards No. 107. The Company estimates that fair values generally approximated carrying values at April 28, 2001, April 29, 2000 and May 1, 1999. Fair values have been determined through information obtained from

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market sources and management estimates.

Earnings Per Share

For computing diluted earnings per share in accordance with SFAS No. 128, "Earnings Per Share," additional weighted average shares attributable to outstanding stock options were 140,000, 267,000 and 250,000 for the years ended April 28, 2001, April 29, 2000 and May 1, 1999, respectively.

Reclassifications

The 2000 and 1999 Consolidated Statement of Cash Flows have been conformed to the presentation adopted in 2001.

2. Segment Information:

The Company has determined, using the management approach, that it operates in two business segments: Handleman Entertainment Resources (H.E.R.) provides category management and distribution services of music products to select mass merchants; and North Coast Entertainment (NCE) encompasses the Company's proprietary activities, which include music and video products, as well as licensing operations.

The accounting policies of the segments are the same as those described in Note 1, "Accounting Policies." Segment data includes intersegment revenues, as well as a charge allocating all 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, minority interest and repositioning and related charges ("segment income").

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The tables below present information about reported segments for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 (in thousands of dollars):

| Fiscal 2001: | H.E.R. ----- | NCE --- | Total ----- |
|------------------------------|-----------------|-------------|----------------|
| Revenues, external customers | \$1,064,003 | \$128,887 | \$1,192,890 |
| Intersegment revenues | -- | 13,840 | 13,840 |
| Segment income | 66,123 | 4,271 | 70,394 |
| Total assets | 498,109 | 186,084 | 684,193 |
| Capital expenditures | 22,011 | 4,492 | 26,503 |
| | | | |
| Fiscal 2000: | H.E.R. ----- | NCE ---- | Total ----- |
| Revenues, external customers | \$1,011,323 | \$126,282 | \$1,137,605 |
| Intersegment revenues | -- | 15,716 | 15,716 |
| Segment income | 54,811 | 14,182 | 68,993 |
| Total assets | 425,743 | 175,468 | 601,211 |
| Capital expenditures | 14,016 | 6,319 | 20,335 |

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| Fiscal 1999: | H.E.R. | NCE | Total |
|------------------------------|------------|-----------|-------------|
| | ----- | --- | ----- |
| Revenues, external customers | \$ 884,670 | \$124,560 | \$1,009,230 |
| Intersegment revenues | 3,737 | 14,408 | 18,145 |
| Segment income | 36,099 | 19,973 | 56,072 |
| Total assets | 377,869 | 152,246 | 530,115 |
| Capital expenditures | 13,004 | 4,050 | 17,054 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

A reconciliation of total segment revenues to consolidated revenues, total segment income to total consolidated income before income taxes and total segment assets to total consolidated assets for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 is as follows (in thousands of dollars):

| | 2001 | 2000 |
|---|-------------|-------------|
| | ---- | ---- |
| Revenues | | |
| ----- | | |
| Total segment revenues | \$1,206,730 | \$1,153,321 |
| Revenues from exited activities | -- | -- |
| Corporate rental income | 89 | -- |
| Elimination of intersegment revenues | (13,840) | (15,716) |
| Consolidated revenues | \$1,192,979 | \$1,137,605 |
| | ===== | ===== |
| Income Before Income Taxes | | |
| ----- | | |
| Total segment income for reportable segments | \$ 70,394 | \$ 68,993 |
| Segment loss for sold operation (Sofsource) | -- | -- |
| Interest revenue | 1,844 | 2,195 |
| Interest expense | (4,476) | (5,373) |
| Repositioning and related charges | -- | -- |
| Gain on sale of subsidiary | -- | -- |
| Unallocated corporate (costs) income | 1,370 | 158 |
| Consolidated income (loss) before income taxes | \$ 69,132 | \$ 65,973 |
| | ===== | ===== |
| Assets | | |
| ----- | | |
| Total segment assets | \$ 684,193 | \$ 601,211 |
| Elimination of intercompany receivables and payables | (93,526) | (81,528) |
| Total consolidated assets | \$ 590,667 | \$ 519,683 |
| | ===== | ===== |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The following is revenue and long-lived asset information by geographic area as of and for the years ended April 28, 2001, April 29, 2000 and May 1, 1999:

| | Revenues | | |
|---------------|-------------|-------------|-------------|
| | 2001 | 2000 | 1999 |
| | ----- | ----- | ----- |
| United States | \$1,030,120 | \$ 997,238 | \$ 926,573 |
| Canada | 85,712 | 92,200 | 76,994 |
| Other foreign | 77,147 | 48,167 | 54,986 |
| | ----- | ----- | ----- |
| | \$1,192,979 | \$1,137,605 | \$1,058,553 |
| | ===== | ===== | ===== |

| | Long-Lived Assets | | |
|---------------|-------------------|------------|------------|
| | 2001 | 2000 | 1999 |
| | ----- | ----- | ----- |
| United States | \$ 143,248 | \$ 130,248 | \$ 107,103 |
| Canada | 3,866 | 4,012 | 3,888 |
| Other foreign | 9,002 | 7,056 | 3,320 |
| | ----- | ----- | ----- |
| | \$ 156,116 | \$ 141,316 | \$ 114,311 |
| | ===== | ===== | ===== |

Foreign revenue is based upon the country in which the legal subsidiary is domiciled. Revenue from no single foreign country other than Canada was material to the consolidated revenues of the Company.

For the years ended April 28, 2001, April 29, 2000 and May 1, 1999, one customer accounted for approximately 35 percent, 35 percent and 31 percent of the Company's revenues, respectively, and a second customer accounted for approximately 44 percent, 42 percent and 39 percent of the Company's revenues, respectively. Approximately 98 percent, 98 percent and 96 percent of the combined revenues for these two customers are included in the H.E.R. segment for the years ended April 28, 2001, April 29, 2000 and May 1, 1999, respectively. Collectively, these customers accounted for approximately 74 percent, 63 percent and 66 percent of accounts receivable at April 28, 2001, April 29, 2000 and May 1, 1999, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

3. Repositioning and Related Charges:

On June 2, 1998 the Board of Directors approved a repositioning program designed to focus the Company on its core music distribution business. The repositioning program resulted in a \$110 million charge to earnings in the first quarter of fiscal 1999 representing asset adjustments and cost accruals directly related to the repositioning program, other than certain costs totaling \$17.4 million that were required to be expensed as incurred in the last three quarters of fiscal 1999. The repositioning activities, including employee severance programs, were completed during fiscal 1999.

The \$127.4 million (pre-tax) repositioning and related charge recognized in fiscal 1999 was comprised of adjustments of assets to net realizable value of \$84.5 million, intangibles write-off of \$13.0 million and other repositioning related costs of \$29.9 million. Adjustments of assets to net realizable value included adjustments to reflect the estimated recovery amount of assets disposed of during fiscal 1999. The components of the provision were, principally, inventory of \$31.6 million and property and equipment of \$11.8 million, as well as certain adjustments to the carrying value of receivables of \$27.2 million, payables of \$4.1 million and investments of \$9.2 million. Intangibles related to either businesses exited, or customers no longer serviced, are included in the intangibles write-off. Other repositioning related costs were principally employee severance costs of \$3.8 million, advisory fees of \$17.2 million, debt restructuring costs of \$2.0 million and inventory handling costs of \$2.0 million.

The amount of each element of the overall repositioning charge was determined based upon estimated costs at the time, or the actual cost of assets compared to management estimates of recoverability. No adjustments were subsequently necessary to adjust the initial overall repositioning provision of \$110 million.

The repositioning program resulted in a reduction of approximately 1,000 positions (approximately 30% of the Company's total workforce at the time). This reduction occurred predominantly in the H.E.R. division. For the most part, the reductions were in the following areas: field sales representatives; distribution facility employees; and the corporate headquarters. Employee severance amounts were determined based upon an employee's length of service, salary grade level and compensation. Total employee severance paid in fiscal 2000 and fiscal 1999 in connection with the repositioning program was approximately \$.3 million and \$3.5 million, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

A reconciliation of the provisions for repositioning and related charges and the remaining liability balance follows (in thousands):

| | |
|--------------------------------|--|
| Adjustment of Assets to Net | Other Repositioning Related Costs, |
|--------------------------------|--|

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| | Realizable Value ----- | Intangibles Write-off ----- | Including Exit Costs ----- |
|--|------------------------------|-----------------------------------|----------------------------------|
| Amount provided during the first quarter ended August 1, 1998 | \$ 84,500 | \$ 13,000 | \$ 12,500 |
| Charges in fiscal 1999 resulting from asset write-offs and cash expenditures | (84,500) | (13,334) | (11,935) |
| Reclassify residual intangibles write-off | -- | 334 | (334) |
| Remaining balance as of May 1, 1999 | \$ -- ===== | \$ -- ===== | 231 |
| Charges in fiscal 2000 resulting from cash expenditures | | | (231) ----- |
| Remaining balance as of April 29, 2000 | | | \$ -- ===== |

The remaining liability balance as of May 1, 1999 is included in accrued and other liabilities in the consolidated balance sheet.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

4. Pension Plan:

The Company has two principal retirement plans which cover substantially all full-time U.S. employees. The benefit obligation, plan assets, funded status, net periodic benefit cost and the amount which is recorded in the Company's consolidated balance sheet at April 28, 2001, April 29, 2000 and May 1, 1999 for these plans are as follows:

| | 2001 ---- | 2000 ---- |
|---|---------------|---------------|
| Change in projected benefit obligation: | | |
| Benefit obligation at beginning of year | \$ 24,684,000 | \$ 26,553,000 |
| Service cost | 1,148,000 | 1,206,000 |
| Interest cost | 2,159,000 | 1,820,000 |
| Amendments | 1,263,000 | -- |
| Actuarial (gain)/loss | 5,229,000 | (3,555,000) |
| Benefits paid | (1,009,000) | (1,340,000) |
| | ----- | ----- |
| Benefit obligation at end of year | \$ 33,474,000 | \$ 24,684,000 |

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| | ===== | ===== |
|--|-----------------|----------------|
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | \$ 20,174,000 | \$ 20,373,000 |
| Actual return on plan assets | 113,000 | 1,385,000 |
| Net realized gain on the sale of assets | 1,117,000 | 1,295,000 |
| Unrealized depreciation | (1,125,000) | (1,556,000) |
| Company contribution | 1,160,000 | 17,000 |
| Benefits paid | (1,009,000) | (1,340,000) |
| | ----- | ----- |
| Fair value of plan assets at end of year | \$ 20,430,000 | \$ 20,174,000 |
| | ===== | ===== |
| | | |
| Funded status at end of year | \$ (13,044,000) | \$ (4,510,000) |
| Unrecognized net (gain)/loss from past experience different from that assumed | 5,834,000 | (982,000) |
| Unrecognized net gain from excess funding | (252,000) | (371,000) |
| Unrecognized prior service cost | 1,705,000 | 644,000 |
| | ----- | ----- |
| Accrued benefit cost included in other liabilities | \$ (5,757,000) | \$ (5,219,000) |
| | ===== | ===== |

Assumptions used in determining the actuarial present value of the projected benefit obligation included a weighted average discount rate of 7.25% for 2001, 7.75% for 2000 and 6.75% for 1999, and a rate of increase in future compensation levels of 5% for all years.

| | 2001 | 2000 |
|---|--------------|--------------|
| | ---- | ---- |
| Components of net periodic benefit cost: | | |
| Service cost | \$ 1,148,000 | \$ 1,206,000 |
| Interest cost | 2,159,000 | 1,820,000 |
| Expected return on plan assets | (1,744,000) | (1,696,000) |
| Amortization of unrecognized transition asset, prior service cost and actuarial gain | 135,000 | (16,000) |
| | ----- | ----- |
| Net periodic benefit cost | \$ 1,698,000 | \$ 1,314,000 |
| | ===== | ===== |

The expected long-term rate of return on assets was 8.5% for all years. Plan assets are invested in various pooled investment funds and mutual funds maintained by the Plan trustee, as well as Handleman Company common stock valued at \$835,000 at April 28, 2001, \$888,000 at April 29, 2000 and \$1,040,000 at May 1, 1999.

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The Company has an unsecured, \$150,000,000 line of credit with a consortium of banks, which is scheduled to expire in September 2002. At April 28, 2001, borrowings available under the credit agreement were \$99,639,000, after \$5,111,000 of outstanding letters of credit, borrowings of \$25,000,000 outstanding at that date, and approximately \$20,250,000 required to be available for guaranteed lines of credit as discussed below. The Company may elect to pay interest under a variety of formulae tied principally to either prime or "LIBOR." As of April 28, 2001, the interest rate was 5.5%. The weighted average amount of borrowings outstanding under the credit agreement was \$5,430,000, \$6,694,000 and \$32,494,000 for the years ended April 28, 2001, April 29, 2000 and May 1, 1999, respectively, and the weighted average interest rate under the credit agreement was 6.85% for the year ended April 28, 2001, 6.74% for the year ended April 29, 2000 and 6.8% for the year ended May 1, 1999.

In fiscal 1995, the Company entered into a \$100,000,000 senior note agreement, as amended, with a group of insurance companies. These notes bear interest at rates of 8.51% or 8.84%. Scheduled maturities for the senior note agreement as of April 28, 2001 are as follows:

| | |
|------|--------------|
| 2002 | \$14,571,000 |
| 2003 | 3,572,000 |
| 2004 | 3,571,000 |
| 2005 | 3,571,000 |
| | ----- |
| | \$25,285,000 |
| | ===== |

The senior note and the credit agreements contain certain restrictions and covenants, relating to, among others, interest coverage ratio, working capital, debt and net worth. As of April 28, 2001, the Company was in compliance with these various provisions.

In fiscal 1999, a subsidiary entered into an \$8,750,000 credit facility. As of April 28, 2001, the interest rate was 7.0% and \$8,700,000 was outstanding and was classified as non-current debt. In fiscal 2001, a second subsidiary entered into an (Pounds)8,000,000 credit facility (approximately \$11,500,000 U.S.) with a certain bank. As of April 28, 2001, the interest rate was 6.6% and \$8,600,000 was outstanding and was classified as non-current debt. The Company has guaranteed repayment of amounts borrowed under each of these facilities, and is required to maintain availability under its \$150,000,000 line of credit to refinance any outstanding balances.

Interest expense for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 was \$4,527,000, \$5,373,000 and \$9,480,000, respectively. Interest paid for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 was \$4,462,000, \$5,039,000 and \$9,526,000, respectively.

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The domestic and foreign components of income (loss) before income taxes and minority interest for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 are as follows:

| | 2001 ----- | 2000 ----- | 1999 ----- |
|--|---------------|---------------|----------------|
| Domestic | \$73,389,000 | \$63,372,000 | \$(44,121,000) |
| Foreign | (4,257,000) | 2,601,000 | (5,141,000) |
| | ----- | ----- | ----- |
| Income (loss) before income taxes and minority interest | \$69,132,000 | \$65,973,000 | \$(49,262,000) |
| | ===== | ===== | ===== |

Provisions for income taxes for the years ended April 28, 2001, April 29, 2000 and May 1, 1999 consist of the following:

| | 2001 ----- | 2000 ----- | 1999 ----- |
|--------------------|---------------|---------------|----------------|
| Currently payable: | | | |
| Federal | \$24,528,000 | \$19,749,000 | \$ (2,686,000) |
| Foreign | 1,985,000 | 2,195,000 | 814,000 |
| State and other | 3,780,000 | 2,845,000 | (392,000) |
| Deferred, net: | | | |
| Federal | (1,145,000) | 1,545,000 | (12,180,000) |
| Foreign | (2,758,000) | (209,000) | (996,000) |
| State and other | (11,000) | 130,000 | (1,009,000) |
| | ----- | ----- | ----- |
| | \$26,379,000 | \$26,255,000 | \$(16,449,000) |
| | ===== | ===== | ===== |

The following table provides a reconciliation of the Company's resulting income tax to the statutory federal income tax:

| | 2001 ----- | 2000 ----- | 1999 ----- |
|--|---------------|---------------|----------------|
| Federal statutory tax | \$24,197,000 | \$23,092,000 | \$(17,241,000) |
| State and local income taxes | 2,273,000 | 1,940,000 | (911,000) |
| Effect of foreign operations | (5,344,000) | 1,076,000 | 1,617,000 |
| Effect of domestic operating loss with no tax benefit | 4,485,000 | -- | -- |
| Write-off of intangible assets | -- | -- | 1,914,000 |
| Prior years' tax accruals no longer necessary | -- | -- | (1,846,000) |
| Other | 768,000 | 147,000 | 18,000 |
| | ----- | ----- | ----- |
| Resulting tax | \$26,379,000 | \$26,255,000 | \$(16,449,000) |
| | ===== | ===== | ===== |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Items that gave rise to significant portions of the deferred tax accounts at April 28, 2001, April 29, 2000 and May 1, 1999 are as follows:

| | April 28, 2001 | | April 29, 2000 | | May 1, 1999 |
|------------------------|---------------------|--------------------------|---------------------|--------------------------|--------------|
| | Deferred Tax Assets | Deferred Tax Liabilities | Deferred Tax Assets | Deferred Tax Liabilities | |
| Allowances | \$ 14,146,000 | \$ 5,202,000 | \$13,585,000 | \$ 6,618,000 | \$13,615,000 |
| Carryforward losses | 14,594,000 | -- | 10,600,000 | -- | 8,300,000 |
| Employee benefits | 4,795,000 | 56,000 | 2,251,000 | 95,000 | 4,788,000 |
| Property and equipment | 1,163,000 | 5,666,000 | 2,802,000 | 6,075,000 | 8,327,000 |
| Inventory | 178,000 | 538,000 | 271,000 | 374,000 | 366,000 |
| Other | 3,710,000 | 347,000 | 1,531,000 | 83,000 | 1,734,000 |
| | 38,586,000 | 11,809,000 | 31,040,000 | 13,245,000 | 37,130,000 |
| Valuation allowance | (11,600,000) | -- | (8,600,000) | -- | (6,300,000) |
| Net | \$ 26,986,000 | \$11,809,000 | \$22,440,000 | \$13,245,000 | \$30,830,000 |

The Company has net operating and capital loss carryforwards for tax purposes of approximately \$42,000,000 which expire at various times from 2002 through 2020. A valuation allowance is provided when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company has valuation allowance recognized related to approximately \$33,000,000 of its loss carryforwards.

Income taxes paid in 2001, 2000 and 1999 were approximately \$26,867,000, \$26,311,000 and \$5,203,000, respectively.

7. Property and Equipment:

Property and equipment consists of the following:

| | 2001 | 2000 | 1999 |
|--------------------------------|--------------|--------------|--------------|
| Land | \$ 1,233,000 | \$ 3,078,000 | \$ 3,354,000 |
| Buildings and improvements | 14,621,000 | 17,126,000 | 16,227,000 |
| Display fixtures | 34,627,000 | 52,362,000 | 45,486,000 |
| Computer hardware and software | 34,110,000 | 22,475,000 | 12,607,000 |
| Equipment, furniture and other | 34,192,000 | 27,207,000 | 31,223,000 |

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| | | | |
|-------------------------------|---------------------------------|---------------------------------|------------------------------|
| | ----- 118,783,000 | ----- 122,248,000 | ----- 108,897, |
| Less accumulated depreciation | 61,896,000 | 70,396,000 | 55,478, |
| | ----- \$ 56,887,000 ===== | ----- \$ 51,852,000 ===== | ----- \$ 53,419, ===== |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

8. Stock Plans:

The Company's shareholders approved the adoption of the Handleman Company 1998 Performance Incentive Plan (the "Plan"), which authorizes the granting of stock options, stock appreciation rights and restricted stock. The maximum number of shares of stock which may be issued under the Plan is 1,500,000 shares. After deducting restricted stock, options and awards issued or granted under the Plan since adoption in September 1998, 550,206 shares of the Company's stock are available for use under the Plan as of April 28, 2001.

During fiscal 2001, 70,294 shares of previously issued restricted stock vested with recipients, and 92,672 shares, net of forfeitures, remain to vest based upon pre-determined periods of continued service. Compensation expense recorded in fiscal 2001 and fiscal 2000 related to the restricted stock awards was \$448,000 and \$579,000, respectively.

Information with respect to options outstanding under the previous and current stock option plans, which have various terms and vesting periods as approved by the Compensation and Stock Option Committee of the Board of Directors, for the years ended May 1, 1999, April 29, 2000 and April 28, 2001, is set forth below. Options were granted during such years at no less than fair market value at the date of grant.

| | Number of Shares | Weighted Average Price |
|------------------------|---------------------|---------------------------|
| | ----- | ----- |
| Balance, May 2, 1998 | 1,407,419 | \$10.24 |
| Granted | 292,100 | 12.06 |
| Terminated | (278,919) | 11.60 |
| Exercised | (257,962) | 9.61 |
| | ----- | ----- |
| Balance, May 1, 1999 | 1,162,638 | 10.53 |
| Granted | 450,200 | 11.30 |
| Terminated | (88,597) | 16.42 |
| Exercised | (117,214) | 8.89 |
| | ----- | ----- |
| Balance April 29, 2000 | 1,407,027 | 10.55 |

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| | | |
|---|-----------|---------|
| Granted | 499,594 | 10.31 |
| Terminated | (171,899) | 12.39 |
| Exercised | (55,069) | 6.96 |
| | ----- | ----- |
| Balance April 28, 2001 | 1,679,653 | \$10.42 |
| | ===== | ===== |
| Number of shares exercisable at April 28, 2001 | 851,614 | \$10.59 |
| | ===== | ===== |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The exercise price range of outstanding options as of May 1, 1999, April 29, 2000 and April 28, 2001 was \$6.00-\$21.83, \$6.00-\$15.87 and \$6.00-\$16.75, respectively. Approximately 77% of outstanding options as of April 28, 2001 had exercise prices of \$10.00 per share or more. The average remaining exercise period for shares exercisable at April 28, 2001 was six years.

The Company applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," in determining stock option compensation expense. The following table presents the proforma effects on the Company's earnings and earnings per share in fiscal years 2001, 2000 and 1999 had stock option compensation expense been determined pursuant to the methodology of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," including amortization to expense the estimated fair value of the granted options over the options' vesting periods.

| | 2001 | 2000 | 1999 |
|----------------------------|--------------|--------------|-----------------|
| | ----- | ----- | ----- |
| Net income (loss): | | | |
| As reported | \$42,031,000 | \$38,648,000 | \$ (35,052,000) |
| Proforma | 41,189,000 | 37,901,000 | (35,655,000) |
| Earnings (loss) per share: | | | |
| As reported - basic | \$ 1.54 | \$ 1.31 | \$ (1.11) |
| - diluted | 1.53 | 1.30 | (1.11) |
| Proforma - basic | 1.51 | 1.29 | (1.13) |
| - diluted | 1.50 | 1.28 | (1.12) |

The fair value of each option grant was estimated as of the date of grant using the Black-Scholes option-pricing model using the following weighted average assumptions for fiscal years 2001, 2000 and 1999:

| | 2001 | 2000 | 1999 |
|--------------------------|--------|--------|--------|
| | ---- | ---- | ---- |
| Expected life (in years) | 5.0 | 5.0 | 5.0 |
| Risk free interest rate | 6.25% | 5.84% | 5.57% |
| Volatility | 42.60% | 42.17% | 39.16% |
| Dividend yield | -- | -- | -- |

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The weighted average estimated fair value of stock options granted during fiscal years 2001, 2000 and 1999 was \$4.80, \$5.16 and \$5.21, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

9. Quarterly Financial Summary (unaudited):

(amounts in thousands except per share data)

| | For the Three Months Ended | | | |
|---|----------------------------|------------------|------------------|----------|
| | July 29, 2000 | Oct. 28, 2000 | Jan. 31, 2001 | Apr 2 |
| Fiscal Year 2001 | ----- | ----- | ----- | ----- |
| Revenues | \$231,435 | \$297,593 | \$348,974 | \$3 |
| Income before income taxes and minority interest | 2,983 | 23,609 | 23,284 | |
| Net income | 1,742 | 14,142 | 16,256 | |
| Earnings per share - basic and diluted | .06 | .51 | .60 | |
| Fiscal Year 2000 | ----- | ----- | ----- | ----- |
| Revenues | \$226,357 | \$288,855 | \$343,246 | \$27 |
| Income before income taxes and minority interest | 1,686 | 23,487 | 25,131 | 1 |
| Net income | 682 | 13,479 | 14,660 | |
| Earnings per share - basic and diluted | .02 | .45 | .50 | |

The high effective tax rate in the fourth quarter of fiscal 2001 resulted from losses at a certain subsidiary where no tax benefit on these losses was recognized because the subsidiary was unconsolidated for tax purposes in fiscal 2001.

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Item 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

Not applicable

PART III

Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Item 10, with the exception of the following information regarding executive officers of the Registrant required by Item 10, is contained in the Handleman Company definitive Proxy Statement for its 2001 Annual Meeting of Shareholders

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to be filed on or before August 24, 2001 and such information is incorporated herein by reference. All officers serve at the discretion of the Board of Directors.

EXECUTIVE OFFICERS OF THE REGISTRANT

| Name and Age | Office and Year First Elected |
|------------------------------|--|
| Stephen Strome 56 | (1) Chairman (2001), Chief Executive Officer (1991) and Director (|
| Peter J. Cline 54 | (2) President (2001) and Chief Operating Officer (2000) |
| Leonard A. Brams 50 | (3) Senior Vice President/Finance, Chief Financial Officer and Sec |
| Stephen Nadelberg 60 | (4) Senior Vice President/President of NCE (1997) |
| Geraldo Lopez 41 | (5) Senior Vice President/General Manager, Customer Teams and Consumer Marketing (2000) |
| Thomas C. Braum, Jr. 46 | (6) Vice President (1992) and Corporate Controller (1988) |

1. Stephen Strome was named Chairman on January 12, 2001. Mr. Strome has served as Chief Executive Officer since May 1991. Prior to his appointment as Chairman, Mr. Strome served as President since March 1990.
2. Peter J. Cline was named President on January 12, 2001. Mr. Cline has served as Chief Operating Officer since May 2000, and as Executive Vice President/President of Handleman Entertainment Resources since joining the Company in April 1994.
3. Leonard A. Brams has served as Senior Vice President/Finance, Chief Financial Officer and Secretary since joining the Company in June 1997. Prior to joining the Company, Mr. Brams was Vice President/Administration and Chief Financial Officer for Talon LLC from 1995 until 1997, and Vice President Finance of United Technologies Automotive from 1990 until 1994.
4. Stephen Nadelberg has served as Senior Vice President/President of North Coast Entertainment since joining the Company in February 1997. Prior to joining the Company, Mr. Nadelberg was employed from 1974 to 1996 by Allied Domecq Spirits & Wines, parent company of Hiram Walker, Inc., where he held various positions, most recently as Vice President and General Manager of global product development.
5. Geraldo Lopez has served as Senior Vice President/General Manager of Customer Teams and Consumer Marketing since joining the Company in May 2000. Prior to joining the Company, Mr. Lopez was President of the International Division and Senior Vice President/General Manager of Southwest Brands of International Home Foods from 1997 until 2000, and held various positions with Frito Lay from 1991 through 1997, most recently as Vice President of the St. Louis/Tulsa market.
6. Thomas C. Braum, Jr. has served as Corporate Controller since June 1988. In February 1992, Mr. Braum was elected Vice President.

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Item 11. EXECUTIVE COMPENSATION

Information required by this item is contained in the Handleman Company definitive Proxy Statement for its 2001 Annual Meeting of Shareholders, to be filed on or before August 24, 2001 and such information is incorporated herein by reference.

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Item 12. SECURITY OWNERSHIP OF CERTAIN
BENEFICIAL OWNERS AND MANAGEMENT

Information required by this item is contained in the Handleman Company definitive Proxy Statement for its 2001 Annual Meeting of Shareholders, to be filed on or before August 24, 2001 and such information is incorporated herein by reference.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information required by this item is contained in the Handleman Company definitive Proxy Statement for its 2001 Annual Meeting of Shareholders, to be filed on or before August 24, 2001 and such information is incorporated herein by reference.

PART IV

Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

- (a) 1. The following financial statements and supplementary data are filed as a part of this report under Item 8.:

Report of Independent Accountants

Consolidated Balance Sheet at April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Income - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Shareholders' Equity - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Consolidated Statement of Cash Flows - Years Ended April 28, 2001, April 29, 2000 and May 1, 1999

Notes to Consolidated Financial Statements

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2. Financial Statement Schedules

II. Valuation and Qualifying Accounts and Reserves

All other schedules for Handleman Company have been omitted since the required information is not present or not present in an amount sufficient to require submission of the schedule, or because the information required is included in the financial statements or the notes thereto.

3. Exhibits as required by Item 601 of Regulation S-K.

S-K Item 601 (3)

The Registrant's Restated Articles of Incorporation dated June 30, 1989 were filed with the Form 10-K dated May 1, 1993, and are incorporated herein by reference. The Registrant's Bylaws adopted March 7, 1990, as amended June 16, 1993 and December 6, 1995, and

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further amended January 12, 2001, are filed as Exhibit A to this Form 10-K.

S-K Item 601 (10)

The Registrant's 1983 Stock Option Plan was filed with the Commission in Form S-8 dated January 18, 1985, File No. 2-95421. The first amendment to the 1983 Stock Option Plan, adopted on March 11, 1987, was filed with the Commission with the Form 10-K for the year ended May 2, 1987.

The Registrant's 1992 Performance Incentive Plan was filed with the Commission in Form S-8, dated March 5, 1993, File No. 33-59100.

The Registrant's 1998 Stock Option and Incentive Plan was filed with the Commission in Form S-8, dated December 21, 1998, File No. 333-69389.

The advisory agreement with David Handleman was filed with the Form 10-K for the year ended April 28, 1990.

The Note Agreement dated as of November 1, 1994 was filed with the Form 10-K for the year ended April 28, 1995.

The Credit Agreement among Handleman Company, the Banks named therein and NBD Bank, N.A., as Agent, dated September 3, 1997 was filed with the Form 10-K for the year ended May 2, 1998.

The change in control agreements dated March 17, 1997 and October 30 and 31, 1997 between Handleman Company and certain executive officers of the Company were filed with the Form 10-K for the year ended May 3, 1997 and Form 10-K for the year ended May 2, 1998, respectively.

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S-K Item 601 (21) - Subsidiaries of the Registrant:

ABE R2 Communications, Inc., a California Corporation
ABE R2 Video, Ltd., a California Limited Partnership
American Sterling Corp., a Delaware Corporation
Anchor Bay Entertainment, GmbH, a German Limited Liability Company
Anchor Bay Entertainment, Inc., a Michigan Corporation
Anchor Bay Entertainment UK Limited, a United Kingdom Corporation
Anchor Bay International, Limited, a Private Limited (U.K.) Corporation
A teeny weeny Production Company, a Delaware Corporation
Bosco Music, Inc., a Michigan Corporation
Click 2 the Music, LLC, a Michigan Limited Liability Company
Eloise Production Company, a Delaware Corporation
Global Entertainment Utility, LLC, a Michigan Limited Liability Company
Handleman Canada, Inc., a Canadian Corporation
Handleman Category Management Company, a Michigan Corporation
Handleman Company of Canada, Limited, an Ontario Corporation
Handleman de Mexico S.A. de C.V.
Handleman do Brasil Commercial Ltda.
Handleman Distribution Company, a Michigan Corporation
Handleman Entertainment Resources, L.L.C., a Michigan LLC
Handleman Online, Inc., a Michigan Corporation
Handleman Ontario Ltd., a British Virgin Islands Corporation

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Handleman Real Estate, LLC, a Michigan LLC
Handleman UK Limited, a United Kingdom Corporation
Hanley Advertising Company, a Michigan Corporation
HCCL , LP, a Canadian Limited Partnership
HGV Video Productions, Inc., an Ontario Corporation
HOORAY! Inc., a New York Corporation
Lifetime Entertainment Limited, a United Kingdom Corporation
Lifetime Holding, Inc., a Michigan Corporation
Madacy Enterprises USA, Inc., a Delaware Corporation
Madacy Entertainment Group, Inc., a Michigan Corporation
Madacy Entertainment Group, Ltd., a Canadian Corporation
Madacy Entertainment (U.K.) Limited, a United Kingdom Corporation
Madacy Music Publishing, Inc., a Canadian Corporation
Maryart Marketing, Inc., a Canadian Corporation
Mediaphon, GmbH, a German Limited Liability Company
Michigan Property and Risk Management Company, a Michigan Corporation
North Coast Entertainment, Inc., a Michigan Corporation
North Coast Entertainment, Ltd., a Canadian Corporation
Oasis Merchandisers Limited, a United Kingdom Corporation
Rackjobbing Services, S.A. de C.V.
Sellthrough Entertainment, Inc., a Michigan Corporation
The itsy bitsy Entertainment Company, a Delaware Corporation
The itsy bitsy Entertainment Company (Canada) Ltd., a Canadian Corporation
The itsy bitsy Entertainment Holding Company, a Michigan Corporation
The itsy bitsy Melody Company, Inc., a New York Corporation
The itsy bitsy Music Publishing Company, Inc., a New York Corporation
TibECo Productions, Inc., a New York Corporation

S-K Item 601 (23) - Consent of Independent Accountants:
Filed with this report.

- (b) No reports on Form 8-K have been filed during the last quarter of the period covered by this report.

Note: Exhibits, if any, attached to this report will be furnished to requesting security holders upon payment of a reasonable fee to reimburse the Registrant for expenses incurred by Registrant in furnishing such Exhibits.

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CONSENT OF INDEPENDENT ACCOUNTANTS

We consent to the incorporation by reference in the Registration Statements of Handleman Company and subsidiaries on Form S-3 (File No. 33-42018) and Form S-8 (File Nos. 2-95421, 33-59100, 33-16637, 33-69030, 333-69389 and 333-60205) of our report dated June 5, 2001 on our audits of the consolidated financial statements and financial statement schedule of Handleman Company and subsidiaries as of April 28, 2001, April 29, 2000 and May 1, 1999, and for the years then ended, which report is included in this Annual Report on Form 10-K.

PricewaterhouseCoopers LLP

Detroit, Michigan
July 13, 2001

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SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS AND RESERVES
 YEARS ENDED MAY 1, 1999, APRIL 29, 2000 AND APRIL 28, 2001

| COLUMN A ----- Description ----- | COLUMN B ----- Balance at Beginning of Period ----- | COLUMN C ----- Additions: Charged to Expense ----- | COLUMN D ----- Deductions Adjustment of, or Char to, Reserv ----- |
|---|--|---|---|
| Year ended May 1, 1999: | | | |
| Accounts receivable, allowance for gross profit impact of estimated future returns | \$17,339,000 ===== | \$ 7,260,000 ===== | \$10,839,000 ===== |
| Other assets, collectability allowance for receivables from bankrupt customers | \$ 5,341,000 ===== | \$ 875,000 ===== | \$ 269,000 ===== |
| Year ended April 29, 2000: | | | |
| Accounts receivable, allowance for gross profit impact of estimated future returns | \$13,760,000 ===== | \$ 6,750,000 ===== | \$ 3,127,000 ===== |
| Other assets, collectability allowance for receivables from bankrupt customers | \$ 5,947,000 ===== | \$ 1,515,000 ===== | \$ 476,000 ===== |
| Year ended April 28, 2001: | | | |
| Accounts receivable, allowance for gross profit impact of estimated future returns | \$17,383,000 ===== | \$ 9,788,000 ===== | \$10,835,000 ===== |
| Other assets, collectability allowance for receivables from bankrupt customers | \$ 6,986,000 ===== | \$ 895,000 ===== | \$ 2,510,000 ===== |

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SIGNATURES

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Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HANDLEMAN COMPANY

DATE: July 24, 2001

BY: /s/ Stephen Strome

Stephen Strome, Chairman of the Board, Chief Executive Officer and Director

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ Leonard A. Brams

/s/ Thomas C. Braum, Jr.

Leonard A. Brams, Senior Vice President, Finance and Chief Financial Officer (Principal Financial Officer)

Thomas C. Braum, Jr., Vice President, Corporate Controller (Principal Accounting Officer)

July 24, 2001

July 24, 2001

DATE

DATE

/s/ David Handleman

/s/ John M. Barth

David Handleman, Director

John M. Barth, Director

July 24, 2001

July 24, 2001

DATE

DATE

/s/ Elizabeth A. Chappell

/s/ Richard H. Cummings

Elizabeth A. Chappell, Director

Richard H. Cummings, Director

July 24, 2001

July 24, 2001

DATE

DATE

/s/ James B. Nicholson

/s/ Lloyd E. Reuss

James B. Nicholson, Director

Lloyd E. Reuss, Director

July 24, 2001

July 24, 2001

DATE

DATE

/s/ Alan E. Schwartz

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Alan E. Schwartz, Director

July 24, 2001

DATE