




Trans World Entertainment 2000 Annual Report



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In 2000, Trans World Entertainment implemented a comprehensive study of our Company and our customers, of the industry and the future. A foundation was forged for a new, unified brand – and a new approach to entertainment retail: ubiquitous, interactive and customer-centric.

The concept is unprecedented. The timing is ideal. From the one Company with the strength, resources and expertise to make it real and do it right.

2001, it all comes together.



Message from the Chairman

□ *This is it.*

I am pleased to announce the official launch of FYE – the first integrated, customer-centric, cross-channel concept for the retail entertainment industry. The brand unification we promised... the technological advances we envisioned... the evolution that will forever change our Company and our industry. It's all in motion.

□ *This is exciting.*

Through careful study of our industry and our customers, we have identified tremendous opportunities – to grow our business, to expand the industry itself, to build unprecedented customer loyalty and to further our leadership position for the long-term.

□ *This is an investment, first and foremost.*

It is an investment in a new brand and new technologies ostensibly – and, ultimately, in the unlimited opportunities of the future. We expect to allocate \$40 million in 2001 to these initiatives. This will include the cost of launching the FYE brand across more than 700 mall stores and our Web site, and the development of a dozen pilot stores. These pilot stores will enable us to test and refine our broadband infrastructure, next-generation listening and viewing stations, Web-based kiosks and other store enhancements. The program will help us roll out the complete store/technology redesign in 2002 in the most effective, efficient way possible – to maximize our return on investment.

□ *This is a credit to our entire team.*

Without the talents, vision and commitment of our board of directors, executive management team, shareholders, employees and a true braintrust of expert technology and brand development partners, these advancements would not be possible. I would like to thank everyone for their contributions in 2000, and I look forward to achieving – together – the new successes that lie ahead.

□ *This is everything we've been waiting for.*

While others in the industry have been daunted, distracted or simply overcome by industry changes, Trans World has been planning, learning and preparing to take our Company to the next level. That time is now.



■ *This is fye.*





□ **unifye**

- Melding advanced technologies and forward vision with an unmatched real estate portfolio and industry experience, we are launching the ultimate retail entertainment infrastructure for the 21st century – united by one powerful brand.



□ Through extensive development and consumer testing, Trans World selected a name that captures the essence of the new brand – representing a unique, interactive, highly personalized entertainment experience...a name derived from and delivering on the phrase “for your entertainment.”

fye...



□ **One Mall Brand**

Our entire mall portfolio, more than 700 units in prime locations across the nation, will be unified as FYE. Through the strategic acquisition of competitors and the cultivation of our own properties, we have carefully assembled the industry's strongest store roster. Now we are making our mall channel even stronger as one integrated brand.

□ **Online and Everywhere**

In tandem with the mall brand unification, we will launch a new Web site at fye.com – creating a consistent, cross-channel experience for our customers, anywhere and anytime.


□ **Broadband Connection**

Beneath the brand surface, FYE will be a powerful infrastructure connected by best-of-breed technology. A broadband digital platform will link every store, our site, our customers and our Company – seamlessly, intelligently, strategically – enabling us to share data more quickly and efficiently. It will make possible a host of immediate innovations and provide a vital backbone for future applications, whether it's digital delivery of product, T-commerce, M-commerce or whatever lies ahead.

A grayscale photograph of a hand reaching out from a dark sleeve against a light, textured background. The hand is positioned in the upper left quadrant, with fingers slightly curled. A thin green line curves from the top right towards the 'a' in the word 'amplifye'.

□ **amplifye**

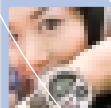
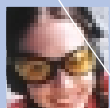




- Through brand unification and technological initiatives, coupled with our knowledge of and passion for the products we sell, we will deliver an enhanced retail experience – with more ways to explore, sample, access and purchase – to satisfy and inspire consumers today and tomorrow.


□ Meet the new entertainment consumers.

- *Passionate:* about the music and movies they love
- *Curious:* hungry for information, eager to explore
- *Mobile:* will consume and enjoy entertainment where, when and how they want to
- *Busy:* active and time-compressed – seeking convenience and flexibility





□ magnifye

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- Here is a change that goes far beyond a new name and new technologies – it is a fundamental business evolution. Like everything Trans World does, and has always done, it is designed to open new opportunities, strengthen our bottom line and increase shareholder value.



□ **The Power and Value of fye**

FYE will be a valued asset to our customers. In exchange for their loyalty, we will offer customization – in-store and online tools to tailor one’s entertainment experience. In exchange for customer data, we will deliver exclusive access to news and products. Be it a kiosk, Web site or face-to-face encounter with an informed employee, every contact point will position us as a trusted customer resource and definitive authority on music and movies. We will be their primary connection to the very things they love...and we will reap the rewards.





■ **Increase Per Customer**

A unified, cross-channel brand will spur tremendous growth – beginning with each customer. With greater loyalty will come greater share of wallet, and long-term, sustainable success.

■ **Growing The Industry**

Just as new entertainment media have always grown the industry as a whole, analysts see strong opportunities in the digital world. FYE will ensure that Trans World is leading this growth.

■ **Efficiencies Plus**

From maximizing our marketing efforts to offering operational efficiencies, the unification of our mall stores and Web site will deliver obvious, tangible benefits. Increased brand strength and notoriety will also magnify our strategic options, such as the ability to form valuable alliances to advance our business goals.

■ **fye To The Future**

We're ready – to tap everything we know, to leverage everything we are, to redefine the retail entertainment industry...to continue leading the way. It's exciting. It's truly limitless. It's FYE.





Financial Highlights

■ 2000 1999 1998 1997 1996

(in thousands, except per share and store data)

Sales	\$1,414,589	\$1,358,132	\$1,282,385	\$571,314	\$481,657
Change in total sales	4.2%	5.9%	124.5%	18.6%	(6.8)%
Change in comparable store sales	0.2%	2.0%	3.7%	10.2%	3.6%
Net income	\$ 40,150	\$ 61,393	\$ 61,010	\$ 20,574	\$ 7,102
Diluted earnings per share	\$ 0.83	\$ 1.15	\$ 1.14	\$ 0.66	\$ 0.24
Total assets	1,002,002	956,410	798,610	374,019	311,610
Shareholders' equity	448,822	494,173	432,376	124,522	102,919
Total stores	984	967	988	539	479

Selected Consolidated Financial Data

Trans World Entertainment Corporation and Subsidiaries



The following table sets forth selected consolidated financial data and other operating information of the Company and gives retroactive effect to the acquisition of Camelot for the periods subsequent to its “fresh-start reporting” on January 31, 1998, upon its reemergence from bankruptcy. The acquisition was accounted for using the pooling-of-interests method of accounting. The selected income statement and balance sheet data for the five fiscal years ended February 3, 2001 set forth below are derived from the audited consolidated financial statements of the Company. Each fiscal year of the Company consisted of 52 weeks, except the fiscal year ended February 3, 2001, which consisted of 53 weeks. All share and per share amounts have been adjusted for stock splits. The information is only a summary and should be read in conjunction with the Company’s audited consolidated financial statements and related notes and other financial information included herein and “Management’s Discussion and Analysis of Financial Condition and Results of Operations”.

	February 3, 2001	January 29, 2000	Fiscal Year Ended January 30, 1999	January 31, 1998	February 1, 1997
<i>(in thousands, except per share and store data)</i>					
INCOME STATEMENT DATA:					
Sales	\$1,414,589	\$1,358,132	\$1,282,385	\$571,314	\$481,657
Cost of sales	917,354	858,588	796,311	361,422	308,952
Gross profit	497,235	499,544	486,074	209,892	172,705
Selling, general and administrative expenses	416,990	371,998	372,886	170,834	150,218
Camelot merger-related costs ⁽¹⁾	—	25,473	—	—	—
Asset impairment charge and restructuring charge (reversal), net ⁽²⁾	—	—	1,537	—	—
Income from operations	80,245	102,073	111,651	39,058	22,487
Interest expense	3,128	3,496	4,989	5,148	12,110
Other expenses (income), net	(6,543)	(4,086)	(2,221)	(153)	(1,343)
Income before income taxes	83,660	102,663	108,883	34,063	11,720
Income tax expense	43,510	41,270	47,873	13,489	4,618
Net income	\$ 40,150	\$ 61,393	\$ 61,010	\$ 20,574	\$ 7,102
Basic earnings per share	\$ 0.84	\$ 1.17	\$ 1.19	\$ 0.70	\$ 0.24
Weighted average number of shares outstanding – basic	47,597	52,457	51,105	29,483	29,271
Diluted earnings per share	\$ 0.83	\$ 1.15	\$ 1.14	\$ 0.66	\$ 0.24
Weighted average number of shares outstanding – diluted	48,498	53,354	53,530	31,032	29,697
BALANCE SHEET DATA: (at the end of the period)					
Working capital	\$ 244,716	\$ 303,562	\$ 274,535	\$ 88,974	\$ 80,368
Total assets	1,002,002	956,410	798,610	374,019	311,610
Current portion of long-term obligations	5,702	5,311	4,802	99	9,557
Long-term obligations	13,767	19,461	36,065	41,409	50,490
Shareholders’ equity	448,822	494,173	432,376	124,522	102,919
OPERATING DATA:					
Store count (open at end of period):					
Mall stores	755	723	741	340	357
Freestanding stores	229	244	247	199	122
Total stores	984	967	988	539	479
Comparable store sales increase ⁽³⁾	0.2%	2.0%	3.7%	10.2%	3.6%
Total square footage (in thousands)	5,322	4,913	4,693	2,442	2,008

(1) The Camelot merger-related costs included the write-off of the book value of retired assets, professional fees associated with the completion of the merger, severance costs, joint proxy printing and distribution costs, and regulatory filing fees.

(2) The asset impairment charge and restructuring charge (reversal), net, during the year ended January 30, 1999, included an asset impairment charge of \$3.7 million to write down the carrying amount of certain fixed assets at stores, primarily leasehold improvements, and the one-time reversal of the remaining balance of \$2.2 million in the store closing reserve originally established during the fiscal year ended February 3, 1996. See note 3 to the consolidated financial statements.

(3) A store is included in comparable store sales calculations at the beginning of its 13th full month of operation.

The following is an analysis of the Company's results of operations, liquidity and capital resources. To the extent that such analysis contains statements which are not of a historical nature, such statements are forward-looking statements, which involve risks and uncertainties. These risks include, but are not limited to, changes in the competitive environment for the Company's merchandise, including the entry or exit of non-traditional retailers of the Company's merchandise to or from its markets; the release by the music industry of an increased or decreased number of "hit releases;" general economic factors in markets where the Company's merchandise is sold; and other factors discussed in the Company's filings with the Securities and Exchange Commission.

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

Trans World Entertainment Corporation and Subsidiaries



RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain income and expense items as a percentage of sales:

	February 3, 2001	Fiscal Year Ended January 29, 2000	January 30, 1999
Sales	100.0%	100.0%	100.0%
Gross profit	35.2%	36.8%	37.9%
Selling, general and administrative expenses	29.5%	27.4%	29.1%
Camelot merger-related costs	—	1.9%	—
Restructuring charge reversal and impairment charge, net	—	—	0.1%
Income from operations	5.7%	7.5%	8.7%
Interest expense	0.2%	0.3%	0.4%
Other expenses (income), net	(0.4)%	(0.3)%	(0.2)%
Income before income taxes	5.9%	7.5%	8.5%
Income tax expense	3.1%	3.0%	3.7%
Net income	2.8%	4.5%	4.8%
Change in comparable store sales	0.2%	2.0%	3.7%

Fiscal Year Ended February 3, 2001 ("2000") Compared to Fiscal Year Ended January 29, 2000 ("1999")

Sales. The Company's sales increased \$56.5 million, or 4.2%, from 1999. The increase was primarily attributable to a comparable store sales increase of 0.2% and the addition of approximately 409,000 square feet of retail selling space through the opening of 12 stores, acquisition of 112 stores (purchase of retail assets from Wax Works, Inc., a privately-held music and video retailer) and relocation of 36 stores, which was partially offset by the closing of 107 stores.

For 2000, comparable store sales increased 0.2% for mall stores and 0.3% for freestanding stores. By merchandise category, comparable store sales decreased 5.4% in music, increased 29.7% in video and 7.7% in other merchandise. The increase in comparable sales for video was driven by DVD sales.

Gross Profit. Gross profit, as a percentage of sales, decreased to 35.2% in 2000 from 36.8% in 1999 primarily as a result of declining sales in the high margin singles and audio cassette categories, increased sales in the lower margin DVD category, and increased promotional pricing.

Selling, General and Administrative Expenses. SG&A, as a percentage of sales, increased to 29.5% in 2000 from 27.4% in 1999. The increase can be attributed to increased spending on strategic initiatives including the unified branding of mall stores, supply chain enhancement and e-commerce development.

Interest Expense. Interest expense decreased from \$3.5 million in 1999 to \$3.1 million in 2000 due to lower average outstanding borrowings.

Other Expenses (Income), Net. Other income, net increased from \$4.1 million in 1999 to \$6.5 million in 2000. The increase was due to interest income from higher average cash balances during the year.

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

Trans World Entertainment Corporation and Subsidiaries



Income Tax Expense. The effective income tax rate was 52.0% in 2000. Included in income tax expense was an \$11.0 million charge, which resulted from a court decision disallowing the deduction of interest expenses related to corporate-owned life insurance policies held by Camelot. Excluding the charge, the Company's effective tax rate was 38.9% in 2000. See Note 6 of Notes to Consolidated Financial Statements for a reconciliation of the statutory tax rate to the Company's effective income tax rate.

Net Income. In 2000, the Company's net income decreased to \$40.2 million compared to a net income of \$61.4 million in 1999. The decrease in net income is attributable to lower gross margins, higher SG&A expenses and the increase in income tax expense related to the court decision on corporate-owned life insurance policies.

Comparisons of 2000 and 1999 are affected by an additional week of results in the 2000 reporting year. Because the Company's year ends on the Saturday nearest to January 31, a fifty-third week is added every five or six years. The fifty-third week in 2000 increased sales by an estimated \$23.7 million, operating income by an estimated \$4.0 million and net income by an estimated \$2.5 million or \$0.05 per share.

Fiscal Year Ended January 29, 2000 ("1999") Compared to Fiscal Year Ended January 30, 1999 ("1998")

Sales. The Company's sales increased \$75.7 million, or 5.9%, from 1998. The increase was primarily attributable to a comparable store sales increase of 2.0% and the addition of approximately 220,000 square feet of retail selling space through the opening of 34 stores and relocation of 46 stores, which was partially offset by the closing of 55 stores. Management attributes the comparable store sales increase to its focus on customer service, superior retail locations, inventory and merchandise presentation.

For 1999, comparable store sales increased 1.6% for mall stores and 4.2% for freestanding stores. By merchandise category, comparable store sales increased 1.1% in music, 9.9% in video and decreased 4.5% in other merchandise.

Gross Profit. Gross profit, as a percentage of sales, decreased to 36.8% in 1999 from 37.9% in 1998 primarily as a result of higher inventory shrinkage in the acquired Camelot stores. The Company has taken action to reduce shrink at the Camelot stores, including implementing policies and procedures that have successfully kept shrink at reduced levels for the Company in the past.

Selling, General and Administrative Expenses. SG&A, as a percentage of sales, decreased to 27.4% in 1999 from 29.1% in 1998. The 1.7% decrease can be attributed to the leverage of SG&A on the total sales increase and the reduction of corporate overhead expenses through the consolidation of the Camelot corporate offices.

Camelot Merger-Related Costs. The Camelot merger costs, net, represents the one-time charge of \$25.5 million for costs directly related to completing the merger with Camelot Music Holdings, Inc. The costs included the write-off of the book value of retired assets, professional fees associated with the completion of the merger, severance costs, joint proxy printing and distribution costs, and regulatory filing fees.

Interest Expense. Interest expense decreased from \$5.0 million in 1998 to \$3.5 million in 1999. The decrease is due to lower average outstanding borrowings and lower interest rates.

Other Expenses (Income), Net. Other income, net increased from \$2.2 million in 1998 to \$4.1 million in 1999. The increase was due to interest income from higher average cash balances during the year.

Income Tax Expense. The effective income tax rate was 40.2% in 1999. See Note 6 of Notes to Consolidated Financial Statements for a reconciliation of the statutory tax rate to the Company's effective income tax rate.

Net Income. In 1999, the Company's net income increased to \$61.4 million compared to net income of \$61.0 million in 1998. Excluding the one-time Camelot merger-related costs, pro forma 1999 net income is \$76.6 million. The improved bottom line performance as compared to 1998 can be attributed to the improved leverage of SG&A expenses due to higher sales and the reduction of corporate overhead expenses.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and Capital Resources. The Company's primary sources of working capital are cash flows provided by operations and borrowing capacity under its revolving credit facility. The Company ended fiscal 2000 with cash balances of approximately \$265.1 million, compared to \$280.0 million at the end of 1999. The decrease primarily relates to an increase in cash used in investing and financing activities.

Cash used in investing activities was \$92.0 million in 2000, as compared to \$53.3 million in 1999. In 2000, the primary uses of cash

were \$55.9 million for acquisitions, primarily relating to the acquired Disc Jockey stores, and \$32.8 million for the acquisition of property and equipment. In 1999, the acquisition of property and equipment accounted for \$51.2 million of cash used in investing activities.

Cash used in financing activities was \$90.2 million in 2000, as compared to \$18.2 million in 1999. In 2000, the primary use of cash was \$85.7 million to repurchase outstanding shares of the Company's common stock under programs authorized by the Board of Directors. As of February 3, 2001, the Company had purchased approximately 10.5 million shares of the 15.0 million shares authorized by the Board of Directors under three separate programs of 5.0 million shares each. During 1999, the two largest uses of cash were a payment of \$22.0 million to pay off the remaining debt associated with the Camelot acquisition and \$11.5 million to repurchase outstanding shares of the Company's common stock.

The Company has a three-year \$100 million secured revolving credit facility with Congress Financial Corporation that expires in July 2003 and automatically renews on a year-to-year basis thereafter at the discretion of both parties. Interest expense decreased to \$3.1 million in 2000 from \$3.5 million in 1999. As of February 3, 2001 and January 29, 2000, the Company did not have any borrowings outstanding under the facility, and \$100 million was available.

The revolving credit facility contains certain restrictive provisions, including provisions governing cash dividends and acquisitions, is collateralized by merchandise inventory and has a minimum net worth covenant.

Capital Expenditures. The majority of the Company's capital expenditures are for new stores and the relocation of existing stores. The Company typically finances its capital expenditures through cash generated from operations. The Company may also receive financing from landlords in the form of construction allowances or rent concessions. Total capital expenditures were approximately \$32.8 million in 2000.

In fiscal 2001, the Company plans to spend approximately \$56.0 million, net of construction allowances, for additions to fixed assets, including costs for the rebranding of the mall stores.

Seasonality. The Company's business is highly seasonal, with the highest sales and earnings occurring in the fourth fiscal quarter. See Note 12 of the Notes to Consolidated Financial Statements for quarterly financial highlights.

Accounting Policies. In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS No. 133, as amended by SFAS No. 137 and SFAS No. 138, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. SFAS No. 133 is required to be adopted in years beginning after June 15, 2000. The Company will adopt SFAS No. 133 effective February 4, 2001. As the Company is not active in the use of derivative instruments or arrangements, management has determined that adoption of SFAS No. 133 will not have a material financial impact on the Company's consolidated financial statements. The Company will continue to evaluate future contractual arrangements entered into that may affect this determination.

Dividend Policy. The Company has never declared or paid cash dividends on its Common Stock. The Company's credit agreement currently allows the Company to pay a cash dividend once in each calendar year. These dividends are restricted to ten percent of the most recent fiscal year's consolidated net income and can only be paid if, after any payment of dividends, the Company maintains \$25 million of availability under the credit agreement. Any future determination as to the payment of dividends would depend upon capital requirements and limitations imposed by the Company's credit agreement and such other factors as the Board of Directors may consider.

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

Trans World Entertainment Corporation and Subsidiaries



Consolidated Balance Sheets

Trans World Entertainment
Corporation and Subsidiaries



	February 3, 2001	January 29, 2000
	<i>(in thousands)</i>	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 265,084	\$280,026
Accounts receivable	8,726	5,973
Merchandise inventory	475,747	437,363
Prepaid expenses and other	5,771	5,203
Total current assets	755,328	728,565
FIXED ASSETS, net	152,741	144,694
DEFERRED TAX ASSET	34,317	34,431
GOODWILL	43,773	31,433
OTHER ASSETS	15,843	17,287
TOTAL ASSETS	\$1,002,002	\$956,410
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable	\$ 430,185	\$353,294
Income taxes payable	28,114	21,908
Accrued expenses and other	37,380	32,021
Deferred taxes	9,231	12,469
Current portion of capital lease obligations	5,702	5,311
Total current liabilities	510,612	425,003
CAPITAL LEASE OBLIGATIONS, less current portion	13,767	19,461
OTHER LIABILITIES	28,801	17,773
TOTAL LIABILITIES	553,180	462,237
SHAREHOLDERS' EQUITY		
Preferred stock (\$0.01 par value; 5,000,000 shares authorized; none issued)	—	—
Common stock (\$0.01 par value; 200,000,000 shares authorized; 53,676,756 shares and 53,425,867 shares issued in 2000 and 1999, respectively)	537	534
Additional paid-in capital	285,292	283,932
Unearned compensation – restricted stock	(6)	(348)
Treasury stock at cost (10,568,432 and 1,177,432 shares in 2000 and 1999, respectively)	(97,579)	(11,855)
Accumulated other comprehensive loss	(1,482)	—
Retained earnings	262,060	221,910
TOTAL SHAREHOLDERS' EQUITY	448,822	494,173
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,002,002	\$956,410

	February 3, 2001	Fiscal Year Ended January 29, 2000	January 30, 1999
	<i>(in thousands, except per share amounts)</i>		
Sales	\$1,414,589	\$1,358,132	\$1,282,385
Cost of sales	917,354	858,588	796,311
Gross profit	497,235	499,544	486,074
Selling, general and administrative expenses	416,990	371,998	372,886
Camelot merger-related costs, net	—	25,473	—
Asset impairment charge and restructuring charge reversal, net	—	—	1,537
Income from operations	80,245	102,073	111,651
Interest expense	3,128	3,496	4,989
Other expense (income), net	(6,543)	(4,086)	(2,221)
Income before income taxes	83,660	102,663	108,883
Income tax expense	43,510	41,270	47,873
NET INCOME	\$ 40,150	\$ 61,393	\$ 61,010
BASIC EARNINGS PER SHARE	\$ 0.84	\$ 1.17	\$ 1.19
Weighted average number of common shares outstanding – basic	47,597	52,457	51,105
DILUTED EARNINGS PER SHARE	\$ 0.83	\$ 1.15	\$ 1.14
Weighted average number of common shares outstanding – diluted	48,498	53,354	53,530

Consolidated Statements of Income

Trans World Entertainment
Corporation and Subsidiaries



Consolidated Statements of Shareholders' Equity

Trans World Entertainment
Corporation and Subsidiaries



	Common Stock		Additional Paid in Capital	Unearned Compensation Stock Plans	Treasury Stock	Accum. Other Comp. Loss	Retained Earnings	Shareholders' Equity
	Shares	Amount						
<i>(in thousands)</i>								
Balance as of January 31, 1998 as previously reported	29,723	\$ 297	\$ 25,287	\$ (175)	\$ (394)	\$ —	\$ 99,507	\$124,522
Opening equity balances of Camelot upon adoption of "fresh-start" accounting	19,301	193	194,175	—	—	—	—	194,368
Balance as of January 31, 1998, as restated	49,024	\$ 490	\$219,462	\$ (175)	\$ (394)	—	\$ 99,507	\$318,890
Issuance of treasury stock under incentive stock programs	—	—	10	—	4	—	—	14
Stock issued	—	—	188	—	—	—	—	188
Issuance of shares of common stock in a public offering	2,250	23	36,600	—	—	—	—	36,623
Amortization of unearned compensation – restricted stock	—	—	—	44	—	—	—	44
Issuance of director stock options	—	—	346	—	—	—	—	346
Issuance of options under Camelot 1998 Stock Option Plan	—	—	5,112	(5,112)	—	—	—	—
Amortization of unearned compensation – Camelot 1998 Stock Option Plan	—	—	—	5,112	—	—	—	5,112
Forfeiture of unearned compensation – restricted stock	—	—	(53)	53	—	—	—	—
Exercise of stock options and related tax benefit	908	9	10,140	—	—	—	—	10,149
Net Income	—	—	—	—	—	—	61,010	61,010
Balance as of January 30, 1999	52,182	\$ 522	\$271,805	\$ (78)	\$ (390)	—	\$160,517	\$432,376
Issuance of treasury stock under incentive stock programs	—	—	9	—	4	—	—	13
Repurchase of shares of treasury stock	—	—	—	—	(11,469)	—	—	(11,469)
Issuance of restricted stock under incentive stock programs	30	—	336	(336)	—	—	—	—
Amortization of unearned compensation – restricted stock	—	—	—	66	—	—	—	66
Issuance of director stock options	—	—	64	—	—	—	—	64
Exercise of stock options and related tax benefit	1,214	12	11,718	—	—	—	—	11,730
Net Income	—	—	—	—	—	—	61,393	61,393
Balance as of January 29, 2000	53,426	\$ 534	\$283,932	\$ (348)	\$ (11,855)	—	\$221,910	\$494,173
Comprehensive income:								
Net Income	—	—	—	—	—	—	40,150	
Unrealized loss on available for sale securities	—	—	—	—	—	(1,482)	—	
Total comprehensive income								38,668
Issuance of treasury stock under incentive stock programs	—	—	6	—	4	—	—	10
Repurchase of shares of treasury stock	—	—	—	—	(85,728)	—	—	(85,728)
Forfeiture of unearned compensation – restricted stock	(30)	—	(335)	335	—	—	—	—
Amortization of unearned compensation – restricted stock	—	—	—	7	—	—	—	7
Issuance of director stock options	—	—	284	—	—	—	—	284
Exercise of stock options and related tax benefit	281	3	1,405	—	—	—	—	1,408
Balance as of February 3, 2001	53,677	\$ 537	\$285,292	\$ (6)	\$ (97,579)	\$(1,482)	\$262,060	\$448,822

See Notes to Consolidated Financial Statements.

	February 3, 2001	Fiscal Year Ended January 29, 2000	January 30, 1999
	<i>(in thousands)</i>		
OPERATING ACTIVITIES:			
Net income	\$ 40,150	\$ 61,393	\$ 61,010
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	38,433	37,709	35,478
Amortization of financing fees	—	—	253
Amortization of lease valuations, net	(712)	(2,765)	(388)
Reversal of restructuring charge	—	—	(2,157)
Loss on impairment from fixed assets	—	6,649	3,694
Stock compensation programs	301	143	5,568
Loss on disposal of assets	2,546	3,670	1,560
Write-off of investment in unconsolidated affiliate	2,100	—	—
Deferred tax expense	(3,124)	8,251	4,529
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(2,753)	(173)	(773)
Merchandise inventory	(7,766)	(11,285)	(73,557)
Prepaid expenses and other	(230)	4,179	(1,422)
Other assets	45	(1,272)	178
Accounts payable	74,525	132,658	17,788
Income taxes payable	6,777	(6,261)	26,461
Accrued expenses and other	4,612	(18,766)	5,884
Store closing reserve	—	—	(6,535)
Other liabilities	13,024	(1,996)	135
Net cash provided by operating activities	167,928	212,134	77,706
INVESTING ACTIVITIES:			
Purchases of fixed assets	(32,782)	(51,234)	(57,143)
Acquisition of businesses, net of cash acquired	(56,539)	—	(103,264)
Purchase of investments in unconsolidated affiliates	(1,453)	(2,100)	(235)
Purchase of available for sale securities	(2,000)	—	—
Disposal of videocassette rental inventory, net of purchases	98	23	2,860
Net cash used by investing activities	(92,676)	(53,311)	(157,782)
FINANCING ACTIVITIES:			
Payments of long-term debt and financing fees	—	(22,000)	(38,281)
Proceeds from long-term debt	—	—	25,000
Payments of capital lease obligations	(5,303)	(4,036)	(1,292)
Proceeds from capital leases	—	9,941	13,651
Payments for purchases of treasury stock	(85,728)	(11,469)	—
Proceeds from public offering of common stock	—	—	36,623
Exercise of stock options	837	9,356	2,750
Net cash (used) provided by financing activities	(90,194)	(18,208)	38,451
Opening cash balance of Camelot upon adoption of "fresh-start" accounting	—	—	86,304
Net (decrease) increase in cash and cash equivalents	(14,942)	140,615	(41,625)
Cash and cash equivalents, beginning of year	280,026	139,411	94,732
Cash and cash equivalents, end of year	\$265,084	\$280,026	\$139,411
Supplemental disclosure of non-cash investing and financing activities:			
Issuance of treasury stock under incentive stock programs	\$ 10	\$ 13	\$ 14
Issuance of restricted shares under restricted stock plan	—	336	—
Income tax benefit resulting from exercises of stock options	571	2,374	7,347

Consolidated Statements of Cash Flows

Trans World Entertainment
Corporation and Subsidiaries



Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Note 1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. Trans World Entertainment Corporation is one of the largest specialty retailers of music, video and related accessories in the United States. The Company operates in a single industry segment, the operation of a chain of retail entertainment stores. At February 3, 2001, the Company operated 984 stores in 46 states, the District of Columbia, Commonwealth of Puerto Rico and the U.S. Virgin Islands, with a majority of the stores concentrated in the Eastern half of the United States.

Basis of Presentation. The consolidated financial statements consist of Trans World Entertainment Corporation, its wholly-owned subsidiary, Record Town, Inc. ("Record Town"), and Record Town's subsidiaries, all of which are wholly-owned. All significant intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On April 22, 1999, the Company merged with Camelot Music Holdings, Inc. ("Camelot"). The transaction was accounted for as a pooling-of-interests. Accordingly, prior period consolidated financial statements have been restated to include combined results of operations, financial position and cash flows of Camelot as though it had been a part of the Company since Camelot's adoption of "fresh-start" accounting on January 31, 1998.

Items Affecting Comparability. The Company's fiscal year is a 52 or 53-week period ending on the Saturday nearest to January 31. Fiscal 2000, 1999 and 1998 ended February 3, 2001, January 29, 2000 and January 30, 1999, respectively, and each fiscal year consisted of 52 weeks, except for fiscal year 2000, which consisted of 53 weeks. The fifty-third week in 2000 increased sales by an estimated \$23.7 million, operating income by an estimated \$4.0 million and net income by an estimated \$2.5 million or \$0.05 per share.

Revenue Recognition. Revenue from sales of merchandise is recognized at the point of sale to the consumer, at which time payment is tendered. There are no provisions for uncollectible amounts since payment is received at the time of sale.

Cash and Cash Equivalents. The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Concentration of Credit Risks. The Company maintains centralized cash management and investment programs whereby excess cash balances are invested in short-term funds and money market instruments considered to be cash equivalents. The Company's investment portfolio is diversified and consists of short-term investment grade securities consistent with its investment guidelines. These guidelines include the provision that sufficient liquidity will be maintained to meet anticipated cash flow needs. The Company maintains cash and cash equivalents with various financial institutions. At times, such amounts may exceed the F.D.I.C. limits. The Company limits the amount of credit exposure with any one financial institution and believes that no significant concentration of credit risk exists with respect to cash investments.

Concentration of Business Risks. The Company purchases inventory for its stores from approximately 660 suppliers, with approximately 71% of purchases being made from five suppliers. In the past, the Company has not experienced difficulty in obtaining satisfactory sources of supply, and management believes that it will retain access to adequate sources of supply. However, a loss of a major supplier could cause a loss of sales, which would have an adverse effect on operating results and also result in a decrease in vendor support for the Company's advertising programs.

Merchandise Inventory and Return Costs. Inventory is stated at the lower of cost or market as determined by the average cost method. The Company is entitled to return merchandise purchased from major vendors for credit against other purchases from these vendors. These vendors often reduce the credit with a merchandise return charge ranging from 0% to 20% of the original merchandise purchase price depending on the type of merchandise being returned. The Company records the merchandise return charges in cost of sales.

Videocassette Rental Inventory. The cost of videocassette rental tapes is capitalized and amortized on a straight-line basis over their estimated economic life with a provision for salvage value. Major movie release additions, which have a relatively short economic life due to the frequency of rental, are amortized over twelve months, while other titles are amortized over thirty-six months. Depreciation and amortization expense related to the Company's videocassette rental inventory totaling \$816,000, \$921,000 and \$1.2 million in fiscal 2000, 1999 and 1998, respectively, is included in cost of sales.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (cont'd)

Fixed Assets and Depreciation. Fixed assets are stated at cost. Major improvements and betterments to existing facilities and equipment are capitalized. Expenditures for maintenance and repairs that do not extend the life of the applicable asset, are charged to expense as incurred. Buildings are depreciated over a 30-year term. Fixtures and equipment are depreciated using the straight-line method over their estimated useful lives, which range from three to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of their estimated useful lives or the related lease term. A majority of the Company's operating leases are ten years in term. Amortization of capital lease assets is included in depreciation and amortization expense.

Impairment of Long-Lived Assets. Fixed assets and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to undiscounted future net cash flows expected to be generated by the asset over its remaining useful life. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is generally measured based on discounted estimated future cash flows. During fiscal 1999, the Company recorded an impairment loss of \$6.7 million as part of the Camelot merger charge for the write-down of certain fixed assets acquired in the merger. During fiscal 1998, the Company recorded an impairment loss of \$3.7 million to write-down the carrying amount of fixed assets, primarily leasehold improvements, at stores where the estimated future cash flows through the end of the store's lease were less than the carrying amount of that store's fixed assets.

Goodwill. Goodwill represents the adjusted amount of the cost of acquisitions in excess of fair value of net assets acquired in purchase transactions, and is being amortized on a straight-line basis over estimated useful lives ranging from 10 to 20 years. The amortization period is determined by taking into consideration the following factors: the critical market position and establishment of brand names; the combined store mass of the companies; the amortization periods generally used in the retail music business; the highly competitive nature of the business including emerging forms of competition; and the overall history of profitability of the acquired businesses. The Company periodically evaluates the carrying amount of goodwill,

as well as the related amortization periods to determine whether adjustments to these amounts or useful lives are required based on current events and circumstances. The Company performs an analysis of the recoverability of goodwill by using a cash flow approach consistent with the analysis of the impairment of long-lived assets.

Advertising Costs. The costs of advertising are expensed in the first period in which such advertising takes place. Total advertising expense was \$22.3 million, \$18.8 million and \$19.2 million in fiscal 2000, 1999 and 1998, respectively.

Store Opening and Closing Costs. Costs associated with opening a store are expensed as incurred. When it is determined that a store will be closed, estimated unrecoverable costs are charged to expense. Such costs include the net book value of abandoned fixtures, equipment, leasehold improvements and a provision for lease obligations, less estimated sub-rental income. The residual value of any fixed asset moved to a store as part of a relocation is transferred to the relocated store.

Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Comprehensive Income. The Company accounts for comprehensive income in accordance with Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income". SFAS No. 130 requires only additional disclosures in the consolidated financial statements; it does not affect the Company's financial position or results of operations. Comprehensive income for 2000 consists of net income and net unrealized losses on available for sale securities and is presented in the consolidated statements of shareholders' equity. During 1999 and 1998, the Company did not have other items of comprehensive income as defined by SFAS No. 130, and accordingly, comprehensive income is equal to net income.

Investment Securities. Certain investments are categorized as available for sale securities in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", and are recorded at fair value based upon quoted market prices. Unrealized gains and losses are excluded from earnings and reflected in shareholders' equity until

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries

Note 1. Nature of Operations and Summary of Significant Accounting Policies (cont'd)

realized. Realized gains and losses for available for sale securities are included in earnings and are computed using the specific identification method for determining the cost of securities sold. A decline in the market value of any available for sale security below cost that is deemed other than temporary is charged to earnings, resulting in the establishment of a new cost basis for the security.

□ As of February 3, 2001, the amortized cost, gross unrealized loss and fair value of the Company's available for sale securities was \$2.0 million, (\$1.5 million), and \$0.5 million, respectively.

Earnings Per Share. The Company accounts for earnings per share under the provisions of SFAS No. 128, "Earnings per Share". This standard requires the Company to disclose basic earnings per share and diluted earnings per share. Basic earnings per share is calculated by dividing net income by the weighted average common shares outstanding for the period. Diluted earnings per share is calculated by dividing net income by the sum of the weighted average shares outstanding and additional common shares that would have been outstanding if the dilutive potential common shares had been issued for the Company's common stock options from the Company's Stock Option Plans (see Note 9). As required by SFAS No. 128, all outstanding common stock options were included even though their exercise may be contingent upon vesting. Weighted average shares are calculated as follows:

	2000	Fiscal Year 1999	1998
Weighted average common shares outstanding – basic	47,597	52,457	51,105
Dilutive effect of employee stock options	901	897	2,425
Weighted average common shares outstanding – diluted	48,498	53,354	53,530
Antidilutive stock options	3,232	1,707	32

Antidilutive stock options outstanding were excluded from the computation of diluted earnings per share because the exercise price of the options was greater than the average market price of the common shares during the period.

Fair Value of Financial Instruments. The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, accounts receivable, accounts payable and other current liabilities approximate fair value because of the immediate or short-term maturity of these financial instruments.

Note 2. Business Combinations

On October 30, 2000, the Company acquired certain assets and assumed certain liabilities and operating lease commitments of 112 stores from Wax Works, Inc., a privately-held music and video retailer. The stores operate under the name "Disc Jockey" and are located primarily in mall locations throughout the Midwest and Southern United States. The acquisition was accounted for using the purchase method of accounting. The Company paid \$49.8 million, net of cash acquired, for the assets, including merchandise inventory, fixed assets, leasehold interests and other related current assets. The Company recognized approximately \$10.2 million in goodwill related to the acquisition. The goodwill is being amortized on a straight-line basis over a 15-year period.

On August 11, 2000, the Company acquired a majority interest in SecondSpin.com for \$4.2 million, net of cash acquired. The acquisition was accounted for under the purchase method of accounting. SecondSpin.com operates online and in store marketplaces for buying and selling of used CDs, videos and DVDs. SecondSpin.com operates four stores in California and Colorado. In addition, the Company provided SecondSpin.com \$2.5 million in the form of convertible debt to repay long-term obligations under a recapitalization agreement with the other shareholders of SecondSpin.com. The Company recognized approximately \$4.4 million in goodwill related to the acquisition. The goodwill is being amortized on a straight-line basis over a 10-year period.

Note 2. Business Combinations (cont'd)

On April 22, 1999, under the Agreement and Plan of Merger dated October 26, 1998, the Company acquired Camelot, a specialty retailer of prerecorded music, videocassettes and DVDs, and related accessories, in a stock-for-stock transaction accounted for as a pooling-of-interests. Camelot operated over 480 retail locations in 38 states, the District of Columbia and the Commonwealth of Puerto Rico. Upon completion of the merger, Camelot became a wholly-owned subsidiary of the Company. In the merger, each share of Camelot's common stock was converted into 1.9 shares of the Company's common stock. Each outstanding option to purchase Camelot common stock immediately prior to the completion of the merger was converted into 1.9 fully vested and exercisable options to acquire the Company's common stock. The exercise prices of these options were adjusted accordingly for the 1.9 to 1 conversion ratio. As a result, the Company issued approximately 19.3 million shares of its common stock and converted 1.3 million options to acquire its common stock. In connection with the merger, all of Camelot's outstanding notes payable were repaid.

Effective July 29, 1998, Camelot acquired all of the outstanding common stock of Spec's Music, Inc. ("Spec's") under the terms of an Agreement and Plan of Merger dated June 3, 1998. Spec's is a retailer of prerecorded music located in South Florida and Puerto Rico. The Spec's acquisition was accounted for using the purchase method of accounting. The total purchase price was \$42.7 million, net of cash acquired, including cash payment of \$18.6 million, repayment of Spec's indebtedness of \$9.2 million, assumption of liabilities aggregating \$14.0 million and acquisition costs of \$900,000. The Company recognized approximately \$9.4 million in goodwill related to the acquisition. The goodwill is being amortized on a straight-line basis over a 20-year period.

Effective February 28, 1998, Camelot acquired certain assets and assumed certain liabilities and operating lease commitments of The Wall Music, Inc. ("The Wall") pursuant to an Asset Purchase Agreement dated December 10, 1997. The purchase price of The Wall was \$74.6 million, net of cash acquired, (including approximately \$2.3 million of acquisition costs) and was paid in cash. The acquisition was accounted for using the purchase method of accounting. The Company recognized approximately \$24.7 million in goodwill related to the acquisition. The goodwill is being amortized on a straight-line basis over a 20-year period.

During 2000, 1999 and 1998, total amortization related to goodwill was \$2.3 million, \$2.4 million and \$1.8 million, respectively.

Note 3. Restructuring Charge

The Company completed its 1995 restructuring program in fiscal 1998. The remaining balance in the store closing reserve of \$2.2 million was credited to operations in the 4th quarter of fiscal 1998.

Note 4. Property, Plant and Equipment

	February 3, 2001	January 29, 2000
Buildings	\$ 18,926	\$ 18,926
Fixtures and equipment	189,186	166,229
Leasehold improvements	111,057	99,903
	319,169	285,058
Allowances for depreciation and amortization	(166,428)	(140,364)
	\$152,741	\$144,694



Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Note 4. Property, Plant and Equipment (cont'd)

Depreciation and amortization expense related to the Company's distribution center facility and equipment of \$1.6 million in fiscal 2000, 1999 and 1998, respectively, is included in cost of sales. All other depreciation and amortization of fixed assets is included in selling, general and administrative expenses. Depreciation and amortization of fixed assets is included in the condensed consolidated statements of income as follows:

	2000	Fiscal Year 1999	1998
		<i>(in thousands)</i>	
Cost of sales	\$ 1,637	\$ 1,612	\$ 1,567
Selling, general and administrative expenses	\$34,567	\$33,732	\$30,552

Note 5. Debt

The Company's \$100.0 million secured revolving credit facility with Congress Financial Corporation expires in July 2003, and automatically renews on a year-to-year basis thereafter at the discretion of both parties. The facility bears interest at the prime interest rate or the Eurodollar interest rate plus 1.75% (7.4% at February 3, 2001), and is collateralized by the Company's assets allowing the Company to borrow up to 65% of its eligible merchandise inventory to a maximum of \$100.0 million.

During fiscal 2000, 1999 and 1998, the highest aggregate balances outstanding under the current and previous revolving credit facilities were \$12.5 million, \$3.3 million and \$35.0 million, respectively. The weighted average interest rates during fiscal 2000, 1999 and 1998 based on average daily balances were 9.50%, 7.44%, and 8.50%, respectively. The Company didn't have any balances outstanding under the Company's revolving credit agreements at the end of fiscal 2000 and 1999.

Interest paid during fiscal 2000, 1999 and 1998 was approximately \$3.1 million, \$3.6 million and \$4.4 million, respectively.

Note 6. Income Taxes

Income tax expense consists of the following:

	2000	Fiscal Year 1999	1998
		<i>(in thousands)</i>	
Federal – current	\$41,664	\$30,498	\$36,207
State – current	4,970	2,521	7,137
Deferred	(3,124)	8,251	4,529
	\$43,510	\$41,270	\$47,873

A reconciliation of the Company's effective tax rates with the federal statutory rate is as follows:

	2000	Fiscal Year 1999	1998
Federal statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal income tax effect	0.8%	1.4%	4.4%
Unearned compensation – stock options	—	—	1.9%
Plan of reorganization adjustments	—	—	2.2%
Merger costs	—	3.6%	—
Change in valuation allowance	1.4%	—	—
Corporate-owned life insurance disallowance	13.1%	—	—
Other	1.7%	0.2%	0.5%
Effective income tax rate	52.0%	40.2%	44.0%

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Note 6. Income Taxes (cont'd)

On October 16, 2000, the United States District Court for the District of Delaware issued an opinion in favor of the Internal Revenue Service ("IRS"), in the case of the IRS vs. CM Holdings Inc. ("Camelot"), a wholly-owned subsidiary of the Company. The case was brought against Camelot by the IRS to challenge the deduction of interest expense for certain tax years that ended on or before February 1994, related to corporate-owned life insurance policies held by Camelot. The court ruled that the interest deductions should not be allowed and the Company is responsible for interest and penalties. As a result of the ruling, the Company reserved \$11.0 million during the fiscal year ended February 3, 2001. The Company has filed a notice of appeal in the United States Third Circuit Court of Appeals in response to the decision.

Significant components of the Company's deferred tax assets and liabilities are as follows:

	February 3, 2001	January 29, 2000
	<i>(in thousands)</i>	
CURRENT DEFERRED TAX ASSETS		
Accrued expenses	\$ 1,287	\$ 1,570
Other	105	36
Total current deferred tax assets	1,392	1,606
CURRENT DEFERRED TAX LIABILITIES		
Inventory	10,593	13,632
Prepaid expenses	30	443
Total current deferred tax liabilities	10,623	14,075
Net current deferred tax liability	\$ (9,231)	\$(12,469)
NON-CURRENT DEFERRED TAX ASSETS		
Fixed assets	\$22,459	\$ 20,911
Federal and state net operating loss carryforwards	5,401	6,804
Accrued rent	5,319	4,448
Capitalized leases	1,001	882
Losses on investments	1,396	—
Accrued expenses	220	820
Amortization of lease valuations and other assets	2,120	2,085
Pension and compensation related accruals	739	1,423
Other	—	11
Total non-current deferred tax assets before valuation allowance	38,655	37,384
Less: valuation allowance	(1,396)	—
Total non-current deferred tax assets	\$37,259	\$ 37,384
NON-CURRENT DEFERRED TAX LIABILITIES		
Goodwill	2,942	2,953
Total non-current deferred tax liabilities	\$ 2,942	\$ 2,953
Net non-current deferred tax asset	\$34,317	\$ 34,431
TOTAL NET DEFERRED TAX ASSET	\$25,086	\$ 21,962

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Note 6. Income Taxes (cont'd)

At February 3, 2001 and January 29, 2000, the Company had gross deferred tax assets of \$40.0 million and \$39.0 million, respectively, and gross deferred tax liabilities of \$13.6 million and \$17.0 million, respectively. The Company had a net operating loss carryforward of \$8.1 million for Federal income tax purposes as of the end of fiscal 2000 and approximately \$87.6 million for state income tax purposes as of the end of fiscal 2000 that expire at various times through 2014 and are subject to certain limitations. The state net operating loss carryforwards are also subject to various business apportionment factors and multiple jurisdictional requirements when utilized.

In assessing the propriety of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of projected future taxable income over the periods in which the deferred tax assets are deductible, the valuation allowance was increased from \$0 to \$1.4 million, a level where management believes that it is more likely than not that the tax benefit will be realized. The valuation allowance was increased to reserve for deferred tax assets attributable to losses on investments. The amount of the deferred tax asset considered realizable could be reduced if estimates of future taxable income during the carryforward period are reduced.

The Company paid income taxes, net of refunds, of approximately \$28.8 million, \$39.3 million and \$17.1 million during fiscal 2000, 1999 and 1998, respectively.

Note 7. Commitments and Contingencies

On October 16, 2000, the United States District Court for the District of Delaware issued an opinion in favor of the Internal Revenue Service, in the case of the IRS vs. CM Holdings Inc., a wholly-owned subsidiary of the Company. The case was brought against Camelot by the IRS to challenge the deduction of interest expense for certain tax years that ended on or before February 1994, related to corporate-owned life insurance policies held by Camelot. The court ruled that the interest deductions should not be allowed

and the Company is responsible for interest and penalties. As a result of the ruling, the Company reserved \$11.0 million during 2000, which is reflected in other (long-term) liabilities in the consolidated balance sheet as of February 3, 2001. The Company has filed a notice of appeal in the United States Third Circuit Court of Appeals in response to the decision.

On August 8, 2000, 30 Attorneys General served a complaint against the Company, the five major music distributors and two other specialty retailers in the U.S. District Court for the Southern District of New York ("AG's suit"). The complaint has been subsequently amended to add additional states as plaintiffs and to reflect the transfer of the case to U.S. District Court in Maine pursuant to the Multidistrict Litigation Rules. The AG's suit alleges that the distributors and retailers conspired to violate the anti-trust laws and to fix prices by requiring retailers to adhere to minimum advertised prices in order to receive cooperative advertising funds from the labels. The complaint alleges that consumers were damaged in an unspecified amount and seeks treble damages and civil penalties. Following the services of the AG's suit, these same defendants were named as defendants in private class action suits ("Class Actions"), each with similar allegations as in the AG's suit. The Class Actions have been consolidated along with the AG's suit in the U.S. District Court in Maine. It is management's belief that the lawsuit is without merit and the Company will ultimately prevail in this regard.

The Company is subject to other legal proceedings and claims that have arisen in the ordinary course of its business and have not been finally adjudicated. Although there can be no assurance as to the ultimate disposition of these matters, it is management's opinion, based upon the information available at this time, that the expected outcome of these matters, individually or in the aggregate, will not have a material adverse effect on the results of operations and financial condition of the Company.

Note 8. Leases

As more fully discussed in Note 11, the Company leases its distribution center and administrative offices under three capital leases with its Chief Executive Officer and largest shareholder. The Company also has a capital lease for its point-of-sale system.

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries

Note 8. Leases (cont'd)

Fixed asset amounts for capital leases, which are included in the fixed assets on the accompanying balance sheets, are as follows:

	February 3, 2001	January 29, 2000
	<i>(in thousands)</i>	
Buildings	\$ 9,342	\$ 9,342
Fixtures and equipment	28,682	26,890
	38,024	36,232
Allowances for depreciation and amortization	(16,266)	(10,729)
	\$ 21,758	\$ 25,503

The Company leases substantially all of its stores, many of which contain renewal options, for periods ranging from five to twenty-five years, with the majority being ten years. Most leases also provide for payment of operating expenses, real estate taxes and for additional rent based on a percentage of sales.

Net rental expense was as follows:

	2000	Fiscal Year 1999	1998
	<i>(in thousands)</i>		
Minimum rentals	\$118,029	\$108,818	\$102,130
Contingent rentals	2,372	2,957	1,310
	\$120,401	\$111,775	\$103,440

Future minimum rental payments required under all leases that have initial or remaining non-cancelable lease terms in excess of one year at February 3, 2001 are as follows:

	Operating Leases	Capital Leases
	<i>(in thousands)</i>	
2001	\$114,724	\$ 7,807
2002	106,396	6,318
2003	95,929	2,994
2004	79,360	1,679
2005	61,967	1,679
Thereafter	180,656	16,396
Total minimum payments required	\$639,032	36,873
Less: amounts representing interest		17,404
Present value of minimum lease payments		19,469
Less: current portion		5,702
Long-term capital lease obligations		\$13,767

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries

Note 9. Benefit Plans

401(k) Savings Plan

The Company offers a 401(k) Savings Plan to eligible employees meeting certain age and service requirements. This plan permits participants to contribute up to 20% of their salary, including bonuses, up to the maximum allowable by Internal Revenue Service regulations. Participants are immediately vested in their voluntary contributions plus actual earnings thereon. Participant vesting of the Company's matching and profit sharing contribution is based on the years of service completed by the participant. Participants are fully vested upon the completion of four years of service. All participant forfeitures of non-vested benefits are used to reduce the Company's contributions in future years. The Company matching contribution totaled \$943,000, \$962,000 and \$1.1 million in fiscal 2000, 1999 and 1998, respectively.

Stock Option Plans

The Company has four employee stock option plans, the 1986 Stock Option Plan, the 1994 Stock Option Plan, the 1998 Stock Option Plan and the 1999 Stock Option Plan (the "Plans"). The Compensation Committee of the Board of Directors may grant options to acquire shares of common stock to employees of the Company and its subsidiaries at the fair market value of the common stock on the date of grant. Under the Plans, options generally become exercisable commencing one year from the date of grant in increments of 25% per year with a maximum term of ten years. Options authorized for issuance under the Plans totaled 12.3 million. At February 3, 2001, of the 10.8 million options remaining authorized for issuance under the Plans, 4.9 million have been granted and are outstanding, 2.2 million of which were vested and exercisable. Options available for future grants at February 3, 2001 and January 29, 2000 were 2.6 million and 3.3 million, respectively.

Under the terms of the Camelot merger agreement, all options issued under the Camelot 1998 Stock Option Plan (the "Camelot Plan") were converted to Trans World options. The Camelot Plan provided for the granting of either incentive stock options or nonqualified stock options to purchase shares of the Company's common stock. Vesting of the options was originally over a four-year period with a maximum term of ten years. Based on the terms of the Camelot Plan, vesting was accelerated based on the market performance of the Company's common stock whereby 50% of the options vested on March 13, 1998. The remaining 50% vested on April 22, 1999 in connection with the merger. At February 3, 2001, 100,700 options were outstanding and exercisable. The Company stopped issuing stock options under the Camelot Stock Option Plan as of April 22, 1999. The Company recognized \$5.1 million in compensation expense during 1998, related to stock options granted below the market price at the date of grant and accelerated vesting.

The following table summarizes information about the stock options outstanding under the Plans and the Camelot Plan at February 3, 2001:

Exercise Price Range	Outstanding			Exercisable	
	Shares	Average Remaining Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$ 1.21 - \$2.67	891,402	5.1	\$ 1.59	891,402	\$ 1.59
2.68 - 5.33	477,427	4.9	4.21	371,034	4.27
5.34 - 10.67	513,500	9.7	9.24	2,500	10.00
10.68 - 13.33	2,276,400	7.8	11.25	852,050	11.19
13.34 - 16.00	568,025	8.2	15.19	83,433	15.01
16.01 - 18.67	282,450	7.2	17.80	142,266	17.80
18.68 - 23.75	2,000	7.8	23.75	1,000	23.75
Total	5,011,204	7.2	\$ 9.48	2,343,685	\$ 6.98



Note 9. Benefit Plans (cont'd)

The Company also has a stock option plan for non-employee directors (the "1990 Plan"). Options under this plan are granted at an exercise price determined by the Compensation Committee of the Board of Directors. Under the 1990 Plan, options generally become exercisable commencing one year from the date of grant in increments of 25% per year with a maximum term of ten years. As of February 3, 2001, there were 750,000 options authorized for issuance and 284,875 options have been granted and are outstanding, 227,500 of which were vested and exercisable. There are 413,909 shares of common stock reserved for possible future option grants under the 1990 Plan.

Under the terms of the Camelot merger agreement, all options issued under the Camelot Outside Director Stock Option Plan (the "Camelot Director Plan") were converted to Trans World options. As of February 3, 2001, there were 4,750 options outstanding and exercisable under the Camelot Director Plan. During 1998, the Company recognized \$234,000 in compensation expense based on the market value of the stock on the date of grant in June 1998 in connection with the initial grant of stock options under the Camelot Director Plan. The Company no longer issues options under the Camelot Director Plan.

The following table summarizes information about the stock options outstanding under the two Director Plans at February 3, 2001:

Exercise Price Range	Outstanding			Exercisable	
	Shares	Average Remaining Life	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$ 1.19 - \$2.67	49,500	4.5	\$ 1.64	49,500	\$ 1.64
2.68 - 5.33	129,375	4.8	3.45	112,125	3.50
5.34 - 8.00	18,000	0.8	6.10	18,000	6.10
8.01 - 10.67	54,000	8.8	9.79	37,500	9.84
10.68 - 13.33	28,625	8.2	11.94	9,500	11.75
13.34 - 15.12	<u>10,125</u>	6.5	15.12	<u>5,625</u>	15.12
Total	<u>289,625</u>	5.7	\$ 5.73	<u>232,250</u>	\$ 4.95

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Trans World Entertainment Corporation and Subsidiaries



Note 9. Benefit Plans (cont'd)

The following tables summarize activity under the Stock Option Plans:

	Employee Stock Option Plans			Director Stock Option Plans		
	Number of Shares Subject To Option	Option Price Range Per Share	Weighted Average Exercise Price	Number of Shares Subject To Option	Option Price Range Per Share	Weighted Average Exercise Price
Balance January 31, 1998	5,516,596	\$0.75-\$11.20	\$ 5.94	258,000	\$ 1.19-\$9.14	\$ 3.93
Granted	529,600	13.88-26.67	17.61	50,000	10.20-15.12	11.65
Exercised	(885,043)	0.75-10.92	3.08	(22,500)	2.09-3.68	3.15
Canceled	(259,134)	1.21-17.79	4.64	—	—	—
Balance January 30, 1999	4,902,019	\$0.75-\$26.67	\$ 7.79	285,500	\$1.19-\$15.12	\$ 5.34
Granted	1,501,000	10.00-15.25	13.42	29,000	12.22-12.96	12.45
Exercised	(1,194,899)	0.75-17.79	7.65	(19,000)	10.92	10.92
Canceled	(143,733)	0.75-17.79	9.65	(10,000)	12.22	12.22
Balance January 29, 2000	5,064,387	\$1.21-\$26.67	\$ 9.44	285,500	\$1.19-\$15.12	\$ 5.45
Granted	1,633,800	8.25-12.06	10.34	58,716	0.00-10.94	7.52
Exercised	(259,673)	1.20-10.92	3.12	(21,216)	0.00-3.68	1.30
Canceled	(1,427,310)	1.21-26.67	11.47	(33,375)	3.36-15.12	9.28
Balance February 3, 2001	5,011,204	\$1.21-\$23.75	\$ 9.48	289,625	\$1.18-\$15.12	\$ 4.95

The per share weighted-average fair value of the stock options granted during fiscal 2000, 1999 and 1998 was \$3.57, \$5.01 and \$6.48, respectively, using the Black Scholes option pricing model, with the following weighted-average assumptions;

2000 – expected dividend yield 0.0%, risk-free interest rate of 5.20%, expected life of five years and stock volatility of 62%;

1999 – expected dividend yield 0.0%, risk-free interest rate of 6.47%, expected life of five years and stock volatility of 72%;

1998 – expected dividend yield 0.0%, risk-free interest rate of 5.15%, expected life of five years and stock volatility of 70%.

The Company applies APB Opinion No. 25, “Accounting for Stock Issued to Employees”, in accounting for its Plans and, accordingly, no compensation cost has been recognized for its stock options in the financial statements for employee stock options, which are issued at the closing stock price on the day of grant. During fiscal 2000, 1999 and 1998, the Company recognized expenses of \$165,000, \$64,000 and \$57,000, respectively, for stock options issued to non-employee directors at an exercise price below the closing stock price on the date of grant. Had the Company determined compensation cost for employee stock options based on fair value in accordance with SFAS No. 123, the Company’s net income would have been reduced to the pro forma amounts indicated on the following page:

Note 9. Benefit Plans (cont'd)

	2000	Fiscal Year 1999	1998
	<i>(in thousands, except per share amounts)</i>		
Net income, as reported	\$40,150	\$61,393	\$61,010
Basic earnings per share, as reported	\$ 0.84	\$ 1.17	\$ 1.19
Diluted earnings per share, as reported	\$ 0.83	\$ 1.15	\$ 1.14
Pro forma net income	\$35,369	\$57,621	\$59,016
Pro forma basic earnings per share	\$ 0.74	\$ 1.10	\$ 1.15
Pro forma diluted earnings per share	\$ 0.73	\$ 1.08	\$ 1.10

Restricted Stock Plan

Under the 1990 Restricted Stock Plan, the Compensation Committee of the Board of Directors is authorized to grant awards for up to 900,000 restricted shares of common stock to executive officers and other key employees of the Company and its subsidiaries. The shares are issued as restricted stock and are held in the custody of the Company until all vesting restrictions are satisfied. If conditions or terms under which an award is granted are not satisfied, the shares are forfeited. Shares begin to vest under these grants after three years and are fully vested after five years, with vesting criteria which includes continuous employment until applicable vesting dates have expired. As of February 3, 2001, a total of 255,000 shares have been granted, of which 180,000 of these shares had vested and 60,000 shares with an unamortized unearned compensation balance of \$388,000, had been forfeited. Unearned compensation is recorded at the date of award, based on the market value of the shares, and is included as a separate component of shareholders' equity and is amortized over the applicable vesting period. The amount amortized to expense in fiscal 2000, 1999 and 1998, net of the impact of forfeitures, was approximately \$7,000, \$66,000 and \$44,000, respectively. At February 3, 2001, outstanding awards and shares available for grant totaled 15,000 and 705,000, respectively.

Supplemental Executive Retirement Plan

The Company maintains a non-qualified Supplemental Executive Retirement Plan (SERP) for certain executive officers of the Company. The SERP, which is unfunded, provides eligible executives defined pension benefits that supplement benefits under other retirement arrangements. The annual benefit amount has been predetermined as part of the plan and vests based on years of service and age at retirement. The Company accounts for the SERP in accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions". For fiscal 2000, 1999 and 1998, net periodic pension costs recognized under the plan totaled approximately \$492,000, \$481,000 and \$342,000, respectively. The projected and accumulated benefit obligation for the SERP was approximately \$3.9 million and \$3.6 million at February 3, 2001 and January 29, 2000, respectively, which is included in accrued expenses in the consolidated balance sheet. In addition, an intangible asset of approximately \$2.3 million and \$2.5 million were recorded at February 3, 2001 and January 29, 2000, respectively, which is included in other assets in the consolidated balance sheet, to reflect the excess of the accumulated benefit obligation over the fair value of plan assets (\$0), net of accrued pension costs.

Note 10. Shareholders' Equity

On January 7, 2000, the Board of Directors approved a stock repurchase plan authorizing the purchase of up to 5.0 million shares of the Company's common stock. During fiscal 2000, the Board of Directors approved the repurchase of up to an additional 10.0 million shares. As of February 3, 2001, the Company had purchased 10.5 million of the 15.0 million shares authorized by the Board, at a total cost of \$85.7 million. At February 3, 2001 and January 29, 2000, the Company held 10,568,432 and 1,177,432 shares, respectively, in treasury stock.

Notes to Consolidated Financial Statements

Trans World Entertainment
Corporation and Subsidiaries



Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries



Note 10. Shareholders' Equity (cont'd)

On July 31, 1998, the Board of Directors approved a three-for-two common stock split to be distributed in the form of a 50% stock dividend. As a result, 10,937,104 shares were issued on September 15, 1998 to shareholders of record on September 1, 1998. Accordingly, amounts equal to the par value of the additional shares issued have been charged to additional paid in capital and credited to common stock. All references throughout these financial statements to number of shares, per share amounts, stock option data and market prices of the Company's common stock have been adjusted to reflect this stock split.

On May 1, 1998, the Company sold an additional 2.25 (adjusted) million shares of its common stock in a public offering for approximately \$36.6 million net of issuance costs. A portion of the proceeds was used to repay long-term debt and the balance of the proceeds was used for general corporate purposes including investments in additional stores, fixtures and inventory.

Note 11. Related Party Transactions

The Company leases its 168,400 square foot distribution center/office facility in Albany, New York from Robert J. Higgins, its Chairman, Chief Executive Officer and largest shareholder, under three capitalized leases that expire in the year 2015. The original distribution center/office facility was constructed in 1985. A 77,100 square foot distribution center expansion was completed in October 1989 on real property adjoining the existing facility. A 19,100 square foot expansion was completed in September 1998 adjoining the existing facility.

Under the three capitalized leases, dated April 1, 1985, November 1, 1989 and September 1, 1998 (the "Leases"), the Company paid Mr. Higgins an annual rent of \$1.7 million, \$1.6 million and \$1.4 million in fiscal 2000, 1999 and 1998, respectively. On January 1, 2000, the aggregate rental payment increased in accordance with the biennial increase in the Consumer Price Index, pursuant to the provisions of each lease. Effective January 1, 2002, and every two years thereafter, the rental payment increases in accordance with the biennial increase in the Consumer Price Index, pursuant to the provisions of the lease. None of the leases contains any real property purchase option at the expiration of its term. Under the terms of the Leases, the Company pays all property taxes, insurance and other operating costs with respect to the premises. Mr. Higgins' obligation for principal and

interest on his underlying indebtedness relating to the real property is approximately \$1.1 million per year.

The Company leases two of its retail stores from Mr. Higgins under long-term leases. Under the first store lease, annual rent payments were \$40,000 in fiscal 2000, 1999 and 1998. Under the second store lease, annual rent payments were \$35,000 in fiscal 2000, 1999 and 1998. Under the terms of the leases, the Company pays property taxes, maintenance and a contingent rental if a specified sales level is achieved. Total additional charges for both locations, including contingent rent, was approximately \$14,700, \$17,700 and \$18,100 in fiscal 2000, 1999 and 1998, respectively. In fiscal 1998, the Company paid Mr. Higgins \$30,000 under one-year operating leases expiring on October 31, 1998, for certain parking facilities contiguous to the Company's distribution center/office facility. This lease was not renewed upon its expiration on October 31, 1998.

The Company regularly utilizes privately chartered aircraft owned or partially owned by Mr. Higgins. Under an unwritten agreement with Quail Aero Services of Syracuse, Inc., a corporation in which Mr. Higgins is a one-third shareholder, the Company paid \$75,000, \$110,000 and \$65,000 for chartered aircraft services in fiscal 2000, 1999 and 1998, respectively. The Company also charters an aircraft from Crystal Jet, a corporation wholly-owned by Mr. Higgins. Payments to Crystal Jet aggregated \$85,000, \$64,000 and \$180,000 in fiscal 2000, 1999 and 1998, respectively. The Company also charters an aircraft from Richmor Aviation, an unaffiliated corporation that leases an aircraft owned by Mr. Higgins. Payments to Richmor Aviation in fiscal 2000, 1999 and 1998 were \$217,000, \$325,000 and \$0, respectively. The Company believes that the charter rates and terms are as favorable to the Company as those generally available to it from other commercial charters.

During 2000, the Company made loans aggregating \$334,000 and \$85,000 to John J. Sullivan, the Company's Senior Vice President and Chief Financial Officer, and Bruce J. Eisenberg, the Company's Senior Vice President – Real Estate, respectively. The loans were in connection with income taxes due on the vesting of restricted stock. The full principal amount of the loans was outstanding on February 3, 2001. The loans bear interest at a rate of 5.88% per annum.

In September 1999, in connection with the hiring of former President and Chief Operating Officer, Michael J. Madden, the Company made a \$200,000 interest-free loan which was repaid subsequent to February 3, 2001.

Note 12. Quarterly Financial Information (Unaudited)

Notes to Consolidated Financial Statements

Trans World Entertainment Corporation and Subsidiaries

	2000	Fiscal 2000 Quarter Ended			
		2/03/01	10/28/00	7/29/00	4/29/00
		<i>(in thousands, except per share amounts)</i>			
Sales	\$1,414,589	\$553,366	\$265,597	\$285,510	\$310,116
Gross profit	497,235	190,693	91,701	103,997	110,844
Net income (loss)	40,150	40,097	(15,596)	6,667	8,982
Basic earnings (loss) per share	\$ 0.84	\$ 0.91	\$ (0.32)	\$ 0.14	\$ 0.18
Diluted earnings (loss) per share	\$ 0.83	\$ 0.89	\$ (0.32)	\$ 0.14	\$ 0.18

	1999	Fiscal 1999 Quarter Ended			
		1/29/00	10/30/99	7/31/99	5/1/99
		<i>(in thousands, except per share amounts)</i>			
Sales	\$1,358,132	\$517,870	\$275,968	\$277,275	\$287,019
Gross profit	499,544	195,049	96,981	102,570	104,944
Net income (loss)	61,393	60,569	3,777	5,691	(8,644)
Basic earnings (loss) per share	\$ 1.17	\$ 1.15	\$ 0.07	\$ 0.11	\$ (0.17)
Diluted earnings (loss) per share	\$ 1.15	\$ 1.12	\$ 0.07	\$ 0.11	\$ (0.17)



**Report of KPMG LLP
(Independent Auditors)**

*Trans World Entertainment
Corporation and Subsidiaries*



The Board of Directors and Shareholders
Trans World Entertainment Corporation:

We have audited the accompanying consolidated balance sheets of Trans World Entertainment Corporation and subsidiaries as of February 3, 2001 and January 29, 2000, and the related consolidated statements of income, shareholders' equity and cash flows for each of the fiscal years in the three-year period ended February 3, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Trans World Entertainment Corporation and subsidiaries as of February 3, 2001 and January 29, 2000, and the results of their operations and their cash flows for each of the fiscal years in the three-year period ended February 3, 2001, in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Albany, New York
March 16, 2001

Trans World Entertainment

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