

HANDLEMAN CO /MI/
Form 10-Q
December 06, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended October 28, 2006

or

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

Commission file number 1-7923

HANDLEMAN COMPANY

(Exact name of registrant as specified in its charter)

MICHIGAN
(State or other jurisdiction of incorporation or organization)

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

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

48084-5225
(Zip Code)

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

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

YES NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Edgar Filing: HANDLEMAN CO /MI/ - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

YES NO

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 December 1, 2006 was 20,286,740.

Table of Contents

HANDLEMAN COMPANY

INDEX

| | PAGE NUMBER(S) |
|------------------------------------------------------------------------------------------------------|---------------------------|
| <u>PART I - FINANCIAL INFORMATION</u> | |
| Item 1. <u>Financial Statements</u> | |
| <u>Consolidated Statements of Operations</u> | 1 |
| <u>Consolidated Balance Sheets</u> | 2 |
| <u>Consolidated Statement of Shareholders' Equity</u> | 3 |
| <u>Consolidated Statements of Cash Flows</u> | 4 |
| <u>Notes to Consolidated Financial Statements</u> | 5 - 20 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 21 - 25 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 26 |
| Item 4. <u>Controls and Procedures</u> | 26 - 27 |
| <u>PART II - OTHER INFORMATION</u> | |
| Item 1. <u>Legal Proceedings</u> | 28 |
| Item 1A. <u>Risk Factors</u> | 28 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 28 |
| Item 3. <u>Defaults Upon Senior Securities</u> | 28 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 29 |
| Item 5. <u>Other Information</u> | 29 |
| Item 6. <u>Exhibits</u> | 30 |
| <u>SIGNATURES</u> | 31 |

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE THREE-MONTH AND SIX-MONTH PERIODS ENDED OCTOBER 28, 2006 AND OCTOBER 29, 2005

(UNAUDITED)

(in thousands of dollars except per share data)

| | Three Months (13 weeks) Ended | | Six Months (26 weeks) Ended | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------|---------------------|-----------------------------|---------------------|
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Revenues | \$ 330,509 | \$ 302,246 | \$ 570,915 | \$ 542,648 |
| Costs and expenses: | | | | |
| Direct product costs | (278,750) | (248,281) | (483,564) | (448,003) |
| Selling, general and administrative expenses | (58,907) | (47,424) | (115,123) | (94,853) |
| Operating (loss) income | (7,148) | 6,541 | (27,772) | (208) |
| Interest expense | (1,495) | (220) | (3,276) | (248) |
| Investment income | 470 | 4,005 | 476 | 5,070 |
| (Loss) income from continuing operations before income taxes | (8,173) | 10,326 | (30,572) | 4,614 |
| Income tax (expense) benefit | (6,064) | (190) | 10,392 | 1,874 |
| (Loss) income from continuing operations | (14,237) | 10,136 | (20,180) | 6,488 |
| Discontinued operations (Note 4): | | | | |
| Loss from operations of discontinued subsidiary companies (including loss on disposal of \$563 for the three and six-month periods ended October 29, 2005) | | (563) | | (563) |
| Income tax benefit | | 201 | | 201 |
| Loss from discontinued operations | | (362) | | (362) |
| Net (loss) income | \$ (14,237) | \$ 9,774 | \$ (20,180) | \$ 6,126 |
| (Loss) income per share: | | | | |
| Continuing operations - basic | \$ (0.70) | \$ 0.48 | \$ (1.00) | \$ 0.31 |
| Continuing operations - diluted | \$ (0.70) | \$ 0.48 | \$ (1.00) | \$ 0.31 |
| Discontinued operations - basic | \$ | \$ (0.02) | \$ | \$ (0.02) |
| Discontinued operations - diluted | \$ | \$ (0.02) | \$ | \$ (0.02) |
| Net income - basic | \$ (0.70) | \$ 0.46 | \$ (1.00) | \$ 0.29 |

Edgar Filing: HANDLEMAN CO /MI/ - Form 10-Q

| | | | | | | | | |
|------------------------------------------------------------------|----|--------|----|--------|----|--------|----|--------|
| Net income - diluted | \$ | (0.70) | \$ | 0.46 | \$ | (1.00) | \$ | 0.29 |
| Weighted average number of shares outstanding during the period: | | | | | | | | |
| Basic | | 20,268 | | 21,027 | | 20,197 | | 21,240 |
| Diluted | | 20,268 | | 21,142 | | 20,197 | | 21,405 |

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

Table of Contents

HANDLEMAN COMPANY

CONSOLIDATED BALANCE SHEETS

AS OF OCTOBER 28, 2006 and APRIL 29, 2006

(in thousands of dollars except share data)

| | October 28, 2006 (Unaudited) | April 29, 2006 |
|-----------------------------------------------------------------------------------------------------|------------------------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 16,875 | \$ 10,346 |
| Accounts receivable, less allowances of \$16,309 at October 28, 2006 and \$13,658 at April 29, 2006 | 291,066 | 257,942 |
| Merchandise inventories | 211,395 | 128,844 |
| Other current assets | 17,390 | 9,898 |
| Total current assets | 536,726 | 407,030 |
| Property and equipment: | | |
| Land, buildings and improvements | 13,885 | 13,896 |
| Display fixtures | 29,932 | 29,470 |
| Computer hardware and software | 63,912 | 62,632 |
| Equipment, furniture and other | 43,502 | 35,964 |
| | 151,231 | 141,962 |
| Less accumulated depreciation | 94,346 | 87,863 |
| | 56,885 | 54,099 |
| Goodwill, net | 36,938 | 36,938 |
| Intangible assets, net | 41,003 | 43,338 |
| Other assets, net | 32,586 | 33,626 |
| Total assets | \$ 704,138 | \$ 575,031 |
| LIABILITIES | | |
| Current liabilities: | | |
| Debt, current portion | \$ 96,560 | \$ 3,960 |
| Notes payable | | 1,000 |
| Accounts payable | 289,074 | 144,401 |
| Accrued and other liabilities | 23,943 | 29,326 |
| Total current liabilities | 409,577 | 178,687 |
| Debt, non-current | | 83,600 |
| Other liabilities | 15,901 | 15,755 |
| Commitments and contingencies (Note 11) | | |
| Total liabilities | 425,478 | 278,042 |
| SHAREHOLDERS' EQUITY | | |
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued | | |

Edgar Filing: HANDLEMAN CO /MI/ - Form 10-Q

| | | |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Common stock, \$.01 par value; 60,000,000 shares authorized; 20,287,000 and 19,990,000 shares issued at October 28, 2006 and April 29, 2006, respectively | 203 | 200 |
| Accumulated other comprehensive income | 18,963 | 16,067 |
| Unearned compensation | | (4,816) |
| Retained earnings | 259,494 | 285,538 |
| Total shareholders' equity | 278,660 | 296,989 |
| Total liabilities and shareholders' equity | \$ 704,138 | \$ 575,031 |

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

Table of Contents

HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
FOR THE SIX-MONTH PERIOD ENDED OCTOBER 28, 2006
(UNAUDITED)
(in thousands of dollars)

| | Six Months (26 weeks) | | | | | | | | Total Shareholders Equity |
|----------------------------------------------------------|-----------------------|--------|--------------------------------------------------|---------------------------------|--------------------------|--------------------------|----------------------------------|----------------------|---------------------------------|
| | Common Stock | | Accumulated Other Comprehensive Income (Loss) | | | | Additional Paid-in Capital | Retained Earnings | |
| | Shares Issued | Amount | Foreign Currency Adjustment | Minimum Pension Liability | Interest Rate Swap | Unearned Compensation | | | |
| April 29, 2006 | 19,990 | \$ 200 | \$ 16,131 | \$ (248) | \$ 184 | \$ (4,816) | | \$ 285,538 | \$ 296,989 |
| Net loss | | | | | | | | (20,180) | (20,180) |
| Adjustment for foreign currency translation | | | 2,953 | | | | | | 2,953 |
| Minimum pension liability adjustment, net of tax of \$32 | | | | 59 | | | | | 59 |
| Interest rate swap, net of tax of \$(64) | | | | | (116) | | | | (116) |
| Comprehensive loss, net of tax | | | | | | | | | (17,284) |
| Stock-based compensation: | | | | | | | | | |
| Performance shares/units | 214 | 2 | | | | 3,484 | (2,088) | | 1,398 |
| Stock options | | | | | | 812 | (439) | | 373 |
| Restricted stock and other | 83 | 1 | | | | 520 | (114) | | 407 |
| Reclassification of additional paid-in capital | | | | | | | 2,641 | (2,641) | |
| Cash dividends, \$0.16 per share | | | | | | | | (3,223) | (3,223) |
| October 28, 2006 | 20,287 | \$ 203 | \$ 19,084 | \$ (189) | \$ 68 | \$ | \$ | \$ 259,494 | \$ 278,660 |

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

Table of Contents

HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE SIX-MONTH PERIODS ENDED OCTOBER 28, 2006 AND OCTOBER 29, 2005

(UNAUDITED)

(in thousands of dollars)

| | Six Months (26 weeks) Ended October 28, 2006 | October 29, 2005 |
|------------------------------------------------------------------------------------------------------|----------------------------------------------------|---------------------|
| Cash flows from operating activities: | | |
| Net (loss) income | \$ (20,180) | \$ 6,126 |
| Adjustments to reconcile net (loss) income to net cash provided from (used by) operating activities: | | |
| Depreciation and amortization | 8,095 | 8,529 |
| Amortization of definite lived intangible assets | 4,612 | 339 |
| Recoupment of license advances | 3,021 | |
| Gain on sale of investment | | (3,844) |
| Unrealized investment income | (26) | (306) |
| Loss on disposal of property and equipment | 243 | 321 |
| Stock-based compensation | 2,617 | 1,816 |
| Pension/SERP curtailment charges | 1,064 | |
| Changes in operating assets and liabilities: | | |
| Increase in accounts receivable | (30,383) | (46,601) |
| Increase in merchandise inventories | (81,146) | (98,136) |
| (Increase) decrease in other operating assets | (6,718) | 2,950 |
| Increase in accounts payable | 139,571 | 136,939 |
| Decrease in other operating liabilities | (5,269) | (8,333) |
| Total adjustments | 35,681 | (6,326) |
| Net cash provided from (used by) operating activities | 15,501 | (200) |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (10,925) | (7,592) |
| License advances and acquired rights | (5,128) | |
| Proceeds from disposition of properties and equipment | 1 | 231 |
| Proceeds from sale of investment | | 3,844 |
| Cash investment in REPS LLC | (1,052) | (19,107) |
| Other equity investments | (1,137) | |
| Net cash used by investing activities | (18,241) | (22,624) |
| Cash flows from financing activities: | | |
| Issuances of debt | 2,233,688 | 373,715 |
| Repayments of debt | (2,224,688) | (338,815) |
| Checks issued in excess of cash balances | 3,075 | 1,902 |
| Cash dividends | (3,223) | (3,400) |
| Repurchases of common stock | | (13,879) |
| Cash proceeds from stock-based compensation plans | 76 | 62 |

Edgar Filing: HANDLEMAN CO /MI/ - Form 10-Q

| | | |
|------------------------------------------------------|-----------|-----------|
| Net cash provided from financing activities | 8,928 | 19,585 |
| Effect of exchange rate changes on cash | 341 | (491) |
| Net increase (decrease) in cash and cash equivalents | 6,529 | (3,730) |
| Cash and cash equivalents at beginning of period | 10,346 | 30,826 |
| Cash and cash equivalents at end of period | \$ 16,875 | \$ 27,096 |

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

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Accounting Policies

In the opinion of management, the accompanying Consolidated Balance Sheets and Consolidated Statements of Operations, Shareholders' Equity and Cash Flows contain all adjustments, including normal recurring adjustments, necessary to present fairly the financial position of the Company as of October 28, 2006, and the results of operations and changes in cash flows for the six months then ended. Because of the seasonal nature of the Company's business, revenues and earnings results for the six months ended October 28, 2006 are not necessarily indicative of what the results will be for the full year. The Consolidated Balance Sheet as of April 29, 2006 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's fiscal year 2006 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended April 29, 2006, including the discussion of the Company's critical accounting policies. The year-end balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

2. New Accounting Pronouncements

In December 2004, Statement of Financial Accounting Standards (SFAS) No. 123R, Share-Based Payment (revised 2004), was issued by the Financial Accounting Standards Board (FASB). SFAS No. 123R requires public companies to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award, usually the vesting period. The Company adopted the provisions of SFAS No. 123R as of April 30, 2006, as required. The impact of adopting SFAS No. 123R on the first quarter of fiscal 2007 was a reduction in net income of \$277,000, of which \$254,000 related to an increase in income tax expense. See Note 10 of Notes to Consolidated Financial Statements for additional information related to the adoption of SFAS No. 123R.

In September 2006, SFAS No. 157, Fair Value Measurements, was issued by the FASB. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements; however, the Statement does not require any new fair value measurements. SFAS No. 157 will be effective for the Company's fiscal year beginning April 29, 2007. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

In September 2006, SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106 and 132(R), was issued by the FASB. This Statement requires an entity to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in comprehensive income in the year in which the changes occur. This portion of SFAS No. 158 will be effective for the Company's fiscal year ended April 28, 2007. This Statement also requires plan assets and benefit obligations to be measured as of an entity's fiscal year end. This requirement will be effective for the Company's fiscal year ended May 2, 2009. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

In September 2006, Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements, was issued by the Securities and Exchange Commission (SEC). SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. There have been two widely-recognized methods for quantifying the effects of financial statement misstatements, the roll-over method and the iron curtain method. The roll-over method focuses primarily on the impact of a misstatement on the income statement, including the reversing effect of prior year misstatements. The use of this method can cause the accumulation of misstatements in the balance sheet. The iron-curtain method, on the other hand, focuses primarily on the effect of correcting the balance sheet with less emphasis on the reversing effects of prior year errors on the income statement. In SAB No. 108, the SEC staff established an approach that requires quantification of financial statement misstatements based on the effects of the misstatements on each of the company's financial statements and the related financial statement disclosures. This model is commonly referred to as a dual approach since it requires quantification of errors under both the iron curtain and the roll-over methods. SAB No. 108 permits public companies to initially apply its provisions either by (i) restating prior financial statements as if the dual approach had always been used or (ii) recording the cumulative effect of initially applying the dual approach as adjustments to the carrying values of assets and liabilities with an offsetting adjustment recorded to the opening balance of retained earnings. Use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment, including how and when the errors arose. SAB No. 108 is effective for fiscal years ending on or after November 15, 2006. The Company will apply the provisions of SAB No. 108 using the cumulative effect transition method in connection with the preparation of its annual financial statements for the year ending April 28, 2007. With the initial application of the provisions of SAB No. 108, the Company expects to record a decrease in prepaid property taxes of approximately \$0.4 million, an increase in deferred income taxes of approximately \$0.6 million, an increase in accrued property taxes of approximately \$1.4 million and a decrease in retained earnings of approximately \$1.2 million. The accompanying financial statements do not reflect these adjustments. Property taxes are being properly accounted for during the Company's fiscal year 2007.

In June 2006, FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109, was issued by the FASB. This Interpretation clarifies the accounting for income taxes recognized in accordance with SFAS No. 109 with respect to recognition and measurement for tax positions that are taken or expected to be taken in a tax return. FIN No. 48 will be effective for the Company's fiscal year beginning April 29, 2007. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

3. Acquisitions*Crave Entertainment Group, Inc.*

On November 22, 2005, Handleman Company acquired the stock of privately-owned Crave Entertainment Group, Inc. (Crave). Crave is a distributor of video game software, including Crave-branded exclusively distributed video game software, as well as video game hardware and accessories to major retailers throughout the United States. This acquisition expanded the Company's customer base, broadened its product lines and provided growth opportunities for both organizations through cross-selling customers, services and products. This acquisition has been recorded in accordance with the provisions of SFAS No. 141, Business Combinations, and the operating results of Crave have been included in the Company's consolidated financial statements since the date of acquisition. The purchase price for the acquisition of Crave totaled \$123,459,000. Handleman Company financed this acquisition through borrowings against its revolving line of credit.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

REPS LLC

On June 24, 2005, Handleman Company acquired all of the operating assets and certain liabilities of REPS LLC (REPS). REPS provides in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers in the United States. The in-store merchandising structure of REPS is similar to the Company's in-store merchandising structure, thus providing the opportunity to consolidate certain functions and generate cost savings and synergies. This acquisition has been recorded in accordance with the provisions of SFAS No. 141 and the operating results of REPS have been included in the Company's consolidated financial statements since the date of acquisition. The purchase price for the net assets of REPS totaled \$20,816,000.

4. Discontinued Operations

In the second quarter of fiscal 2004, the Company sold its Anchor Bay Entertainment subsidiary companies. In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the financial results of these subsidiary companies were reported separately as discontinued operations in the Company's Consolidated Statements of Operations for all periods presented, since the operations and cash flows of these companies were eliminated from the ongoing operations of the Company. The Company does not have any continuing involvement in the operations of these companies after the disposal transaction.

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

5. Accounts Receivable

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

| | October 28, 2006 | April 29, 2006 |
|-------------------------------------------------|-----------------------------|---------------------------|
| Trade accounts receivable | \$ 307,375 | \$ 271,600 |
| Less allowances for: | | |
| Gross profit impact of estimated future returns | (11,219) | (9,570) |
| Doubtful accounts | (5,090) | (4,088) |
| Accounts receivable, net | \$ 291,066 | \$ 257,942 |

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

6. **Goodwill and Intangible Assets**

Goodwill

The Company accounts for goodwill and intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*. Accordingly, the Company performs an annual impairment test for goodwill in the fourth quarter of each fiscal year or as business conditions warrant a review. The goodwill test for impairment is conducted on a reporting unit level, whereby the carrying value of each reporting unit, including goodwill, is compared to its fair value. Fair value is estimated using the present value of free cash flows method. The Company did not record any goodwill impairment charges during the first six months of fiscal 2007.

Goodwill represents the excess of consideration paid over the estimated fair values of net assets of businesses acquired. Goodwill included in the Company's Consolidated Balance Sheets as of October 28, 2006 and April 29, 2006 was \$36,938,000, which was net of amortization of \$1,224,000 at each of these balance sheet dates. The category management and distribution operations business segment had goodwill of \$10,309,000 at each of these balance sheet dates, while the video game operations business segment had the remaining \$26,629,000 of goodwill.

Intangible Assets

Intangible assets relate to the acquisitions of Crave Entertainment Group, Inc. and REPS LLC and represent all of the intangible assets of the Company. The Company performs annual impairment analyses, or as business conditions warrant a review, comparing the carrying value of its intangible assets with the future economic benefit of these assets. Based on such analyses, the Company adjusts, as necessary, the value of its intangible assets. The Company did not record any intangible asset impairment charges during the first six months of fiscal 2007.

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

On a monthly basis, management evaluates software development agreements to determine if balances are in a prepaid or payable status when, due to sales volume, the Company has fully expensed advances made to developers and additional royalties are owed. Royalties payable to developers and licensors are classified as accrued royalties and included in *Accrued and other liabilities* in the Company's Consolidated Balance Sheets. Accrued royalties as of October 28, 2006 totaled \$303,000.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The following information relates to intangible assets subject to amortization as of October 28, 2006 and April 29, 2006 (in thousands of dollars):

| Amortized | October 28, 2006 | | April 29, 2006 | |
|---------------------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Intangible Assets | | | | |
| Trademark | \$ 7,900 | \$ 1,329 | \$ 7,900 | \$ 474 |
| Customer relationships | 28,100 | 4,547 | 28,100 | 1,547 |
| Non-compete agreements | 3,970 | 1,264 | 3,970 | 676 |
| Software development costs/license advances | 14,612 | 6,439 | 9,484 | 3,419 |
| Total | \$ 54,582 | \$ 13,579 | \$ 49,454 | \$ 6,116 |

| Amortized | October 28, 2006 | | April 29, 2006 | |
|---------------------------------------------|------------------|--------------------------------------|------------------|--------------------------------------|
| | Net Amount | Weighted Average Amortization Period | Net Amount | Weighted Average Amortization Period |
| Intangible Assets | | | | |
| Trademark | \$ 6,571 | 180 mos. | \$ 7,426 | 180 mos. |
| Customer relationships | 23,553 | 227 mos. | 26,553 | 227 mos. |
| Non-compete agreements | 2,706 | 41 mos. | 3,294 | 41 mos. |
| Software development costs/license advances | 8,173 | 17 mos. | 6,065 | 17 mos. |
| Total | \$ 41,003 | 151 mos. | \$ 43,338 | 165 mos. |

The Company's aggregate amortization expense for the first six months of fiscal 2007 and fiscal 2006 totaled \$7,463,000 and \$248,000, respectively. The Company estimates future aggregate amortization expense as follows (in thousands of dollars):

| Fiscal Years | Amounts |
|-------------------|------------------|
| Remainder of 2007 | \$ 8,527 |
| 2008 | 11,433 |
| 2009 | 5,647 |
| 2010 | 3,737 |
| 2011 | 2,771 |
| Thereafter | 8,888 |
| Total | \$ 41,003 |

7. Debt

On October 27, 2006, Handleman Company and certain borrowing subsidiaries entered into a second amendment (2006 Credit Agreement) to the amended and restated credit agreement dated November 22, 2005 (2005 Credit Agreement). The 2006 Credit Agreement reduces the Company's line of credit to \$225,000,000 from \$250,000,000, which was available under the 2005 Credit Agreement, and converts the unsecured

Edgar Filing: HANDLEMAN CO /MI/ - Form 10-Q

2005 Credit Agreement to a secured obligation with a first priority security interest in all of the Company's real and personal assets. In addition, the 2006 Credit Agreement deferred the Company's obligation to meet its debt service coverage ratio and the leverage ratio covenants until February 26, 2007.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The 2006 Credit Agreement limits the Company's borrowings to the lesser of (i) the facility commitment amount of \$225,000,000, or (ii) an amount equal to the borrowing base, consisting of 85% of eligible accounts receivable, 50% of eligible inventory and 100% of cash, less \$15,000,000. Pursuant to the 2006 Credit Agreement, the Company may elect to pay interest under a variety of formulae tied to either prime plus 1.25% or LIBOR plus 2.25%. The 2006 Credit Agreement facility fee was increased to 0.50%. Without having obtained the 2006 Credit Agreement, it was probable that the Company would have violated one or more of the covenants, as defined in the 2005 Credit Agreement. The Company is currently in negotiations with its banks and expects to enter into a new multi-year credit facility prior to February 26, 2007. Absent a new multi-year credit facility, it is probable that the Company would violate the previously described covenants within the next twelve months. As a result, the Company's \$96,560,000 in borrowings outstanding at October 28, 2006 under the 2006 Credit Agreement were all classified as current. The Company had borrowings of \$87,560,000 against its line of credit at April 29, 2006, of which \$3,960,000 was classified as current and \$83,600,000 was classified as non-current. This debt was primarily incurred to finance the Crave acquisition.

8. Derivatives and Market Risk*Derivative Financial Instruments*

In the normal course of business, Handleman Company is exposed to market risk associated with changes in interest rates and foreign currency exchange rates. To manage a portion of these inherent risks, the Company may purchase certain types of derivative financial instruments, from time to time, based on management's judgment of the trade-off between risk, opportunity and cost. The Company does not hold or issue derivative financial instruments for trading or speculative purposes.

Interest Rate Swaps

In order to reduce variable interest rate exposure on borrowings, on February 7, 2006, the Company entered into an interest rate swap agreement for a notional amount of \$75,000,000. The amount of the swap agreement will be incrementally reduced to \$50,000,000 in April 2007, to \$25,000,000 in April 2008, and will expire in April 2009. The interest rate is fixed at 4.9675%, plus a charge that varies based on the ratio of debt to EBITDA (earnings before interest, taxes, depreciation and amortization), as defined in the Company's revolving credit agreement.

The interest rate swap is accounted for in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and is an effective cash flow hedge on related debt. The ineffective portion of any such hedge is included in current earnings. The hedge was effective during the six months ended October 28, 2006. The fair value of the swap agreement as of October 28, 2006 and April 29, 2006 was \$105,000 and \$285,000, respectively, and is recorded in Other assets, net in the Company's Consolidated Balance Sheets. Net year-over-year changes in the fair value of the swap is recorded, net of taxes, in Accumulated other comprehensive income in the Company's Consolidated Balance Sheets.

Currency Forward Contracts

The Company's businesses primarily operate in the local currencies of the countries in which they conduct business. During the course of its business, the Company may enter into currency forward contracts to reduce its foreign exchange risk. The Company does not speculate, and only enters into such contracts when they can be directly tied to a future payment in a currency other than the local currency for that business.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

9. Pension Plan

The Company has two qualified defined benefit pension plans (pension plans) that cover substantially all full-time United States (U.S.) and Canadian employees. In addition, the Company has two nonqualified defined benefit plans, U.S. and Canadian Supplemental Executive Retirement Plans (SERPs), which cover select employees.

During the first quarter of fiscal 2007, the Company's Board of Directors approved amendments to freeze the Company's U.S. pension plan and the U.S. SERP. Accordingly, during the first quarter of fiscal 2007, the Company recorded non-cash curtailment charges of \$680,000 and \$384,000 related to the Company's U.S. pension plan and U.S. SERP, respectively. These charges were calculated in accordance with SFAS No. 88, Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, using actuarial assumptions as of July 29, 2006. SFAS No. 88 requires curtailment accounting if an event eliminates, for a significant number of employees, the accrual of defined benefits for some or all of their future services. In the event of a curtailment, losses are recognized for the unrecognized prior service cost associated with years of service no longer expected to be rendered.

The information below, for all periods presented, combines U.S. and Canadian pension plans and U.S. and Canadian SERPs. Components of net periodic benefit cost are as follows (in thousands of dollars):

| | Pension Plans | | SERPs | |
|---------------------------------------------------------------------------|---------------------|---------------------|---------------------|---------------------|
| | Three Months Ended | | Three Months Ended | |
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Service cost | \$ 455 | \$ 475 | \$ 126 | \$ 62 |
| Interest cost | 832 | 684 | 134 | 102 |
| Expected return on plan assets | (1,090) | (815) | | |
| Amortization of unrecognized prior service cost, actuarial gain and other | 35 | 522 | 5 | (487) |
| Net periodic benefit cost | \$ 232 | \$ 866 | \$ 265 | \$ (323) |

| | Pension Plans | | SERPs | |
|---------------------------------------------------------------------------|------------------------|------------------------|------------------------|------------------------|
| | Six Months Ended | | Six Months Ended | |
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Service cost | \$ 896 | \$ 1,041 | \$ 234 | \$ 231 |
| Interest cost | 1,685 | 1,491 | 277 | 261 |
| Expected return on plan assets | (2,205) | (1,774) | | |
| Amortization of unrecognized prior service cost, actuarial gain and other | 189 | 1,133 | 76 | (334) |
| Curtailment loss | 680 | | 384 | |
| Net periodic benefit cost | \$ 1,245 | \$ 1,891 | \$ 971 | \$ 158 |

For the six months ended October 28, 2006, contributions to the Company's defined benefit pension plans were \$203,000. The Company anticipates contributing an additional \$201,000 to the pension plans in the remainder of fiscal 2007, for a total contribution of \$404,000. These amounts represent contributions to the Canadian pension plan only. The Company does not expect to contribute to the U.S. pension plan during fiscal 2007, but expects to contribute \$116,000 to the SERPs for the fiscal year ending April 28, 2007.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

10. Stock-Based Compensation

Effective April 30, 2006, the Company adopted the provisions of SFAS No. 123(R) using the modified prospective transition method, and accordingly prior period amounts have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based compensation in accordance with SFAS No. 123, beginning May 4, 2003.

Upon the adoption of SFAS No. 123, the Company selected the prospective transition method, as defined in SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, an amendment to SFAS No. 123. Under the prospective method, all stock-based awards issued after May 3, 2003 were accounted for utilizing the fair value provisions of SFAS No. 123 and expensed over the vesting period. The following table illustrates the effect on net income and income per share if the fair value recognition provisions of SFAS No. 123 had been applied to all stock-based awards for the quarter and six months ended October 29, 2005 (in thousands of dollars except per share data):

| | Three Months | Six Months |
|---------------------------------------------------------------------------------------------------------------------------------------------|---------------------|--------------------|
| | Ended | Ended |
| | October 29, | October 29, |
| | 2005 | 2005 |
| Net income | \$ 9,774 | \$ 6,126 |
| Add: Stock-based employee compensation (income) expense included in reported net income, net of related tax effects | (293) | 1,055 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (792) | (2,092) |
| Proforma net income | \$ 8,689 | \$ 5,089 |
| Net income per share: | | |
| Reported basic | \$.46 | \$.29 |
| diluted | .46 | .29 |
| Proforma basic | .41 | .24 |
| diluted | .41 | .24 |

The Company is authorized to grant stock options, performance shares, performance units and restricted stock under the 2004 Stock Plan and the 2001 Stock Option and Incentive Plan. The Company's 2004 Stock Plan was approved by the Company's shareholders during fiscal 2005. The Company's 2001 Stock Option and Incentive Plan was approved during fiscal 2002. The Company's 1998 Stock Option and Incentive Plan continues in effect for outstanding awards under that plan.

The maximum number of shares of stock that may be issued under the 2004 Stock Plan is 750,000 shares. During the six-month period ended October 28, 2006, the Company granted 363,820 shares under this plan. After deducting stock options, performance shares, performance units and restricted stock issued or granted under this plan since adoption in September 2004, 238,814 shares of the Company's stock are available for use under this plan as of October 28, 2006.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The maximum number of shares of stock which may be issued under the 2001 Stock Option and Incentive Plan is 1,600,000 shares. During the six-month period ended October 28, 2006, the Company granted 112,900 shares under this plan. After deducting stock options, performance shares and restricted stock issued or granted under this plan since adoption in September 2001, there are 74,723 shares of the Company's stock available for use under this plan as of October 28, 2006.

The Company's 1998 Stock Option and Incentive Plan continues in effect for outstanding awards under this plan; however, no additional shares will be issued out of this plan.

The Company recorded compensation expense for various stock-based compensation awards issued pursuant to the plans described herein in the amounts of \$1.3 million and \$(0.3) million, for the three-month periods ended October 28, 2006 and October 29, 2005, respectively. Compensation expense for the six-month periods ended October 28, 2006 and October 29, 2005 was \$2.6 million and \$1.8 million, respectively. The Company did not record a cumulative effect of change in accounting principle upon adoption of SFAS No. 123(R), since its pre-adoption actual forfeiture experience approximated its expected future forfeiture estimates. Related income tax (expense) benefits were recorded during the three-month periods ended October 28, 2006 and October 29, 2005 of \$(0.1) million and zero, respectively; for the six-month periods ended October 28, 2006 and October 29, 2005, income tax benefits were recorded in the amounts of \$0.9 million and \$0.8 million, respectively.

Fair Value Estimation Methodology and Assumptions

The Company's use of the Black-Scholes option pricing model requires management to make various assumptions including the risk-free interest rate, expected term, expected volatility and dividend yield. Expected volatilities are based on the historical volatility of the Company's stock. The expected term represents the period of time that stock-based compensation awards granted are expected to be outstanding and is estimated based on considerations including the vesting period, contractual term and anticipated employee exercise patterns. The risk-free rate for periods during the contractual life of stock-based compensation awards is based on the U.S. Treasury yield curve in effect at the time of grant for periods corresponding to the expected life of the award. Dividend yield assumptions are based on historical patterns and future expectations.

Prior to the adoption of SFAS No. 123(R), the Company used the Black-Scholes option pricing model to determine the fair value of its equity based stock option awards and issuances under its Employee Stock Purchase Plan (ESPP). All other awards were based on the intrinsic value of the underlying stock. The weighted average assumptions used to estimate the fair value for stock options granted and ESPP shares issued during the three-month and six-month periods ended October 28, 2006 and October 29, 2005 are as follows:

| | Three-Months Ended | | Six-Months Ended | |
|--------------------------|---------------------|---------------------|---------------------|---------------------|
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Expected life (in years) | 6.0 | | 5.5 | 0.5 |
| Risk-free interest rate | 4.78% | | 4.81% | 3.38% |
| Expected volatility | 36.25% | | 35.61% | 16.75% |
| Expected dividend yield | 3.84% | | 3.88% | 1.48% |

The weighted average estimated fair values of stock options granted and ESPP shares issued during the three-month period ended October 28, 2006 was \$2.39. There were no stock options granted or ESPP shares issued during the three-month period ended October 29, 2005. The weighted average estimated fair values of stock options granted and ESPP shares issued during the six-month periods ended October 28, 2006 and October 29, 2005 were \$2.33 and \$4.32, respectively.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Stock Options

Information with respect to options outstanding under the previous and current stock plans, which have various terms (not exceeding 10 years), and vesting periods (not exceeding three years) as approved by the Compensation Committee of the Board of Directors for the six-month period ended October 28, 2006, is set forth below. Options were granted at no less than fair market value at the date of grant.

| | Number of Shares | Weighted Average Price |
|------------------------------------|---------------------|------------------------------|
| Balance as of April 29, 2006 | 676,726 | \$ 17.61 |
| Granted | 125,000 | \$ 8.03 |
| Terminated | (49,332) | \$ 12.48 |
| Exercised | | |
| Balance as of October 28, 2006 | 752,394 | \$ 16.35 |
| Exercisable as of October 28, 2006 | 576,364 | \$ 16.94 |

During the second quarter of fiscal 2007, the Company terminated the 25,000 shares granted during the first quarter of fiscal 2007, which related to the departure of a key company executive.

The following table relates to the Company's outstanding and exercisable stock options as of October 28, 2006:

| Exercise Price Range | Total Options Outstanding | | | Currently Exercisable Options | |
|----------------------|---------------------------|---------------------------------|---------------------------------------------|-------------------------------|---------------------------------|
| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Number of Shares | Weighted Average Exercise Price |
| \$ 8.33 - \$12.99 | 241,726 | \$ 10.30 | 90 months | 141,726 | \$ 11.69 |
| \$13.00 - \$16.99 | 270,768 | \$ 16.34 | 70 months | 270,768 | \$ 16.34 |
| \$17.00 - \$22.95 | 239,900 | \$ 22.47 | 92 months | 163,870 | \$ 22.47 |
| Total | 752,394 | | | 576,364 | |

The weighted average grant date fair values of stock options vested during the six-month periods ended October 28, 2006 and October 29, 2005 were \$7.53 and \$6.66, respectively.

As of October 28, 2006, unrecognized compensation cost related to non-vested stock options totaled \$0.6 million. This unrecognized compensation cost is expected to be recognized over a weighted average period of 1.6 years.

Performance Shares

The Company grants performance shares to certain employees as authorized within its stock plans. The performance shares expected to be issued are based upon achieving free cash flow objectives, as defined, and vest over a three-year period. Expense recorded for performance shares is recognized over the vesting period and is based upon the probability of meeting the Company's performance target, and is adjusted

periodically, as required.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

During the six months ended October 28, 2006, the Company granted 220,120 performance shares, net of forfeitures of its common stock under the plans. The performance shares will be distributed to the participants if certain fixed performance criteria are satisfied by May 2, 2009.

Information related to performance shares for the six-month period ended October 28, 2006 is as follows:

| | Estimated | | |
|---------------------------------------|---------------------|-------------------|------------------|
| | Number of | Weighted- | Maximum |
| | Shares to be | Average | Number of |
| | Awarded | Grant Date | Shares |
| | | Fair Value | Available |
| Balance as of April 29, 2006 | 702,050 | \$ 18.66 | 896,250 |
| Granted | 247,820 | \$ 7.08 | 371,730 |
| Terminated | (71,200) | \$ 14.99 | (106,800) |
| Distribution | (313,650) | \$ 16.93 | (313,650) |
| Balance as of October 28, 2006 | 565,020 | \$ 15.00 | 847,530 |

During the second quarter of fiscal 2007, the Company terminated 21,500 shares granted during the first quarter of fiscal 2007, related to the departure of a key company executive.

As of October 28, 2006, unrecognized compensation cost related to non-vested performance shares totaled \$3.2 million. This unrecognized compensation cost is expected to be recognized over a weighted average period of 1.7 years.

The weighted average estimated fair values of performance share awards granted during the six-month periods ended October 28, 2006 and October 29, 2005 were \$7.08 and \$16.61, respectively.

Performance Units

Beginning in fiscal 2006, the Company granted performance units to certain employees as authorized within its stock plans. The performance units are payable in cash based upon achieving free cash flow objectives as defined and measured against pre-determined benchmarks, and accordingly, result in the recognition of a liability representing the Company's future obligation. As of October 28, 2006 and April 29, 2006, approximately \$1.1 million and \$0.6 million, respectively, were recorded as non-current liabilities in the Company's Consolidated Balance Sheets. Performance units vest over a three-year period and compensation expense associated with these performance units is adjusted to market value at each reporting date over the vesting period.

During the six months ended October 28, 2006, the Company granted 275,320 performance units, net of forfeitures, under the plans. The performance units will be distributed to the participants if certain fixed performance criteria are satisfied by May 2, 2009.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Information related to performance units for the six-month period ended October 28, 2006 is as follows:

| | Estimated | | |
|--------------------------------|---------------------|-------------------|------------------|
| | Number of | Weighted- | Maximum |
| | Shares to be | Average | Number of |
| | Awarded | Grant Date | Shares |
| | | Fair Value | Available |
| Balance as of April 29, 2006 | 226,200 | \$ 16.61 | 339,300 |
| Granted | 307,020 | \$ 7.03 | 460,530 |
| Terminated | (53,800) | \$ 10.85 | (80,700) |
| Balance as of October 28, 2006 | 479,420 | \$ 11.12 | 719,130 |

During the second quarter of fiscal 2007, the Company terminated 21,500 shares granted during the first quarter of fiscal 2007, related to the departure of a key company executive.

As of October 28, 2006, unrecognized compensation cost related to performance units totaled \$2.5 million. This unrecognized compensation cost is expected to be recognized over a weighted average period of 2.2 years.

The weighted average estimated fair values of performance unit awards granted during the six-month periods ended October 28, 2006 and October 29, 2005 were \$7.03 and \$16.61, respectively.

Restricted Stock

The Company grants restricted stock to certain employees and directors, as authorized within its stock plans. Restricted stock is expensed over the vesting period, which varies by grant.

Information related to non-vested restricted stock for the six-month period ended October 28, 2006 is as follows:

| | Estimated | Weighted |
|--------------------------------|---------------------|-------------------|
| | Number of | Average |
| | Shares to be | Grant Date |
| | Awarded | Fair Value |
| Balance as of April 29, 2006 | 65,637 | \$ 17.76 |
| Granted | 103,900 | \$ 7.78 |
| Terminated | (29,000) | \$ 8.15 |
| Vested | (14,497) | \$ 19.23 |
| Balance as of October 28, 2006 | 126,040 | \$ 11.57 |

During the second quarter of fiscal 2007, the Company terminated 25,000 shares granted during the first quarter of fiscal 2007, related to the departure of a key company executive.

Restricted stock granted during the six months ended October 28, 2006, net of forfeitures, was 77,400 shares with a weighted-average grant date fair value of \$8.06. As of October 28, 2006, unrecognized compensation cost related to restricted stock totaled \$0.7 million. This unrecognized compensation cost is expected to be recognized over a weighted average period of 1.4 years.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Employee Stock Purchase Plan

In fiscal 2002, the Company's shareholders approved the adoption of the Handleman Company 2001 ESPP. The ESPP provides eligible employees the right to purchase common stock of the Company, through payroll deductions, at a price equal to 85% of the lesser of the fair market value of the stock on (a) the first day of an offering period, or (b) the last day of the period. Under the terms of the ESPP, eligible employees may elect to have up to 10% of their regular base earnings withheld to purchase Company stock, with a maximum not to exceed \$25,000 for each calendar year. The Company has reserved 700,000 shares of common stock for issuance under the ESPP. As of October 28, 2006, the Company had \$69,000 of employee withholdings, included in Accrued and other liabilities in the Company's Consolidated Balance Sheets, to be used to purchase Company stock. Through October 28, 2006, 88,984 shares have been issued to employees under the ESPP since its inception.

11. Contingencies

The Company has the following contingent liabilities related to its acquisition of Crave Entertainment Group during fiscal 2006: (i) up to \$21,000,000 in earn out payments that are payable based upon Crave's adjusted EBITDA for the calendar years 2005, 2006 and 2007, as those figures are calculated for each of such years; and (ii) up to \$2,000,000 to be paid on or about January 2, 2008, if three certain Crave employees remain with that entity through December 31, 2007. The Company is accruing this \$2,000,000 liability over 25 months with the related expense included in Selling, general and administrative expenses in the Company's Consolidated Statements of Operations. No earn out payments were achieved by Crave for calendar 2005 and the Company does not expect any earn out payments to be achieved by Crave for calendar 2006.

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

12. Comprehensive (Loss) Income

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

| | Three Months Ended | | Six Months Ended | |
|------------------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Net (loss) income | \$ (14,237) | \$ 9,774 | \$ (20,180) | \$ 6,126 |
| Changes in: | | | | |
| Foreign currency translation adjustments | 1,643 | 1,760 | 2,953 | (3,336) |
| Minimum pension liability, net of tax | | | 59 | |
| Interest rate swap, net of tax | (194) | | (116) | |
| Total comprehensive (loss) income, net | \$ (12,788) | \$ 11,534 | \$ (17,284) | \$ 2,790 |

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

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

| | October 28, 2006 | April 29, 2006 |
|--------------------------------------------------|---------------------|-------------------|
| Foreign currency translation adjustments | \$ 19,084 | \$ 16,131 |
| Minimum pension liability, net of tax | (189) | (248) |
| Interest rate swap, net of tax | 68 | 184 |
| Total accumulated other comprehensive income | \$ 18,963 | \$ 16,067 |

13. Segment Information

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

The accounting policies of the segments are the same as those described in Note 1, Accounting Policies, contained in the Company's Form 10-K for the year ended April 29, 2006. Segment data includes a charge allocating corporate costs to the operating segments, where applicable. The Company evaluates performance of its segments and allocates resources to them based on income before interest expense, investment income and income taxes (segment income).

The tables below present information about reported segments for the three months ended October 28, 2006 and October 29, 2005 (in thousands of dollars):

| | Category Management and Distribution Operations | Video Game Operations | Total |
|---------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| Three Months Ended October 28, 2006: | | | |
| Revenues, external customers | \$ 285,352 | \$ 45,157 | \$ 330,509 |
| Segment (loss) | (4,845) | (2,661) | (7,506) |
| Capital expenditures | 6,482 | 163 | 6,645 |

| | Category Management and Distribution Operations | Video Game Operations | Total |
|---------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| Three Months Ended October 29, 2005: | | | |
| Revenues, external customers | \$ 302,246 | \$ | \$ 302,246 |
| Segment income | 6,262 | | 6,262 |
| Capital expenditures | 4,679 | | 4,679 |

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

A reconciliation of total segment revenues to consolidated revenues from continuing operations, total segment (loss) income to consolidated (loss) income from continuing operations before income taxes, and total segment assets to consolidated assets as of and for the three months ended October 28, 2006 and October 29, 2005 is as follows (in thousands of dollars):

| | October 28, 2006 | October 29, 2005 |
|---------------------------------------------------------------------------|---------------------|---------------------|
| Revenues | | |
| Total segment revenues | \$ 330,509 | \$ 302,246 |
| Corporate revenues | | |
| Consolidated revenues from continuing operations | \$ 330,509 | \$ 302,246 |
| (Loss) Income From Continuing Operations Before Income Taxes | | |
| Total segment (loss) income | \$ (7,506) | \$ 6,262 |
| Interest expense | (1,495) | (220) |
| Investment income | 470 | 4,005 |
| Unallocated corporate income | 358 | 279 |
| Consolidated (loss) income from continuing operations before income taxes | \$ (8,173) | \$ 10,326 |

The tables below present information about reported segments for the six months ended October 28, 2006 and October 29, 2005 (in thousands of dollars):

| | Category Management and Distribution Operations | Video Game Operations | Total |
|-------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| Six Months Ended October 28, 2006: | | | |
| Revenues, external customers | \$ 494,960 | \$ 75,955 | \$ 570,915 |
| Segment (loss) | (21,477) | (6,944) | (28,421) |
| Total assets | 608,680 | 135,470 | 744,150 |
| Capital expenditures | 10,639 | 286 | 10,925 |

| | Category Management and Distribution Operations | Video Game Operations | Total |
|-------------------------------------------|-------------------------------------------------------------|-----------------------------|------------|
| Six Months Ended October 29, 2005: | | | |
| Revenues, external customers | \$ 542,648 | \$ | \$ 542,648 |
| Segment (loss) | (811) | | (811) |
| Total assets | 630,075 | | 630,075 |
| Capital expenditures | 7,592 | | 7,592 |

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

A reconciliation of total segment revenues to consolidated revenues from continuing operations, total segment loss to consolidated (loss) income from continuing operations before income taxes, and total segment assets to consolidated assets as of and for the six months ended October 28, 2006 and October 29, 2005 is as follows (in thousands of dollars):

| | October 28, 2006 | October 29, 2005 |
|---------------------------------------------------------------------------|---------------------|---------------------|
| Revenues | | |
| Total segment revenues | \$ 570,915 | \$ 542,648 |
| Corporate revenues | | |
| Consolidated revenues from continuing operations | \$ 570,915 | \$ 542,648 |
| (Loss) Income From Continuing Operations Before Income Taxes | | |
| Total segment loss for reportable segments | \$ (28,421) | \$ (811) |
| Interest expense | (3,276) | (248) |
| Investment income | 476 | 5,070 |
| Unallocated corporate income | 649 | 603 |
| Consolidated (loss) income from continuing operations before income taxes | \$ (30,572) | \$ 4,614 |
| Assets | | |
| Total segment assets | \$ 744,150 | \$ 630,075 |
| Elimination of intercompany receivables and payables | (40,012) | |
| Consolidated assets | \$ 704,138 | \$ 630,075 |

14. Common Stock - Basic and Diluted Shares

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

| | Three Months Ended | | Six Months Ended | |
|---------------------------------------------------------------------------------------------|---------------------|---------------------|---------------------|---------------------|
| | October 28, 2006 | October 29, 2005 | October 28, 2006 | October 29, 2005 |
| Weighted average shares during the period - basic | 20,268 | 21,027 | 20,197 | 21,240 |
| Additional shares from assumed exercise of stock-based compensation | | 115 | | 165 |
| Weighted average shares adjusted for assumed exercise of stock-based compensation - diluted | 20,268 | 21,142 | 20,197 | 21,405 |

Table of Contents

Handleman Company

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

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

On November 22, 2005, the Company acquired the stock of privately-owned Crave Entertainment Group, Inc. Crave is a distributor of video game hardware, software and accessories to retailers throughout the U.S. This acquisition expanded the Company's customer base, broadened its product lines and allows for growth opportunities in both business segments through cross-selling customers, services and products.

On June 24, 2005, the Company acquired all of the operating assets and certain liabilities of REPS LLC (REPS). REPS provides nationwide in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers. The in-store merchandising structure of REPS is similar to the Company's in-store merchandising structure, thus providing the opportunity to consolidate certain functions and generate cost savings and synergies.

The operating results of Crave and REPS have been included in the Company's Consolidated Financial Statements since their dates of acquisition.

Overview

For the second quarter of fiscal 2007, which ended on October 28, 2006, the Company had a net loss of \$14.2 million or \$0.70 per diluted share, compared to net income of \$9.8 million or \$0.46 per diluted share for the second quarter of fiscal 2006, which ended on October 29, 2005. The net loss for the second quarter of fiscal 2007 was entirely from continuing operations, whereas net income for the second quarter of fiscal 2006 included income from continuing operations of \$10.1 million or \$0.48 per diluted share and a loss from discontinued operations of \$0.3 million or \$0.02 per diluted share.

The Company had a net loss for the first six months of fiscal 2007 of \$20.2 million or \$1.00 per diluted share, compared to net income of \$6.1 million or \$0.29 per diluted share for the first six months of fiscal 2006.

Results of Operations

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

Revenues for the second quarter of fiscal 2007 were \$330.5 million, compared to \$302.2 million for the second quarter of fiscal 2006. The Company had an incremental increase in revenues of \$45.2 million attributable to the inclusion of Crave during the second quarter of fiscal 2007. This increase was offset, in part, by revenue decreases in the U.S. and Canada of \$12.7 million and \$4.4 million, respectively. U.S. and Canadian revenues were negatively impacted by a decline in music industry sales. In addition, U.S. revenues were also impacted by the mix of new release titles, which shifted consumer purchases to retail sources other than the mass merchant retailer (the Company's primary customer base), while revenues in Canada were negatively impacted by a higher proportion of sales of lower priced promotional product.

Revenues for the first six months of fiscal 2007 were \$570.9 million, compared to \$542.6 million for the first six months of fiscal 2006. This improvement in year-over-year revenues was due to the addition of \$76.0 million and \$16.0 million of revenue attributable to Crave and REPS, respectively. These increases were offset, in part, by \$29.3 million, \$15.0 million and \$5.0 million declines in revenues in the U.S., UK and Canada, respectively.

Table of Contents

Direct product costs as a percentage of revenues was 84.3% for the second quarter ended October 28, 2006, compared to 82.1% for the second quarter ended October 29, 2005. The increase in direct product costs as a percentage of revenues for the second quarter of fiscal 2007 was primarily attributable to the following: (i) the addition of Crave revenues this year, which carry higher direct product costs as a percentage of revenues, contributed 1.1% to the overall increase in direct product costs as a percentage of revenues; (ii) accrual adjustments, predominately those related to increased product markdowns in the second quarter of this year, compared to the same period last year, contributed 0.4% to the overall increase in direct product costs as a percentage of revenues, and (iii) the greater proportion of revenues related to customer programs and promotions, and as well as a shift in product mix, which increased overall direct product costs as a percentage of revenues by 0.3%. In addition, direct product costs for the second quarters of fiscal 2007 and 2006 included costs associated with acquiring and preparing inventory for distribution of \$5.5 million and \$4.4 million, respectively, which contributed 0.4% to the overall increase in direct product costs as a percentage of revenues. Direct product costs as a percentage of revenues was 84.7% for the first six months of fiscal 2007, compared to 82.6% for the first six months of fiscal 2006. Direct product costs for the first six months of fiscal years 2007 and 2006 included costs associated with acquiring and preparing inventory for distribution of \$10.5 million and \$8.2 million, respectively.

Selling, general and administrative (SG&A) expenses were \$58.9 million or 17.8% of revenues for the second quarter of fiscal 2007, compared to \$47.4 million or 15.7% of revenues for the second quarter of fiscal 2006. The increase in SG&A expenses over the comparable prior year period was primarily due to (i) the inclusion of Crave expenses of \$4.8 million; (ii) an increase in amortization of definite lived intangible assets related to the acquisitions of Crave and REPS of \$1.7 million and \$0.3 million, respectively; (iii) an increase in outside consulting services of \$1.7 million; (iv) an increase in stock-based compensation expense of \$1.6 million, mainly resulting from changes in the market price of the Company's common stock; and (v) startup costs in the UK, related to the Company's new business arrangement with a key retailer and the commencement of the greeting card business in the amounts of \$2.0 million and \$1.1 million, respectively. These increases were partially offset by decreases in certain other U.S. operating expenses totaling \$1.3 million. SG&A expenses for the first six months of this year were \$115.1 million or 20.2% of revenues, compared to \$94.9 million or 17.5% of revenues for the first six months of last year.

Income before interest expense, investment income and income taxes (operating income) for the second quarter of fiscal 2007 was a loss of \$7.1 million, compared to income of \$6.5 million for the second quarter of fiscal 2006. Operating income for the first six months of this year was a loss of \$27.8 million, compared to a loss of \$0.2 million for the first six months of last year.

Interest expense for the second quarter of fiscal 2007 increased to \$1.5 million from \$0.2 million for the second quarter of fiscal 2006. Interest expense for the first six months of fiscal 2007 was \$3.3 million, compared to \$0.2 million for the comparable period last year. This year-over-year change was due to increased borrowings in the third quarter of fiscal 2006, primarily related to the financing of the Crave acquisition.

Investment income for the second quarter of fiscal 2007 decreased to \$0.5 million from \$4.0 million for the second quarter of fiscal 2006. During the second quarter of fiscal 2006, the Company recorded investment income of \$3.8 million related to a gain on the sale of an investment in PRN, a company that provides in-store media networks. Under the terms of the sale agreement, the Company received an additional \$0.5 million in the third quarter of fiscal 2006 and may receive additional proceeds of approximately \$1.5 million through September 2009, subject to general and tax indemnification claims. During the second quarter of fiscal 2007, the Company recorded investment income of \$0.4 million related to investment gains on assets held for the Company's Supplemental Executive Retirement Plan compared to investment expense related to losses on assets held of \$0.1 million recorded in the second quarter of fiscal 2006. Investment income for the first six months of fiscal 2007 was \$0.5 million, compared to \$5.1 million for the first six months of fiscal 2006.

Table of Contents

The effective income tax rates for the second quarters of fiscal years 2007 and 2006 were (74.2)% and 1.8%, respectively. The income tax rate in the second quarter of fiscal 2007 was a result of applying jurisdictional income tax rates to forecasted earnings by business unit for fiscal 2007, in accordance with accounting guidelines. The effective income tax rate for the first six months of fiscal 2007 was 34.0%, compared to (40.6)% for the same period last year. The significantly lower income tax rates in both the second quarter and first six months of fiscal 2006 were due to the partial release of a valuation allowance related to a capital loss and the tax benefit resulting from the cancellation of a worthless debt from an insolvent subsidiary, both occurring in the second quarter of fiscal 2006, in the amounts of \$2.1 million and \$1.0 million, respectively.

Other

Accounts receivable at October 28, 2006 was \$291.1 million, compared to \$257.9 million at April 29, 2006. This increase was mainly due to the higher revenues in the second quarter of this year, compared to those in the fourth quarter of last year, which is attributable to the seasonal nature of the Company's business.

Merchandise inventories at October 28, 2006 was \$211.4 million, compared to \$128.8 million at April 29, 2006. The increase in merchandise inventories was principally due to increased inventory purchases to support the higher sales level anticipated in the third quarter of fiscal 2007 due to the upcoming holiday season.

Other current assets at October 28, 2006 was \$17.4 million, compared to \$9.9 million at April 29, 2006. This change was mainly due to an increase in income taxes receivable.

Accounts payable was \$289.1 million at October 28, 2006, compared to \$144.4 million at April 29, 2006. This increase was due to higher inventory purchases, as previously discussed.

Accrued and other liabilities decreased to \$23.9 million at October 28, 2006 from \$29.3 million at April 29, 2006. This change was primarily due to decreases in income taxes payable, accrued payroll related items, sales and use taxes payable and accrued royalties of \$2.2 million, \$1.9 million, \$1.9 million and \$1.5 million, respectively, partially offset by an increase in accrued consulting fees of \$1.8 million.

During the second quarter of fiscal 2007, the Company did not repurchase any shares of its common stock. As of October 28, 2006, the Company had repurchased 2,044,000 million shares, or 63% of the shares under the current 15% share repurchase program authorized by Board of Directors.

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

Liquidity and Capital Resources

On October 27, 2006, Handleman Company and certain borrowing subsidiaries entered into a second amendment (2006 Credit Agreement) to the amended and restated credit agreement dated November 22, 2005 (2005 Credit Agreement). The 2006 Credit Agreement reduces the Company's line of credit to \$225.0 million from \$250.0 million, which was available under the 2005 Credit Agreement, and converts the unsecured 2005 Credit Agreement to a secured obligation with a first priority security interest in all of the Company's real and personal assets. In addition, the 2006 Credit Agreement deferred the Company's obligation to meet its debt service coverage ratio and the leverage ratio covenants until February 26, 2007.

Without having obtained the 2006 Credit Agreement, it was probable that the Company would have violated one or more of the covenants, as defined in the 2005 Credit Agreement. The Company is in negotiations with its banks and expects to enter into a new multi-year credit facility prior to February 26, 2007. Absent a new multi-year credit facility, it is probable that the Company would violate the previously

Table of Contents

described covenants within the next twelve months. As a result, the Company's \$96.6 million in borrowings outstanding at October 28, 2006, under the 2006 Credit Agreement, were all classified as current. The Company had borrowings of \$87.6 million outstanding as of April 29, 2006, of which \$4.0 million was classified as current and \$83.6 million was classified as non-current. This debt was primarily incurred to finance the Crave acquisition. Management expects the new multi-year facility, along with cash provided from operations, will provide sufficient liquidity to finance the operations of Crave and fund the Company's day-to-day operations, including seasonal increases in working capital.

On February 7, 2006, the Company entered into an interest rate swap agreement for a notional amount of \$75.0 million in order to reduce variable interest rate exposure. This long-term outstanding debt was principally incurred to finance the Crave acquisition. The amount of the swap agreement will incrementally reduce to \$50.0 million in April 2007, to \$25.0 million in April 2008, and will expire in April 2009. The interest rate is fixed at 4.9675%, plus a charge that varies based on the ratio of debt to EBITDA (earnings before interest, taxes, depreciation and amortization), as defined in the Company's revolving credit agreement.

On September 6, 2006 the Company announced a quarterly cash dividend of \$0.08 per share. As a result, \$1.6 million was paid on October 6, 2006 to shareholders of record at the close of business on September 20, 2006.

Net cash provided from operating activities for the six months ended October 28, 2006 was \$15.5 million, compared to net cash used by operating activities of \$0.2 million for the same six-month period of last year. This increase was predominately due to favorable year-over-year changes in merchandise inventories, accounts receivable and non-cash charges of \$17.0 million, \$16.2 million and \$12.8 million, respectively. This increase was partially offset by unfavorable year-over-year changes in net income and other operating assets/liabilities of \$26.3 million and \$6.6 million, respectively.

Net cash used by investing activities was \$18.2 million for the six months ended October 28, 2006, compared to net cash used by investing activities of \$22.6 million for the six months ended October 29, 2005. This change was primarily the result of the Company's year-over-year decrease in the cash investment in REPS of \$18.1 million. This decrease was offset in part by increased spending on license advances and acquired rights, and property and equipment of \$5.1 million and \$3.3 million, respectively, and a decrease in proceeds from the sale of investments of \$3.8 million.

Net cash provided from financing activities was \$8.9 million for the six months ended October 28, 2006, compared to net cash provided from financing activities of \$19.6 million for the comparable six-month period of last year. This change was principally due to a decrease in net debt issuances of \$25.9 million, offset in part by a decline in the repurchase of the Company's common stock in the amount of \$13.9 million over the comparable quarter of last year.

The following table summarizes the Company's contractual cash obligations and commitments as of October 28, 2006 along with their expected effects on its liquidity and cash flows in future periods (in thousands of dollars):

| | Contractual Cash Obligations and Commitments | | | | |
|-----------------------------------------------------------|-----------------------------------------------------|-----------------------------|--------------------------|--------------------------|--------------------------|
| | Total | Less than 1 Year | 1 3 Years | 4 5 Years | After 5 Years |
| Debt obligations | \$ 96,560 | \$ 96,560 | \$ | \$ | \$ |
| Operating leases | 46,549 | 4,203 | 20,410 | 7,765 | 14,171 |
| Less: operating sub-leases | (2,087) | (285) | (1,707) | (95) | |
| Purchase obligations | 60,972 | 60,972 | | | |
| Other obligations | 96,740 | 7,306 | 34,825 | 18,650 | 35,959 |
| Outstanding letters of credit | 3,361 | 3,361 | | | |
| Total contractual cash obligations and commitments | \$ 302,095 | \$ 172,117 | \$ 53,528 | \$ 26,320 | \$ 50,130 |

Table of Contents

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

Industry Update

The mass merchant retailer segment of the music industry, in which the Company's current customer base primarily operates, continued to gain slight market share within the industry during the Company's second quarter of fiscal 2007; however, the music industry posted decreases in overall unit sales. Specifically, in the United States market during the Company's second fiscal quarter, mass merchant music sales and overall music industry sales on a unit basis, decreased almost 5% each over the comparable prior year period. Similarly, during the Company's second fiscal quarter, overall music industry sales decreased by 7% and 3% on a unit basis in the UK and Canadian markets, respectively, over the comparable prior year period.

Company Outlook

The Company continues to focus on realigning its cost structure to reduce selling, general and administrative expenses. Programs which have already been implemented include: (i) freezing the Company's U.S. defined benefit pension plan and the U.S. Supplemental Executive Retirement Plan; (ii) adjusting employee healthcare benefits; (iii) undertaking several initiatives to improve service level efficiencies; and (iv) adjusting field and warehouse wage levels to benchmarks. The initiatives already implemented are expected to reduce Company expenses in excess of \$10 million annually. Additional cost savings programs have been identified and are expected to provide an additional annual savings in the range of \$10 million to \$15 million, when completed. These amounts are prior to any one-time implementation costs.

* * * * *

This document contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties, and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements including, without limitation, risks associated with achieving the business integration objectives expected with the Crave Entertainment Group acquisition, changes in the music and video game industries, continuation of satisfactory relationships with existing customers and suppliers, establishing satisfactory relationships with new customers and suppliers, effects of electronic commerce inclusive of digital music distribution, success of new music and video game releases, dependency on technology, ability to control costs, relationships with the Company's lenders, pricing and competitive pressures, dependence on third-party carriers to deliver products to customers, the ability to secure funding or generate sufficient cash required to build and grow new businesses, the occurrence of catastrophic events or acts of terrorism, certain global and regional economic conditions, and other factors detailed from time to time in the Company's filings with the Securities and Exchange Commission. Handleman Company notes that the preceding conditions are not a complete list of risks and uncertainties. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this document.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risk

In order to reduce variable interest rate exposure on a portion of its borrowings, the Company entered into an interest rate swap agreement for a notional amount of \$75.0 million. See Note 8 of Notes to Consolidated Financial Statements for additional information regarding the interest rate swap agreement.

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

Item 4. Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. The Company completed an evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Act")) as of October 28, 2006, under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were not effective as a result of the material weakness described below.

A material weakness is a control deficiency or combination of control deficiencies that result in more than a remote likelihood that a material misstatement of the annual or interim consolidated financial statements will not be prevented or detected. The following material weakness was identified in the Company's assessment of the effectiveness of disclosure controls and procedures as of April 29, 2006:

The Company did not maintain effective controls over the completeness and accuracy of revenue and the related valuation of accounts receivable. Specifically, controls over invoice cancellations were not effective to ensure revenue was recorded in the appropriate accounting period and that the corresponding accounts receivable were properly valued. This control deficiency resulted in an adjustment to the Company's fiscal 2006 consolidated financial statements. Additionally, this control deficiency could result in a misstatement of the Company's revenues and accounts receivable that would result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Therefore, management has concluded this control deficiency constitutes a material weakness.

REMEDIATION OF THE MATERIAL WEAKNESS IN INTERNAL CONTROL

OVER FINANCIAL REPORTING

In order to address the material weakness identified as of April 29, 2006, during the fourth quarter of fiscal 2006 and the first quarter of fiscal 2007, management implemented additional controls and procedures related to invoice cancellations and the accounts receivable reserve to ensure that the Company records revenue in the proper period and that it properly states the accounts receivable reserve balance at the end of each reporting period. These additional controls and procedures included:

the implementation of invoice monitoring and cancellation policies to ensure the timely processing of invoice cancellations,

the enhancement of accounts receivable reserve procedures to ensure the accounts receivable reserve properly considers unprocessed invoice cancellations, and

enhanced book to physical inventory reconciliation procedures to assist with the identification of issues in a timely manner.

Table of Contents

The Company believes appropriate controls are designed and in place, however, the Company must test the controls for a sufficient period of time before the Company can determine whether it has remediated the material weakness.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

Except for the remediation activities discussed above, the Company has not made any changes in internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) during the second fiscal quarter ended October 28, 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting .

Table of Contents

PART II OTHER INFORMATION

Item 1. 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 the ultimate outcome of which is not expected to be material to future results of consolidated operations, financial position and cash flows. The Company has provided for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

Item 1A. Risk Factors

The Company is subject to numerous risks and uncertainties which could adversely affect the Company's business, financial condition, operating results and cash flows. Such risks and uncertainties have been disclosed in the Company's most recent Annual Report on Form 10-K for the fiscal year ended April 29, 2006.

On October 27, 2006, the Company amended its revolving credit facility as discussed in Note 7 of Notes to Consolidated Financial Statements. In addition, the 2006 Credit Agreement deferred the Company's obligation to meet its debt service coverage ratio and the leverage ratio covenants until February 26, 2007. Without having obtained the 2006 Credit Agreement, it was probable that the Company would have violated one or more of the covenants, as defined in the 2005 Credit Agreement. The Company is currently in negotiations with its banks and expects to enter into a new multi-year credit facility prior to February 26, 2007.

There have been no other significant changes in risks and uncertainties during the second quarter of fiscal 2007.

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

On February 23, 2005, the Company's Board of Directors authorized a share repurchase program. Under this authorization, which has no expiration date, the Company can repurchase up to 15% of its then outstanding balance of 21,787,611 shares. The table below sets forth information with respect to shares repurchased under the 15% authorization in the second quarter ended October 28, 2006.

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|----------------------------------------------|----------------------------------|------------------------------|----------------------------------------------------------------------------------|--------------------------------------------------------------------------------|
| July 30, 2006 through September 2, 2006 | | | | 1,224,142 |
| September 3, 2006 through September 30, 2006 | | | | 1,224,142 |
| October 1, 2006 through October 28, 2006 | | | | 1,224,142 |
| Total | | | | 1,224,142 |

Item 3. Defaults Upon Senior Securities

None.

Table of Contents

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

An Annual Meeting of Shareholders of Handleman Company was held on September 6, 2006. Two matters were voted at the Annual Meeting, the election of three directors and the ratification of the appointment of PricewaterhouseCoopers LLP as the Company's registered public accounting firm for the fiscal year ending April 28, 2007. James B. Nicholson, Lloyd E. Reuss and Stephen Strome were elected for three-year terms expiring in 2009. Following are the results of the vote: James B. Nicholson, 15,445,004 votes for, 296,726 votes withheld; Lloyd E. Reuss, 15,445,040 votes for, 296,690 votes withheld; and Stephen Strome, 15,444,030 votes for, 297,700 votes withheld. Other directors, whose term of office continued after the meeting, are Elizabeth Chappell, Eugene A. Miller, P. Daniel Miller, Irvin D. Reid, Ralph J. Szygenda and Thomas S. Wilson. The appointment of PricewaterhouseCoopers LLP was ratified with 15,569,723 votes for, 160,456 votes against and 11,551 votes withheld.

Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

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

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

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

Table of Contents

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

HANDLEMAN COMPANY

DATE: December 6, 2006

BY: /s/ Stephen Strome
STEPHEN STROME
Chairman of the Board and
Chief Executive Officer
(Principal Executive Officer)

DATE: December 6, 2006

BY: /s/ Thomas C. Braum, Jr.
THOMAS C. BRAUM, JR.
Executive Vice President and
Chief Financial Officer
(Principal Financial Officer)