# 2001 ANNUAL REPORT

## Handleman Company

*The Indispensable Link to Entertainment*

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# Financial Highlights

| *(amounts in millions except per share and other data)* | 2001 | 2000 |
|---|---|---|
| **Operational data** | | |
| Revenues | $ 1,193.0 | $ 1,137.6 |
| Income before income taxes and minority interest | 69.1 | 66.0 |
| Net income | 42.0 | 38.6 |
| Earnings per share, diluted | 1.53 | 1.30 |
| Weighted average shares outstanding, diluted | 27.5 | 29.7 |
| **Balance sheet data** | | |
| Working capital | $ 162.9 | $ 129.7 |
| Total assets | 590.7 | 519.7 |
| Debt, non-current | 53.0 | 34.0 |
| Shareholders' equity | 253.2 | 223.3 |
| Book value per share | 9.54 | 8.06 |
| **Other data** | | |
| Number of shareholders | 3,100 | 3,200 |
| Number of employees | 2,700 | 2,500 |

| | Revenues | |
|---|---|---|
| *(amounts in millions)* | 2001 | 2000 |
| **Handleman Entertainment Resources** | $ 1,064.0 | $ 1,011.3 |
| **North Coast Entertainment** | 142.7 | 142.0 |
| Eliminations | (13.7 ) | (15.7 ) |
| **TOTAL** | **$ 1,193.0** | **$ 1,137.6** |


**Scott Sellers,**
**Kristen Viviano,**
**Jesse Centofanti,**
**Jacqueline Gardner,**
**Stephen Pritchard,**
**Colleen Gibbons,**
**Merchandise Allocation**

Handleman Company continued to sustain its position as the *Indispensable Link* in the music industry during fiscal 2001 by further enhancing the service and efficiencies we offer both the music labels and our mass merchant customers. While we continued to grow our core category management and music distribution business, we also positioned ourselves to take full advantage of new international and e-business opportunities.

As one of the world's largest music merchandisers, Handleman Entertainment Resources (H.E.R.) enjoyed another year of growth, as we focused on improving the productivity of our mass merchant customers, both on and off the Internet. In November of 2000, the Company established a new business unit, Handleman Online, to spearhead our drive into "virtual" category management, and by the end of the year, we had secured our first major e-commerce customer, JCPenney.com. We began managing, maintaining and fulfilling the music and video portion of JC Penney's online catalog operations in June 2001.

Perhaps the biggest news of the year, however, came from the United Kingdom (UK), where we were awarded ASDA's business effective February 2001. ASDA, a member of the Wal-Mart family and the third largest mass merchant in the UK, selected Handleman as the category manager and distributor of music and video products for its 243 stores. We estimate that, in the first full year of service, this new business will result in a 10 percent increase in Handleman's revenues.

During fiscal 2001, we also invested in higher-margin proprietary products and licenses through our North Coast Entertainment (NCE) subsidiary and its portfolio companies. Building on a successful track record of marketing audio and video products, as well as children's character licenses, NCE continues to explore new ways of generating above-average returns for Handleman. While Madacy and The itsy bitsy Entertainment Company produced disappointing results, Anchor Bay enjoyed their best year ever in terms of sales and operating profits.

**"Just as DNA forms the indispensable link in human genetics, so Handleman serves as the *Indispensable Link* in the music industry, connecting entertainment vendors with mass merchant retailers through its unique array of assets - its experienced people, state-of-the-art systems and customized portfolio of services."**

**— Stephen Strome,**
*Chairman and Chief Executive Officer*

In spite of a tough music market, sales were up last year even without the increased revenues from the fourth quarter ASDA business. While new releases were not as strong as in the prior year and music industry sales flattened, H.E.R.'s mass merchant customers continued to gain share. Overall, total Company net sales grew five percent to $1.19 billion for the year ended April 28, 2001. Net sales for H.E.R. grew five percent to $1.06 billion. Net income for the Company as a whole increased nearly nine percent to $42 million, and earnings per share were the highest in the Company's history at $1.53 per diluted share, up 18 percent from the prior year. In fact, thanks to solid music sales, expense controls and share repurchases, we have enjoyed 19 consecutive quarters of uninterrupted earnings per share growth, year-over-year, as of fiscal year-end.

Our strong performance, coupled with our continuing efforts to manage our balance sheet, resulted in EBITDA of $105 million, $12 million of which we used to repurchase 1,230,880 shares of our common stock.


**Lynette Reich,**
**Field Sales**

Last year, we completed a comprehensive study of our businesses and identified the following five strategic growth opportunities, which collectively form the foundation for our goal of $2 billion in sales by the end of our fiscal year 2005.

- Stimulate H.E.R. Domestic Growth
- Explore International Expansion
- Exploit e-Commerce Opportunities
- Grow North Coast Entertainment
- Undertake Strategic Transactions

**Stimulate H.E.R. Domestic Growth**

As one of the world's largest purchasers and category managers of music, Handleman Entertainment Resources will continue to capitalize on the continuing shift in music sales to the mass merchant channel. By leveraging our Channel of Choice™ operating model, Handleman customers have benefited from the largest market share gains, year-over-year, in the music industry for the past six years. Our goal is to increase our existing customers' share of the music business, while attracting additional large retail customers to our market-leading merchandising capabilities. H.E.R.'s strength is its ability to distill the complexity of the music business for its mass merchant customers. We select from among 35,000 new releases a year what will sell best in a 3,500 title department in a particular locality. This capability will become even more valuable as music formats and distribution options proliferate.

**"Our Field Sales professionals are focused on store-level execution and ensuring that our music assortment matches the local community's tastes and demographics."**

**— Peter Cline,**
*President and Chief Operating Officer*

**Explore International Expansion**

Today, Handleman operates in five of the top ten music markets in the world: Canada, Brazil, Mexico, the United Kingdom and, of course, the United States. Having established a European presence in fiscal year 2000 with the acquisition of Lifetime Entertainment (renamed Handleman UK Ltd.), we look forward to significant growth in that market with the addition of ASDA as a customer. We are closely reviewing and evaluating other markets, including France and Germany, as well as markets in the Americas such as Puerto Rico and Argentina. As we implement our core category management model in our international markets, we will seek opportunities to leverage our operations through expanding our customer base and offering our e-business solutions to our customers.

**Exploit e-Commerce Opportunities**

As part of our strategic drive to protect and extend our leadership position in music category management, Handleman is actively exploring and exploiting new Internet-driven markets. While the digital distribution of music will remain a relatively small portion of music sales over the next five years, according to industry forecasts, we intend to fulfill that demand for our customers, no matter what form it may take. We will continue to invest over the next three years to build and grow Internet-enabled businesses:

- mFinity™ is an end-to-end music website solution or ASP (application service provider) that enables retailers to outsource their music and video e-commerce business to Handleman, including web site operation, hosting, product fulfillment and cross-category promotion. In June of 2001, shortly after our fiscal year closed, mFinity™ went live with its first major customer, JCPenney.com. J.C. Penney has contracted with us to operate the music and video portion of its online catalog site. mFinity's™ flexible, proprietary platform and our long history in music category management allows Handleman Online to deliver a truly superior level of service at a lower cost than retailers, e-tailers


**Jeff Jorgenson,**
**Richard Alonzo,**
**Jim James,**
**Steve Moser,**
**Erica Babcock,**
**Music Purchasing**

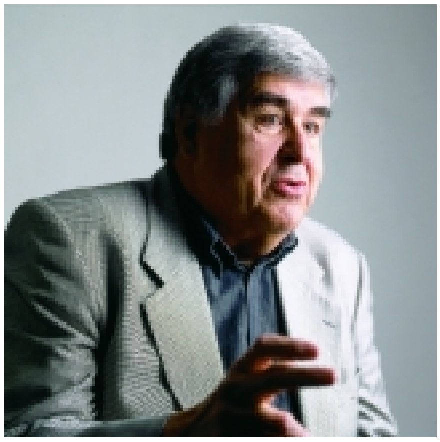
or portals could achieve themselves.

• e-Fulfillment leverages our world-class distribution center in Reno, which has expanded its SKUs to more than 55,000, an inventory that will allow us to fulfill orders to meet the wide range of titles requested by online consumers. With this service, we are offering e-tailers the opportunity to outsource the "back end" of their music web sites and let Handleman fulfill their orders. This business will also support both mFinity™ and Handleman's Music Mart kiosks.

• Digital dowwnloads are available through the mFinity™ website. Consumers can legally purchase and download over 150,000 singles and full length albums, some of which are used to promote new artists and albums. While consumers have not yet fully embraced this functionality, the Company is prepared to capitalize on this online offering when consumers are ready.

• Handleman's Music Mart kiosks are Internet-based, in-store kiosks that allow mass merchants to compete effectively with music specialty retailers by expanding dramatically the inventory "available" to consumers. Consumers can use these kiosks to sample CDs, view album and artist information, and order titles for delivery to their home. The kiosks feature state-of-the-art security and rights management controls and allow for a great deal of content and format flexibility. In fact, our newest generation kiosks will even accommodate on-demand manufacturing of physical CDs within the store. While we're still in the testing phase with this technology, retailers have expressed interest; we'll proceed at a pace dictated by continuing market research.

To gain accelerated access to content and mitigate our own risk, Handleman has allied with some of the leading music technology pioneers, including Muze, Liquid Audio and IBM, in developing these services. These partnerships, in combination with H.E.R.'s leadership in category management, position Handleman well to grow our business no matter what course the music industry takes.



**"We are fortunate to have people who are knowledgeable, love music and know how to use our technological tools to determine exactly the right amount of product to put in a given store at exactly the right time."**

**— Samuel Milicia,**
*Senior Vice President, Music Product*

### Grow North Coast Entertainment

North Coast Entertainment (NCE) will continue to play a role in Handleman's growth and is already pursuing several strategies, including broadening its intellectual property ownership by securing new licensing rights for audio and video titles. NCE will also expand internationally, focusing initially on markets where H.E.R. has established a strong presence. In addition, NCE companies are exploring ways to expand sales through the Internet.

• Madacy Entertainment will increase sales by pursuing expanded product ownership and licensing opportunities, as well as by providing music content to Handleman's e-commerce business solutions. Madacy's new Relentless label anticipates several new releases during fiscal 2002, as do its Madacy Kids, Madacy Latino and Madacy Christian divisions.

• Anchor Bay Entertainment announced its expansion into Europe in fiscal 2001 with its formation of Anchor Bay Entertainment UK Limited. In addition, Anchor Bay is looking to acquire additional video rights and extend its existing licensing rights to cover broader territories.

• The itsy bitsy Entertainment Company will grow its portfolio of children's entertainment licenses with an emphasis on the preschool market. In fiscal 2002, the Company will be implementing several cost containment measures to lower operating costs.

Adam Moy,
Madonna Ponkey,
Dan Wilson,
Natalie Millar,
Arif Rahman,
Ken Eagle,
Technology Management Group

## Undertake Strategic Transactions

Throughout its history, Handleman has engaged in strategic transactions - both acquisitions and sales - where and when it made good business sense. During the late 1980s and early 1990s, as the Company grew its mass merchant music distribution and category management business, we executed several such transactions. We formed and expanded NCE using a similar strategy. Handleman will continue this practice of strategic transactions including acquisitions that complement our core category management business, as well as investments in strategically important technology companies. As we look to implement our strategic plan, we anticipate that our strong balance sheet and positive cash flow will allow us to be aggressive in exploiting the investment and alliance opportunities that present themselves.

## Conclusion

Handleman's strategic growth plan lays out a road map for increasing sales in our core business on a global basis while capitalizing on opportunities in e-commerce. We are confident that these initiatives will fuel growth in both sales and earnings and allow the Company to leverage its expertise and resources across new markets.

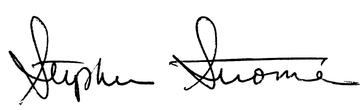
While brick-and-mortar stores and compact discs will continue to predominate in music sales well into the future, we at Handleman are prepared to accommodate any and every variation on that traditional theme. Handleman has a long history of making change work for its customers, as well as for the home entertainment industry. We are optimistic about growing our existing businesses and taking advantage of opportunities presented by developments in e-commerce, where we expect to be a leader in music distribution.

**"Our technical sophistication continues to enable Handleman Company to keep 18-24 months ahead of our competition and create greater value for our customers and vendors."**

**— Bob Sausa,**
*Senior Vice President,*
*Chief Information Officer*

Our operating results, combined with our strong balance sheet and leading-edge systems, provide us with a solid foundation as we grow our business. But it's our people and their collective knowledge that give Handleman a true advantage in our competitive environment. As we've adapted to changes in both the music and retail industries over the past year, our people have consistently been one step ahead, anticipating customers' needs and music consumers' desires. I appreciate and salute their dedication, their enthusiasm and their untiring efforts on behalf of Handleman Company.

Of course, no one has given more to Handleman than our namesake. As one of our founder's sons, David Handleman was elected Chairman Emeritus in January 2001 upon his retirement as Chairman of the Board. In his sixty-plus years of service to the Company, David helped position Handleman as the preeminent force in music distribution and category management, and his vision and dedication will continue to serve the Company as he remains an advisor and member of the Board. I have succeeded David as Chairman of the Board, and Peter Cline, who has served as Executive Vice President and Chief Operating Officer of the Company, has assumed the title and responsibilities of President. Let me take this opportunity to recognize the significant contributions of both David and Peter and express my confidence in Handleman's entire management team. It's been my privilege working with them this past year, and I look forward to our successes in the years to come.



Stephen Strome
Chairman & Chief Executive Officer


Orletta Cross,
Shelley Hofmann,
Alfred Ishak,
Human Resources

"Honesty and Integrity," "Accountability," "Continuous Learning and Improvement," "Focused on Our Stakeholders;" these are the values that Handleman employees demonstrate every day in their interactions with our customers, vendors and shareholders.

Handleman's people are the core of the *Indispensable Link*, and we celebrate them by fostering a work environment that respects and fulfills their career goals. In fiscal 2001, we continued to enhance our career development, recruitment and training programs.

**Career Development**

Our vision is to be the "Employer of Choice" and we are committed to offering rewarding programs to our employees through career building and cross-functional development opportunities.

*Executive Candidate Training Program* – identifies "star" managers and rotates them through every department in the Company, ensuring retention.

*Executive Development Review* – keeps our succession planning and career development current for not only senior executives, but all levels of management throughout the Company.

*Cross Functional Development* – increases the adaptability of our employees and our Company to respond to the changing needs of our business.

*Sales Representative Pre-Employment Screening Testing* – ensures that we hire the highest potential sales representatives by assessing them against a composite profile of our best performers.

*Mentor Program* – pairs high potential employees interested in further career development with a management mentor.

**"We have an environment at Handleman Company that embraces our values, while encouraging freedom and confidence to make decisions at all levels. Our shareholders should feel confident in the highly skilled and passionate employees operating the Company."**

**— Mark Albrecht,**
*Senior Vice President, Human Resources and Organizational Development*

**Recruitment**

Our challenge is to attract, hire and develop the future leaders of our business. This is a challenge we accept every day.

*Management Associate Training Program* – recruits promising candidates from top universities in the area for a management career with Handleman.

*Operations Management Training Program* – develops talent at our automated distribution centers.

*Summer Intern Program* – introduces college students to the diverse opportunities at Handleman.

*"Employer of Choice"* – extends our commitment beyond filling positions to creating an exceptional employment environment through attractive benefits and broad training opportunities.

**Training and Development**

We use our training and development capabilities to promote continuous learning and improvement, creating a strategic advantage over our competition.

*Handleman University* – extends a full curriculum of learning opportunities to Handleman employees through a partnership with Walsh College.

*Sales Representative Training Program* – launches the careers of new sales hires by taking them through a 4-week training program designed by top field sales personnel.

*Values / Vision* – provides direction to all Handleman employees as they make business decisions on behalf of the Company.

*Executive Forum* – expands our horizons by bringing in outside speakers once a quarter to talk about broader issues.


James Piland,
Becky Delahaye,
Michelle Graham,
Gary Hancock,
John Cartwright,
Bridget Ercolani,
Lora Smith,
Customer Teams
Erin Perkins,
Kelly Connolly,
Handleman Online

**Handleman Entertainment Resources**

In its ongoing quest to strengthen its position as the *Indispensable Link* in the music industry supply chain, Handleman Entertainment Resources (H.E.R.) continued to improve the productivity of both the labels it distributed and the stores it served in fiscal 2001. H.E.R. helped its mass merchant customers to outperform the industry yet again, while successfully extending its expertise to new markets, both geographical and technological.

With the launch of Handleman Online, Inc., a business unit dedicated to exploring e-commerce opportunities for music and entertainment, H.E.R. declared its intention to be wherever music consumers might migrate, whether online or off, in a store or at home. Meanwhile, H.E.R. expanded its European footprint, overhauling the United Kingdom-based Lifetime Entertainment operations that it purchased in 1999 (since renamed Handleman UK Ltd.) and introduced the leading-edge Channel of Choice™ systems and services there. These advances helped us win the music distribution business of the third largest supermarket and general merchandising chain in the UK, ASDA, effective February 2001. This added business should boost Handleman's worldwide revenues by approximately 10 percent during the first year of service.

Bolstered by the ASDA volume in the fourth quarter, H.E.R. turned in a solid performance in fiscal year 2001, both in terms of our own growth and that of our customers. H.E.R.'s net music sales grew five percent in fiscal 2001 to $1.06 billion. Against every significant metric in both the U.S. and Canada, H.E.R.'s performance improved. Inventory turns, for example, increased from 7.4 times to 7.8 times, while returns from customers sank to historically low levels. This sort of win/win performance improved not only our own profitability, but that of our mass merchant customers as well. Operating income in fiscal 2001 was up 21 percent as selling, general and administrative (SG&A) costs and inventory investment continued to decline.

**"Music is a fun, tricky, emotional...and very complex category. Channel of Choice™ de-mystifies it. It sets us apart by delivering value to our customers. But it's the H.E.R. professionals that make it work — for retailers in five countries across three continents."**

**— Gerry Lopez**
*Senior Vice President, General Manager of Customer Teams, H.E.R.*

**Channel of Choice™: Making the Complex Simple**

Handleman Entertainment Resources' greatest strength is its ability to distill the complexity of the hit-driven, rapidly changing and intensely local music business into effective merchandising solutions for its mass merchant customers on a store-by-store basis. H.E.R. does more than simply act as a distributor of product. The state-of-the art systems and experienced sales and marketing teams at H.E.R. enable Handleman to act as the "last mile" solution for mass merchant retailers, determining what shoppers want on a localized basis, from a universe of about 300,000 SKUs (stock-keeping units).

Music is a highly dynamic business. Best selling products change weekly, rather than seasonally or annually as with most other merchandise categories. For example, in the U.S., of the 300,000 music selections available in any given year, 220,000 sell 1,000 units or less. Further, of the approximately 35,000 new albums released per year, only about 5,000 ever sell more than 1,000 copies. Handleman helps its customers differentiate their product assortment, driving sales for


**North American Operations**

H World Headquarters, Troy, MI

*Sales Offices*

1 Albany, NY
2 Atlanta, GA
3 Baltimore, MD
4 Chicago, IL
5 Detroit, MI
6 Kansas City, MO
7 Los Angeles, CA
8 Calgary, AB
9 Montreal, QU
10 Toronto, ON

*Automated Distribution Centers*

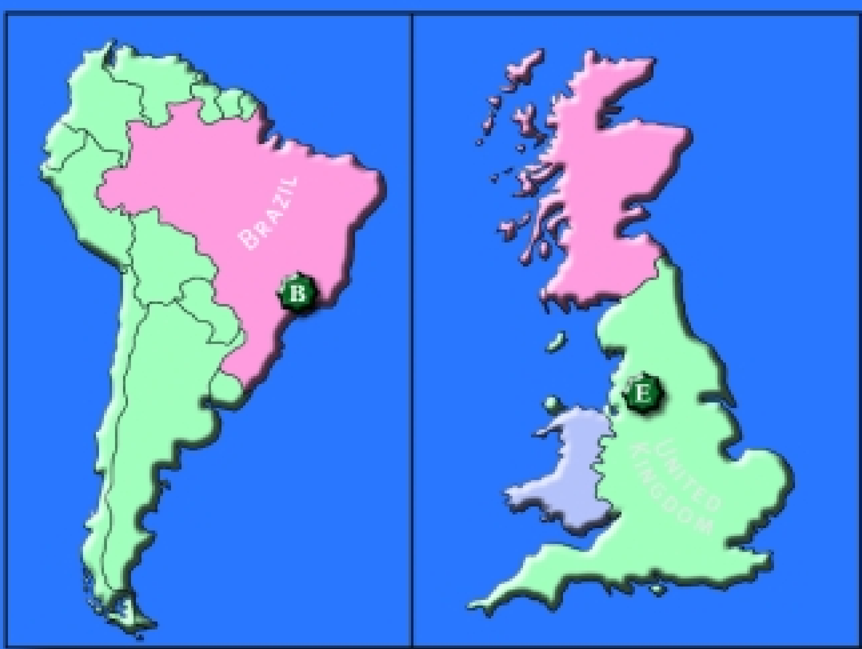
1 Indianapolis, IN
2 Reno, NV
3 Toronto, ON

*North Coast Entertainment*

M Madacy - Montreal, QU
IB itsy bitsy Entertainment Co. - New York, NY
A Anchor Bay Entertainment, Troy, MI

**International Operations**

M Mexico Office & Distribution Center - Mexico City, Mexico
E United Kingdom Office & Distribution Center - Warrington, U.K.
B Brazil Office - Sao Paulo, Brazil



mass merchants in a product category that is difficult and complex to manage, but can add significantly to the bottom line.

With limited space and an average selection of about 3,500 titles per store, Handleman's mass merchant customers have gained considerable market share over the last 10 years as a result of H.E.R.'s Channel of Choice™ software and systems. The reason is simple: we are able to produce customized product assortments for each location based on sales trends, demographic profile and other store-specific characteristics. As a result, Handleman customers sell a disproportionately high volume of popular new albums, up to 25% of the total units sold at retail in the United States for many "hit" releases.

**Field Empowerment**

Music is an intensely local business. In any given month, across the 4,000-odd music departments that we service, there are typically between 300 to 400 different "top-ten" selling titles. Tastes vary from neighborhood to neighborhood and from store to store, depending on the demographic and ethnic composition of the shoppers.

Recognizing this reality, we've placed more of the decision-making authority for local product assortment into the hands of our field organization. In the third year of a multi-year plan, we have expanded the number of regional offices, appointed dozens of new District Managers and are now transitioning our 800-person Field Sales Force to an organization that reinforces in-store execution as the No. 1 priority every day. Toward that end, we enlisted our top sales executives last year to design a four-week training program for new hires to help ensure their immediate success. We introduced flexible selling tools that help field sales representatives implement merchandising programs store-by-store. We've also charged each of our 62 district managers with full accountability for the day-to-day management of a 50 to 60-store music chain, generating between $10 to $14 million in annual revenues.

**International**

Today, Handleman has operations in five markets that together account for half of the world's music sales. In North America, H.E.R. is the largest music distributor and category manager in not only the United States, but also Canada and Mexico. In fact, on any given day, one out of every six CDs sold in Canada is supplied by Handleman. We expect continued solid growth in Canada as we roll out our Channel of Choice™ category management capabilities over the coming year. In Mexico, we've stabilized our operations, driven productivity up to record levels and gained new customers. Further south in Brazil, we operate a service company dedicated to helping Wal-Mart compete effectively with its small store base.

H.E.R. enjoyed its greatest growth during fiscal year 2001 in the United Kingdom with the addition of ASDA. This customer will provide an estimated $100 million in annual revenues. Building on the Lifetime Entertainment business we acquired in 1999, we have leased a new 100,000 square foot facility, migrated our category management platform and are in the process of installing an automated, state-of-the-art distribution system that is expected to be considerably more productive than anything we have operating today. Should the system meet expectations, we have every intention of installing it in our Automated Distribution Centers (ADCs) in the United States and Canada. This is precisely the sort of prudent risk-taking we encourage at Handleman as part of our commitment to continuous learning and improvement.

The third largest music market in the world, the UK gives H.E.R. a presence from which to extend its Channel of Choice™ category management expertise into the European market.

**Conclusion**

Fiscal 2001 was a year of strong accomplishment for H.E.R., during which it refined its core category management business model and successfully transferred it to new markets and distribution media. H.E.R. not only solidified its leadership position as a cutting edge music category manager both in the United States and internationally, it also positioned itself to be a major participant in the distribution of music through new technologies.

David Vasile,
Erin Perkins,
Joe Richards,
Keith Bammel,
Kelly Connolly,
Tony Vecchiato,
David Burchi,
Chris Wend,
Jim Girling,
Handleman Online

While seemingly in its infancy (less than 5% of U.S. music sales), the online distribution of music is a trend that will continue to gain momentum over the next several years, and we at Handleman are well positioned to capitalize on it. Last year, we established a separate business unit, Handleman Online, to oversee a portfolio of e-commerce services designed to meet consumer's evolving music preferences. What distinguishes our efforts in the digital arena is our ability to draw on years of music merchandising experience and assemble a full-service solution for our customers. As shopping platforms and music formats proliferate and ultimately converge, one thing is certain: Handleman will be there, bringing the "right" music to consumers, both offline and online.

At Handleman, we are technology-agnostic. Our value-added is our ability to micro-market music on a local basis and integrate the online experience with our customers' in-store systems. To accomplish this objective in an online environment, we've partnered with leading-edge technology providers, including Muze, Liquid Audio, and IBM, and created best-in-class music solutions in four principal areas.

**"Jupiter Research estimates that a quarter of the music market will migrate online by 2005, some $5.4 billion in sales. Of that total, nearly three quarters will be generated by the sale of physical product shipped to the consumer's home. With the advent of Handleman Online we are positioned to take full advantage of this opportunity."**

**— David Vasile**

*Vice President and General Manager, Handleman Online*

### mFinity™ e-store

We completed development last year of our own full-function entertainment website solution called mFinity™. Targeted at retailers who want to expand their online presence (e-tailers, portals, mass merchants), the mFinity™ application service provider (ASP), is a full-service virtual music store that can be transparently integrated into a retailer's website. Using our "skinning" technology, we can emulate the "look and feel" of the host site, as well as its navigation and "shopping cart" functionality; the consumer is completely unaware that they have left the retailer's site and entered the mFinity™ site maintained by Handleman. mFinity™ is also offered as a stand-alone solution.

mFinity™ can provide information on over 55,000 compact disc titles or digitally download over 150,000 selections through Liquid Audio directly to the consumer's home. In addition, it offers full search capabilities, 30-second song clips, album information and cover art, artist biographies and discographies, the ability to preorder albums in advance of the release date and a full suite of special merchandising and cross-merchandising capabilities. Consumers can compile wish lists, use gift certificates and even rate specific albums for fellow shoppers. Not surprisingly, a major retailer, JC Penney, has already signed on to add an mFinity™ music store to its online catalog site.

### e-fulfillment

Handleman now offers online merchants the opportunity to outsource the "back-end" of their music websites, kiosks and other operations using our e-fulfillment services. By leveraging our state-of-the-art distribution center in Reno, Nevada and dramatically expanding the number of SKUs stocked there, we are now able to fulfill orders to meet the wide range of titles requested by online consumers in the United States in a given year. Our fully automated operations have the capacity to handle 350,000 consumer orders per day for delivery to the home or nearest store via a broad range of shipping options.

Handleman e-fulfillment services also support


Your Source for Music
mF:nity
Music retailing without boundaries
shopping bag
Home | Customer Service | Privacy | Copyright
Search by
Artist
Browse
New Releases
Browse by Artist
Browse by Genre
Alternative
Blues
Country
Jazz
Pop
Rock
Soundtracks
Urban
Dave Matthews Band
Everyday
add to bag
Windows Media Player
Now Playing
Media Guide
CD Audio
Media Library
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Ambience: Niagara
Start
10:20 AM

consumer orders through our mFinity™ e-store and Handleman's Music Mart kiosks. The experience for the consumer is seamless, as everything from the packing slip to the promotional material in the box is branded with the retailer's logo.

**Digital Downloads**

Handleman Online recently partnered with Liquid Audio, the industry leader in digital distribution technology, to provide digital downloads through our online product offerings. Through this joint effort, consumers can download over 150,000 singles and full length albums through our mFinity™ website. Digital content is secured using Digital Rights Management to ensure royalties are paid for each consumer sale. Handleman Online is taking a leading role in establishing the viability of for-sale music downloads in the online retail space and is prepared to capitalize on other emerging digital distribution models.

**Handleman's Music Mart Kiosks**

Interactive in-store music kiosks are customized and branded for each retail customer, with a selection of titles that is targeted to local tastes and demographic composition. Our first-generation kiosk, which is already being tested in Canada, allows consumers to check in-store inventory, listen to clips, access artist information and place an order for home delivery. Handleman's Music Mart kiosks are supported by the same technology as our mFinity™ webstore, thus providing the consumer with the same wide range of information and services. While still in the pilot stages we are gathering valuable insights about how consumers utilize this technology to preview and purchase music. Meanwhile, we've already developed the prototype for our second-generation kiosk, which will enable on-demand manufacturing of compact discs in the store.

Not only are Handleman's Music Mart kiosks a convenience for customers, it is also a cost-saver for retailers in that it allows them to dramatically expand the inventory of music available to consumers without taking on additional inventory costs. If consumers cannot find the title they are looking for at their local mass merchant, they can use the kiosk to order it directly from Handleman's distribution center, which stocks up to 55,000 different titles. Moreover, the kiosks create whole new in-store merchandising and sales opportunities, as the screens can be programmed to support store-specific promotions and special offers.

**mFinity™ can provide information on over 55,000 compact disc titles or digitally download over 150,000 selections directly to the consumer's home. In addition, it offers full search capabilities, 30-second song clips, album information and cover art, artist biographies and discographies, the ability to preorder albums in advance of the release date and a full suite of special merchandising and cross-merchandising capabilities.**

**Conclusion**

By making investments in our online division and developing a full suite of e-commerce offerings, Handleman is providing our customers with industry leading solutions regardless of the channel or format through which consumers purchase music.

Unlike many of the early entrants into this market, we have concentrated on making the right investments to allow us to take a dominant position in the market while using strategic partnerships, where possible, to cost effectively enhance our core offerings. What we've developed is a multi-dimensional business model that can be adapted quickly to ensure our continued success no matter what direction the music industry takes. Handleman Company is well positioned to participate in the growing channel of online music distribution.


Bo Altherr,
Julie Campion,
Kristen Prylow,
Joan Jacob,
Anchor Bay Entertainment

**North Coast Entertainment**

North Coast Entertainment (NCE), the licensed and proprietary products division of Handleman, comprises three companies. Anchor Bay Entertainment is a leading independent home video label and markets a wide selection of titles ranging from children's classics to exercise to horror/suspense on VHS and DVD. Madacy Entertainment is a major independent record label which produces and markets an exciting range of music and video products with a catalog spanning all genres. The itsy bitsy Entertainment Company is a leading licensor of preschool entertainment for young children and their caregivers.

In fiscal year 2001, North Coast Entertainment net sales were $142.7 million, accounting for 12 percent of Handleman's total sales. While Anchor Bay enjoyed a record year, fueled by a surge in DVD sales, results at Madacy and itsy bitsy were down from the prior year. Both divisions invested in the creative development of music and film properties, respectively. We believe these expenditures will extend our business into higher-growth, higher-margin arenas.

**"NCE's entrepreneurial and creative skills are the *Indispensable Link* to its customers and their consumers. We are able to identify and capitalize on emerging trends and see sales and profit opportunities where others do not."**

— Stephen Nadelberg,
*Senior Vice President,*
*President of NCE*

**Anchor Bay Entertainment**

Anchor Bay has carved out a unique niche acquiring and restoring cinematic gems and packaging them in innovative and appealing ways for collectors and movie buffs. The 13th largest home video label, Anchor Bay competes successfully with the major Hollywood studios, and for fiscal year 2001, generated record sales and profits.

Anchor Bay serves two customer segments: mass merchants and specialty entertainment retailers. The Company is successful in both channels, as it offers a comprehensive range of titles in genres that appeal to consumers in both channels. In serving mass merchants, Anchor Bay enjoys success with children's, family and fitness videos. The popular *Thomas the Tank Engine* series generated record sales last year, and *Baby Songs* titles continue to be very popular in the children's category. Recently licensed classic titles, including *One Magic Christmas,* appeal to the family market. As for fitness, Anchor Bay ranks No. 2 in that category, having sold more than one million units of its *Crunch* series alone. Six of the Top 50 VideoScan Fitness videos are Anchor Bay titles, and the company is extending its franchise still further with last year's introduction of a *For Dummies* series of exercise tapes. The first, *Yoga for Dummies*, is already a Top Ten VideoScan title.

When it comes to specialty entertainment retailers, Anchor Bay delivers a truly superior lineup of comedies (*Monty Python's Life of Brian, Tapeheads*), action/fantasy adventures (*The Sword and the Sorcerer*) and horror classics. In fact, Anchor Bay is the "Halloween headquarters" for the video industry with titles such as John Carpenter's *Halloween* and Sam Raimi's *Evil Dead* trilogy. In a recent poll of movie fans conducted by moviedatabase.com, 10 of the 50 best horror movies ever made were Anchor Bay titles. One title that did exceptionally well last year was *Manhunter*, the prequel to *Silence of the Lambs*, which Anchor Bay re-released to coincide with the February 2001 theatrical release of *Hannibal*.


Products representing the diverse North Coast Entertainment family include *Halloween, Manhunter, Teletubbies, Eloise* and *WonderKids.*

The surging popularity of the DVD format is further good news for Anchor Bay, as it gives the company yet another opportunity to sell its "library" of films to consumers upgrading from VHS, as well as to a new generation of strictly DVD consumers. Since DVD early adopters are typically young men, Anchor Bay's strong presence in horror/suspense and action/adventure positions the company well in this market. By the end of fiscal 2001, Anchor Bay offered more than 300 titles on DVD, all packaged with Anchor Bay's inimitable creativity and attention to detail. Anchor Bay's DVDs accounted for an impressive 30 percent of the unit's sales in fiscal 2001.

Anchor Bay has also extended its reach internationally with the establishment of Anchor Bay Entertainment UK Limited, a new independent video company. Anchor Bay Entertainment UK Limited will bring to the United Kingdom the same high quality videos that U.S. film and entertainment enthusiasts have come to expect from Anchor Bay. Moreover, it complements Handleman's international strategy.

**Madacy Entertainment Group**

Calendar 2000 marked the fifth consecutive year Madacy Entertainment was named North America's largest independent record label. With the exclusive rights to more than 100,000 recordings, including pop, classical, dance, country, kids, gospel, and a variety of other genres, Madacy is a major supplier of pre-packaged music compilations. One such album, *20 Classical Favorites*, was Billboard's Top Budget Classical Album for the year 2000 based on unit sales. Madacy also forged alliances and partnerships with SFX Entertainment and PBS to create synergies in product development.

Calendar 2000 also marked the first full year of operation for the Madacy Label Group, which released a number of new albums under its various imprints, including *Barrage* (an internationally renowned, live theater group), a reggae collection called *Reggae Rocks - The Tide Is High*, and *Simple Path*, a debut country album from Madacy's Relentless label recording artist, Irene Kelley. Other releases include albums from such established artists as Sherrie Austin, Merle Haggard, Don McLean, Asleep At The Wheel, and Randy Travis.

Madacy Sports Music dominates the niche genre of sports CDs, creating compilations of original team songs, popular in-arena music and live radio announcer calls.

Madacy also launched other new businesses to spur its growth in particularly "hot" segments of the music market. Madacy Latino is capitalizing on the tremendous growth in this segment, which has grown over 40 percent in the past two years. Madacy Kids, which celebrates its first birthday with sales over 1 million units, released a new children's album, *In My Arms*, from Crystal Gayle, and enjoyed great successes with its *Mommy & Me* and *WonderKids* lines. Madacy Kids continues to expand into other children's categories including pop, dance, and foreign language recordings. Madacy Christian, is already the 5th largest distributor in that genre according to SoundScan.

Madacy's strong relationships with the major record labels, its entertainment marketing expertise and its extensive library of recording masters give the company, and Handleman, a considerable advantage in the music arena.

**The itsy bitsy Entertainment Company**

The itsy bitsy Entertainment Company (TibECo) creates television, feature film programming, consumer products and online entertainment for children and their families. The exclusive marketer of Ragdoll Ltd.'s *Teletubbies* throughout the Americas, TibECo is largely responsible for orchestrating the excitement that has surrounded the series since its debut in 1998. Today, the success of the popular pre-school program continues, and *Teletubbies* is quickly achieving the status of a classic children's brand. Ragdoll recently extended TibECo's rights to market *Teletubbies* and broadcast partner PBS has committed to continue airing the top-rated series.

TibECo also has the rights to the children's storybook character, *Eloise* and is introducing Eloise-inspired products to high-end specialty retailers nationwide. At the same time TibECo is positioning *Eloise* for both big and small screens. The property is perfectly poised to captivate the coveted girls market and capitalize on the strong demand for classic children's properties.

**Conclusion**

Fiscal 2001 was a year in which Anchor Bay achieved record sales and income as it focused on developing its core franchises in children's, family, exercise, and horror/suspense. It was also a year of transition for Madacy and TibECo. Madacy expanded their business into new growth segments to meet changing market conditions, while TibECo refocused their efforts on their core business. Looking forward, NCE's entrepreneurial and creative skills make it well positioned to add value to Handleman Company by providing revenue from a diverse customer base as well as by adding higher margin product to the mix.

# ELEVEN-YEAR REVIEW

*(amounts in thousands except per share data, ratios and percentages)*

| | 2001 | % | 2000 | % | 1999 | % | 1998 | % | 1997 | % |
|---|---|---|---|---|---|---|---|---|---|---|
| **SUMMARY OF OPERATIONS:** | | | | | | | | | | |
| Revenues | $1,192,979 | 100.0 | $1,137,605 | 100.0 | $1,058,553 | 100.0 | $1,104,522 | 100.0 | $1,181,037 | 100.0 |
| Gross profit, after direct product costs* | 296,170 | 24.8 | 288,776 | 25.4 | 266,870 | 25.2 | 270,052 | 24.4 | 274,258 | 23.2 |
| Selling, general & administrative expenses | 224,406 | 18.8 | 219,625 | 19.3 | 211,682 | 20.0 | 243,778 | 22.1 | 250,286 | 21.2 |
| Depreciation and amortization; included in selling, general & administrative expenses | 20,949 | 1.8 | 20,109 | 1.8 | 20,488 | 1.9 | 32,733 | 3.0 | 35,330 | 3.0 |
| Repositioning and related charges, and other unusual charges*** | — | | — | | 96,362 | 9.1 | 13,684 | 1.2 | — | |
| Interest expense, net | 2,632 | .2 | 3,178 | .3 | 8,088 | .8 | 12,319 | 1.1 | 10,967 | .9 |
| Income (loss) before income taxes and minority interest | 69,132 | 5.8 | 65,973 | 5.8 | (49,262) | ** | 271 | ** | 13,005 | 1.1 |
| Income tax expense (benefit) | 26,379 | 2.2 | 26,255 | 2.3 | (16,449) | ** | 2,800 | .3 | 4,909 | .4 |
| Net income (loss) | 42,031 | 3.5 | 38,648 | 3.4 | (35,052) | ** | 312 | ** | 5,352 | .5 |
| Dividends | — | | — | | — | | — | | — | |
| Weighted average number of shares outstanding | | | | | | | | | | |
| Basic | 27,318 | | 29,425 | | 31,568 | | 32,868 | | 33,481 | |
| Diluted | 27,458 | | 29,692 | | 31,818 | | 32,886 | | 33,500 | |
| **PER SHARE DATA:** | | | | | | | | | | |
| Earnings (loss) per share | | | | | | | | | | |
| Basic | $ 1.54 | | $ 1.31 | | $ (1.11) | | $ .01 | | $ .16 | |
| Diluted | 1.53 | | 1.30 | | (1.11) | | .01 | | .16 | |
| Dividends per share | — | | — | | — | | — | | — | |
| **BALANCE SHEET DATA:** | | | | | | | | | | |
| Merchandise inventories | $ 113,348 | | $ 100,298 | | $ 102,589 | | $ 187,173 | | $ 188,215 | |
| Total assets | 590,667 | | 519,683 | | 487,856 | | 613,056 | | 667,886 | |
| Debt, current | 14,571 | | 14,571 | | 18,571 | | 18,571 | | 15,000 | |
| Debt, non-current | 53,014 | | 33,986 | | 39,857 | | 114,768 | | 135,520 | |
| Working capital | 162,867 | | 129,721 | | 152,721 | | 246,916 | | 260,936 | |
| Shareholders' equity | 253,228 | | 223,282 | | 225,686 | | 273,807 | | 283,653 | |
| **FINANCIAL RATIOS:** | | | | | | | | | | |
| Working capital ratio (Current assets/current liabilities) | 1.6 | | 1.5 | | 1.7 | | 2.1 | | 2.1 | |
| Inventory turns (Direct product costs/average inventories throughout year) | 6.8 | | 6.6 | | 5.5 | | 3.9 | | 4.1 | |
| Debt to total capitalization ratio (Debt, non-current/debt, non-current plus shareholders' equity) | 17.3% | | 13.2% | | 15.0% | | 29.5% | | 32.3% | |
| Return on assets (Net income/average assets) | 7.6% | | 7.7% | | ** | | ** | | .8% | |
| Return on beginning shareholders' equity (Net income/beginning shareholders' equity) | 18.8% | | 17.1% | | ** | | .1% | | 1.9% | |

* Amount in fiscal 1996 includes an inventory reduction provision of $14,500

** Not meaningful

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

| 1996 | % | 1995 | % | 1994 | % | 1993 | % | 1992 | % | 1991 | % |
|---|---|---|---|---|---|---|---|---|---|---|---|
| $1,132,607 | 100.0 | $1,226,062 | 100.0 | $1,066,566 | 100.0 | $1,121,705 | 100.0 | $1,020,237 | 100.0 | $702,737 | 100.0 |
| 230,185 | 20.3 | 278,464 | 22.7 | 249,049 | 23.4 | 278,159 | 24.8 | 257,711 | 25.3 | 185,874 | 26.5 |
| 252,377 | 22.3 | 220,511 | 18.0 | 195,199 | 18.3 | 200,561 | 17.9 | 184,438 | 18.1 | 142,881 | 20.3 |
| 36,884 | 3.3 | 31,801 | 2.6 | 31,725 | 3.0 | 30,401 | 2.7 | 27,764 | 2.7 | 15,902 | 2.3 |
| 1,500 | .1 | 5,500 | .4 | 2,000 | .2 | — | | 1,323 | .1 | 3,500 | .5 |
| 12,039 | 1.1 | 8,024 | .7 | 6,211 | .6 | 6,713 | .6 | 7,034 | .7 | 1,606 | .2 |
| (35,731) | ** | 44,429 | 3.6 | 45,639 | 4.3 | 70,885 | 6.3 | 64,916 | 6.4 | 37,887 | 5.4 |
| (12,738) | ** | 17,809 | 1.4 | 17,983 | 1.7 | 27,142 | 2.4 | 24,903 | 2.5 | 14,400 | 2.1 |
| (22,476) | ** | 28,023 | 2.3 | 27,656 | 2.6 | 43,743 | 3.9 | 40,013 | 3.9 | 23,487 | 3.3 |
| 9,070 | | 14,755 | | 14,701 | | 13,589 | | 13,258 | | 13,081 | |
| 33,576 | | 33,518 | | 33,389 | | 33,229 | | 33,166 | | 32,771 | |
| 33,576 | | 33,518 | | 33,389 | | 33,229 | | 33,166 | | 32,771 | |
| $ (.67) | | $ .84 | | $ .83 | | $ 1.32 | | $ 1.21 | | $ .72 | |
| (.67) | | .84 | | .83 | | 1.32 | | 1.21 | | .72 | |
| .27 | | .44 | | .44 | | .41 | | .40 | | .40 | |
| $ 212,700 | | $ 276,109 | | $ 234,594 | | $ 241,502 | | $ 240,369 | | $167,073 | |
| 693,914 | | 754,076 | | 640,998 | | 659,076 | | 655,075 | | 423,727 | |
| 4,000 | | — | | 32,200 | | 17,860 | | — | | 23,600 | |
| 143,600 | | 146,200 | | 76,364 | | 105,702 | | 135,750 | | 15,930 | |
| 245,329 | | 270,970 | | 216,149 | | 241,329 | | 237,151 | | 126,559 | |
| 279,560 | | 311,652 | | 299,493 | | 288,700 | | 260,861 | | 233,614 | |
| 1.9 | | 1.9 | | 1.8 | | 1.9 | | 1.9 | | 1.7 | |
| 3.4 | | 3.5 | | 3.2 | | 3.3 | | 3.5 | | 3.1 | |
| 33.9% | | 31.9% | | 20.3% | | 26.8% | | 34.2% | | 6.4% | |
| ** | | 4.0% | | 4.3% | | 6.7% | | 7.4% | | 5.6% | |
| ** | | 9.4% | | 9.6% | | 16.8% | | 17.1% | | 10.7% | |

The Company has two business segments: Handleman Entertainment Resources ("H.E.R.") and North Coast Entertainment ("NCE"). H.E.R. consists of music category management and distribution operations, principally in North America and the United Kingdom. NCE encompasses the Company's proprietary operations, which include music and video products, as well as licensing operations. All references herein to NCE exclude Sofsource, which was sold during the first quarter of fiscal 1999. Business segment sales discussed herein include intercompany sales which are eliminated in consolidation.

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

| | Years Ended (dollar amounts in millions) | | |
|---|---|---|---|
| | **April 28, 2001** *(52 weeks)* | **April 29, 2000** *(52 weeks)* | **May 1, 1999** *(52 weeks)* |
| **Handleman Entertainment Resources** | $1,064.0 | $1,011.3 | $ 888.4 |
| % of Total | *89.2* | *88.9* | *83.9* |
| **North Coast Entertainment** | 142.7 | 142.0 | 139.0 |
| % of Total | *12.0* | *12.5* | *13.1* |
| **Eliminations, principally NCE sales to H.E.R., net of corporate rental income** | (13.7) | (15.7) | (17.5) |
| % of Total | *(1.2)* | *(1.4)* | *(1.6)* |
| **Exited activities** (1) | -- | -- | 48.7 |
| % of Total | | | *4.6* |
| **TOTAL** | **$1,193.0** | **$1,137.6** | **$1,058.6** |

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

### Comparison of Fiscal 2001 with Fiscal 2000

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

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

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

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

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

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

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

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

The effective income tax rate for fiscal 2001 of 38.2% was lower than the fiscal 2000 tax rate of 39.8%. The decrease in the rate from last year was primarily due to tax benefits resulting from tax planning initiatives. The effective rate for fiscal 2001, was higher than expected due to higher losses at TibECo where no tax benefit on these losses was recognized because TibECo was an unconsolidated subsidiary for income tax purposes for fiscal 2001. The Company expects its effective tax rate for fiscal 2002 to approximate its rate for fiscal 2001.

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

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

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

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

During fiscal 2001, the Company repurchased 1,230,880 shares of its common stock at a cost of $12 million, leaving 26,540,000 shares outstanding as of April 28, 2001. The current stock repurchase program was approved by the Board of Directors in December 2000 and allows the Company to repurchase up to 10% of its outstanding common stock as of that date. Under the current authorization, which has no expiration date, the Company can repurchase in fiscal year 2002 or later approximately 2,100,000 additional shares.

**Comparison of Fiscal 2000 with Fiscal 1999**

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

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

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

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

Direct product costs as a percentage of revenues was 74.6% for fiscal 2000, compared to 74.8% for fiscal 1999. The slight decrease in direct product costs as a percentage of revenues was primarily attributable to the inclusion of higher direct product costs related to product lines exited during fiscal 1999, which had a dampening effect on the prior year's gross profit margin percentage.

In the first quarter of fiscal 1999, the Company's Board of Directors approved a repositioning program which resulted in a $110 million charge during that quarter, representing asset adjustments and cost accruals directly related to the repositioning program. A component of the $110 million charge was a $31.6 million provision for merchandise inventory write-downs required to liquidate inventory through non-traditional channels as a result of the Company exiting certain product lines (video, book and software) and no longer servicing certain customers.

The table below displays the proforma presentation of operations for the fiscal years ended April 29, 2000 and May 1, 1999, as if the inventory write-downs had been included in direct product costs (in millions):

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

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

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

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

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

Accounts receivable, net was $234.0 million at April 29, 2000, compared to $218.0 million at May 1, 1999. This increase was primarily due to the higher level of sales in the fourth quarter of fiscal 2000, compared to the fourth quarter of fiscal 1999.

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

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

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

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

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

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

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

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

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

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

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

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Fiscal 1999 |
|---|---|---|---|---|---|
| Adjustments of assets to net realizable value | $ 84.5 | | | | $ 84.5 |
| Intangibles write-off | 13.0 | | | | 13.0 |
| Other repositioning related costs | 12.5 | 7.0 | 6.9 | 3.5 | 29.9 |
| **Total** | **$ 110.0** | **$7.0** | **$6.9** | **$3.5** | **$127.4** |

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

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

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

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

## LIQUIDITY AND CAPITAL RESOURCES

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

Property and equipment consist primarily of display fixtures, computer hardware and software, warehouse equipment and facilities. The Company also acquires or licenses video and music products which it markets. Purchases of these assets are expected to be funded primarily by cash flow from operations.

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

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

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

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

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

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

**OTHER INFORMATION**

The Company's financial statements have reported amounts based on historical costs which represent dollars of varying purchasing power and do not measure the effects of inflation. If the financial statements had been restated for inflation, net income would have been lower because depreciation expense would have to be increased to reflect the most current costs.

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

* * * * * *

*Information in this report contains forward-looking statements that are not historical facts and involve risk and uncertainties. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements, including, without limitation, conditions in the music industry, ability to enter into profitable agreements with customers in the new businesses outlined in the Company's strategic growth plan, securing funding or providing sufficient cash required to build and grow the new businesses, customer requirements, continuation of satisfactory relationships with existing customers and suppliers, effects of electronic commerce, relationships with the Company's lenders, pricing and competitive pressures, certain global and regional economic conditions, and other factors discussed or detailed from time to time in the Company's filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this report.*

## STATEMENT OF MANAGEMENT RESPONSIBILITY

Management of Handleman Company is responsible for the preparation, integrity and fair presentation of the financial statements and other information included in this Annual Report. The financial statements have been prepared in conformity with generally accepted accounting principles, incorporating, where appropriate, management's best estimates and judgements based on currently available information.

Management believes that the Company's internal control systems provide reasonable assurance that assets are safeguarded, transactions are recorded and reported appropriately, and policies are followed. An important element of the Company's control systems is the ongoing education of the organization in order to promote a control conscious entity. Management's commitment to this program is emphasized through policies and procedures (including a code of conduct), an effective internal audit function and a highly qualified financial staff.

The Company engages independent public accountants who are responsible for performing an independent audit of the financial statements. Their report, which appears herein, is based on obtaining an understanding of the Company's accounting systems and procedures and testing them, as they deem necessary. The Company places no restrictions on the scope of the audit procedures, shares information openly with the independent public accountants, and fully supports their audit process.

The Company's Audit Committee is composed entirely of outside directors and has the powers and responsibilities set forth in the Audit Committee Charter. The Audit Committee meets regularly, and when appropriate separately, with the independent public accountants, the internal auditors and management to review the work of each and to satisfy itself that each is discharging its responsibilities properly. Both the independent public accountants and the internal auditors have unrestricted access to the Audit Committee.

| | | | |
|---|---|---|---|
| Stephen Strome<br>*Chairman and*<br>*Chief Executive Officer* | Peter J. Cline<br>*President and*<br>*Chief Operating Officer* | Leonard A. Brams<br>*Senior Vice President, Finance,*<br>*Chief Financial Officer and*<br>*Secretary* | Thomas C. Braum, Jr.<br>*Vice President and*<br>*Corporate Controller* |

## REPORT OF INDEPENDENT ACCOUNTANTS

PRICEWATERHOUSECOOPERS

**To the Board of Directors and Shareholders of Handleman Company:**

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholders' equity, and of cash flows present fairly, in all material respects, the financial position of Handleman Company and subsidiaries (the "Company") at April 28, 2001, April 29, 2000 and May 1, 1999, and the results of their operations and their cash flows for each of the three years in the period ended April 28, 2001, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

Detroit, Michigan
June 5, 2001

## Consolidated Statement of Income

### Years ended April 28, 2001, April 29, 2000 and May 1, 1999

### (amounts in thousands except per share data)

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Revenues | $ 1,192,979 | $ 1,137,605 | $ 1,058,553 |
| Costs and expenses: | | | |
| Direct product costs | 896,809 | 848,829 | 791,683 |
| Selling, general and administrative expenses | 224,406 | 219,625 | 211,682 |
| Interest expense, net | 2,632 | 3,178 | 8,088 |
| Repositioning and related charges | — | — | 127,362 |
| Gain on sale of subsidiary | — | — | (31,000) |
| Income (loss) before income taxes and minority interest | 69,132 | 65,973 | (49,262) |
| Income tax (expense) benefit | (26,379) | (26,255) | 16,449 |
| Minority interest | (722) | (1,070) | (2,239) |
| Net income (loss) | $ 42,031 | $ 38,648 | $ (35,052) |
| Earnings (loss) per common share | | | |
| Basic | $ 1.54 | $ 1.31 | $ (1.11) |
| Diluted | 1.53 | 1.30 | (1.11) |
| Weighted average number of common shares outstanding during the year | | | |
| Basic | 27,318 | 29,425 | 31,568 |
| Diluted | 27,458 | 29,692 | 31,818 |

## Consolidated Balance Sheet

### Years ended April 28, 2001, April 29, 2000 and May 1, 1999

### (amounts in thousands except share data)

| **ASSETS** | 2001 | 2000 | 1999 |
|---|---|---|---|
| Current assets: | | | |
| Cash and cash equivalents | $ 33,628 | $ 27,510 | $ 27,405 |
| Accounts receivable, less allowance of $16,336 in 2001, $17,383 in 2000 and $13,760 in 1999 for gross profit impact of estimated future returns | 265,280 | 234,005 | 217,968 |
| Merchandise inventories | 113,348 | 100,298 | 102,589 |
| Other current assets | 19,720 | 16,036 | 21,560 |
| Total current assets | 431,976 | 377,849 | 369,522 |
| Property and equipment, net | 56,887 | 51,852 | 53,419 |
| Other assets, net | 101,804 | 89,982 | 64,915 |
| Total assets | $ 590,667 | $ 519,683 | $ 487,856 |
| **LIABILITIES** | | | |
| Current liabilities: | | | |
| Accounts payable | $ 209,766 | $ 202,339 | $ 156,300 |
| Debt, current portion | 14,571 | 14,571 | 18,571 |
| Accrued and other liabilities | 44,772 | 31,218 | 41,930 |
| Total current liabilities | 269,109 | 248,128 | 216,801 |
| Debt, non-current | 53,014 | 33,986 | 39,857 |
| Other liabilities | 15,316 | 14,287 | 5,512 |
| **SHAREHOLDERS' EQUITY** | | | |
| Preferred stock, par value $1.00; 1,000,000 shares authorized; none issued | — | — | — |
| Common stock, $.01 par value; 60,000,000 shares authorized: 26,540,000, 27,691,000 and 31,049,000 shares issued in 2001, 2000 and 1999, respectively | 265 | 277 | 310 |
| Paid-in capital | — | — | 6,828 |
| Foreign currency translation adjustment | (7,479) | (6,449) | (5,220) |
| Unearned compensation | (63) | (443) | (1,557) |
| Retained earnings | 260,505 | 229,897 | 225,325 |
| Total shareholders' equity | 253,228 | 223,282 | 225,686 |
| Total liabilities and shareholders' equity | $ 590,667 | $ 519,683 | $ 487,856 |

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

## Consolidated Statement of Cash Flows

### Years ended April 28, 2001, April 29, 2000 and May 1, 1999

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Net income (loss) | $ 42,031 | $ 38,648 | $ (35,052) |
| Adjustments to reconcile net income (loss) to net cash provided from operating activities: | | | |
| Depreciation | 16,004 | 15,962 | 16,526 |
| Amortization of acquisition costs | 4,945 | 4,147 | 3,962 |
| Recoupment of license advances | 12,992 | 10,793 | 9,478 |
| Loss on disposal of property and equipment | 844 | 1,008 | 590 |
| Repositioning charge | — | — | 110,000 |
| Gain on sale of subsidiary | — | — | (31,000) |
| Loss on sale of book business | — | — | 1,291 |
| (Increase) decrease in accounts receivable | (31,275) | (8,424) | 12,101 |
| (Increase) decrease in merchandise inventories | (13,050) | 5,817 | 79,285 |
| (Increase) decrease in other operating assets | (10,608) | 5,682 | (2,787) |
| Increase (decrease) in accounts payable | 7,427 | 36,113 | (20,795) |
| Increase (decrease) in other operating liabilities | 14,583 | (2,270) | (68,634) |
| Total adjustments | 1,862 | 68,828 | 110,017 |
| Net cash provided from operating activities | 43,893 | 107,476 | 74,965 |
| **Cash flows from investing activities:** | | | |
| Additions to property and equipment | (26,503) | (20,335) | (17,054) |
| Proceeds from disposition of property and equipment | 4,750 | 361 | 4,742 |
| License advances and acquired rights | (22,965) | (30,042) | (13,561) |
| Cash investment in Lifetime Entertainment Limited | — | (6,432) | — |
| Cash investment in The itsy bitsy Entertainment Company, Inc. | — | — | (4,754) |
| Proceeds from sale of subsidiary | — | — | 45,000 |
| Proceeds from sale of book business and other | — | — | 3,308 |
| Net cash provided from (used by) investing activities | (44,718) | (56,448) | 17,681 |
| **Cash flows from financing activities:** | | | |
| Issuances of debt | 1,262,171 | 1,363,621 | 2,142,705 |
| Repayments of debt | (1,243,143) | (1,373,492) | (2,217,616) |
| Repurchase of common stock | (12,055) | (41,983) | (21,009) |
| Other changes in shareholders' equity, net | (30) | 931 | 5,117 |
| Net cash provided from (used by) financing activities | 6,943 | (50,923) | (90,803) |
| Net increase in cash and cash equivalents | 6,118 | 105 | 1,843 |
| Cash and cash equivalents at beginning of year | 27,510 | 27,405 | 25,562 |
| Cash and cash equivalents at end of year | $ 33,628 | $ 27,510 | $ 27,405 |

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

## CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

**YEARS ENDED APRIL 28, 2001, APRIL 29, 2000 AND MAY 1, 1999**
**(AMOUNTS IN THOUSANDS)**

| | Common Stock Shares Issued | Common Stock Amount | Paid-In Capital | Foreign Currency Translation Adjustment | Unearned Compen-sation | Retained Earnings | Total Share-holders' Equity |
|---|---|---|---|---|---|---|---|
| **May 2, 1998** | 31,977 | $ 320 | $ 20,710 | $ (7,600) | $ — | $ 260,377 | $ 273,807 |
| Net loss | | | | | | (35,052) | (35,052) |
| Adjustment for foreign currency translation | | | | 2,380 | | | 2,380 |
| Comprehensive loss, net of tax | | | | | | | (32,672) |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 368 | 4 | 4,290 | | (1,557) | | 2,737 |
| Common stock repurchased | (1,742) | (18) | (20,991) | | | | (21,009) |
| Additional investment in The itsy bitsy Entertainment Company, Inc. | 446 | 4 | 2,819 | | | | 2,823 |
| **May 1, 1999** | 31,049 | 310 | 6,828 | (5,220) | (1,557) | 225,325 | 225,686 |
| Net income | | | | | | 38,648 | 38,648 |
| Adjustment for foreign currency translation | | | | (1,229) | | | (1,229) |
| Comprehensive income, net of tax | | | | | | | 37,419 |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 181 | 2 | 1,559 | | 1,114 | (515) | 2,160 |
| Common stock repurchased | (3,539) | (35) | (8,387) | | | (33,561) | (41,983) |
| **April 29, 2000** | 27,691 | 277 | — | (6,449) | (443) | 229,897 | 223,282 |
| Net income | | | | | | 42,031 | 42,031 |
| Adjustment for foreign currency translation | | | | (1,030) | | | (1,030) |
| Comprehensive income, net of tax | | | | | | | 41,001 |
| Common stock issuances, net of forfeitures, in connection with employee benefit plans | 80 | | | | 380 | 620 | 1,000 |
| Common stock repurchased | (1,231) | (12) | | | | (12,043) | (12,055) |
| **April 28, 2001** | 26,540 | $ 265 | $ — | $ (7,479) | $ (63) | $ 260,505 | $ 253,228 |

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

**1. Accounting Policies:**

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

*Fiscal Year* - The Company's fiscal year ends on the Saturday closest to April 30th. Fiscal years 2001, 2000 and 1999 consisted of 52 weeks.

*Principles of Consolidation* - The consolidated financial statements include the accounts of the Company and all subsidiaries where the Company has voting control. All intercompany accounts and transactions have been eliminated. Minority interest recognized in the statement of income represents the minority shareholders' portion of the income (loss) for less than wholly-owned subsidiaries. The minority interest share of the net assets of these subsidiaries of $4,187,000, $5,000,000 and $5,244,000 as of April 28, 2001, April 29, 2000, and May 1, 1999, respectively, is included in other liabilities in the accompanying consolidated balance sheet. The Company does not have any material equity investments other than in companies in which they have voting control.

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

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

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

*Inventory Valuation* - Merchandise inventories are recorded at the lower of cost (first-in, first-out method) or market. The Company accounts for inventories using the full cost method which includes costs associated with acquiring and preparing inventory for distribution. Costs associated with acquiring and preparing inventory for distribution of $11,086,000, $11,178,000 and $10,980,000 were incurred during the years ended April 28, 2001, April 29, 2000, and May 1, 1999, respectively. Merchandise inventories as of April 28, 2001, April 29, 2000 and May 1, 1999 include $855,000, $843,000 and $892,000, respectively, of such costs.

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

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

| | |
|---|---|
| Display fixtures | 5 years |
| Computer hardware and software | 3-5 years |
| Equipment, furniture and other | 3-10 years |
| Buildings and improvements | 10-40 years |

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

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

*Long-Lived Assets* - At each balance sheet date, management evaluates the carrying value and remaining estimated lives of long-lived assets, including intangible assets, for potential impairment by considering several factors, including management's plans for future operations, recent operating results, market trends and other economic factors relating to the operation to which the assets apply. Recoverability of these assets is measured by a comparison of the carrying amount of such assets to the future undiscounted net cash flows expected to be generated by the assets. If such assets were deemed to be impaired as a result of this measurement, the impairment that would be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset as determined on a discounted basis.

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

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

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

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

**2. Segment Information:**

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

The accounting policies of the segments are the same as those described in Note 1, "Accounting Policies." Segment data includes intersegment revenues, as well as a charge allocating all corporate costs to the operating segments. The Company evaluates performance of its segments and allocates resources to them based on income before interest, income taxes, minority interest and repositioning and related charges ("segment income").

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

| **Fiscal 2001:** | **H.E.R.** | **NCE** | **Total** |
|---|---|---|---|
| Revenues, external customers | $ 1,064,003 | $ 128,887 | $ 1,192,890 |
| Intersegment revenues | — | 13,840 | 13,840 |
| Segment income | 66,123 | 4,271 | 70,394 |
| Total assets | 498,109 | 186,084 | 684,193 |
| Capital expenditures | 22,011 | 4,492 | 26,503 |
| **Fiscal 2000:** | **H.E.R.** | **NCE** | **Total** |
| Revenues, external customers | $ 1,011,323 | $ 126,282 | $ 1,137,605 |
| Intersegment revenues | — | 15,716 | 15,716 |
| Segment income | 54,811 | 14,182 | 68,993 |
| Total assets | 425,743 | 175,468 | 601,211 |
| Capital expenditures | 14,016 | 6,319 | 20,335 |
| **Fiscal 1999:** | **H.E.R.** | **NCE** | **Total** |
| Revenues, external customers | $ 884,670 | $ 124,560 | $ 1,009,230 |
| Intersegment revenues | 3,737 | 14,408 | 18,145 |
| Segment income | 36,099 | 19,973 | 56,072 |
| Total assets | 377,869 | 152,246 | 530,115 |
| Capital expenditures | 13,004 | 4,050 | 17,054 |

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

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Revenues | | | |
| Total segment revenues | $ 1,206,730 | $ 1,153,321 | $ 1,027,375 |
| Revenues from exited activities | — | — | 48,684 |
| Corporate rental income | 89 | — | — |
| Elimination of intersegment revenues | (13,840) | (15,716) | (17,506) |
| Consolidated revenues | $ 1,192,979 | $ 1,137,605 | $ 1,058,553 |
| Income Before Income Taxes | | | |
| Total segment income for reportable segments | $ 70,394 | $ 68,993 | $ 56,072 |
| Segment loss for sold operation (Sofsource) | — | — | (135) |
| Interest revenue | 1,844 | 2,195 | 1,392 |
| Interest expense | (4,476) | (5,373) | (9,480) |
| Repositioning and related charges | — | — | (127,362) |
| Gain on sale of subsidiary | — | — | 31,000 |
| Unallocated corporate (costs) income | 1,370 | 158 | (749) |
| Consolidated income (loss) before income taxes | $ 69,132 | $ 65,973 | $ (49,262) |
| Assets | | | |
| Total segment assets | $ 684,193 | $ 601,211 | $ 530,115 |
| Elimination of intercompany receivables and payables | (93,526) | (81,528) | (42,259) |
| Total consolidated assets | $ 590,667 | $ 519,683 | $ 487,856 |

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

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

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

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

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

**3. Repositioning and Related Charges:**

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

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

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

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

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

| | **Adjustment of Assets to Net Realizable Value** | **Intangibles Write-off** | **Other Repositioning Related Costs, Including Exit Costs** | **Accrued Liability Account** |
|---|---|---|---|---|
| Amount provided during the first quarter ended August 1, 1998 | $ 84,500 | $ 13,000 | $ 12,500 | $ 110,000 |
| Charges in fiscal 1999 resulting from asset write-offs and cash expenditures | (84,500) | (13,334) | (11,935) | (109,769) |
| Reclassify residual intangibles write-off | — | 334 | (334) | — |
| Remaining balance as of May 1, 1999 | $ — | $ — | 231 | 231 |
| Charges in fiscal 2000 resulting from cash expenditures | | | (231) | (231) |
| Remaining balance as of April 29, 2000 | | | $ — | $ — |

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

**4. Pension Plan:**

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

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Change in projected benefit obligation: | | | |
| Benefit obligation at beginning of year | $ 24,684,000 | $ 26,553,000 | $ 24,291,000 |
| Service cost | 1,148,000 | 1,206,000 | 1,109,000 |
| Interest cost | 2,159,000 | 1,820,000 | 1,650,000 |
| Amendments | 1,263,000 | — | — |
| Actuarial (gain)/loss | 5,229,000 | (3,555,000) | 879,000 |
| Benefits paid | (1,009,000) | (1,340,000) | (1,376,000) |
| Benefit obligation at end of year | $ 33,474,000 | $ 24,684,000 | $ 26,553,000 |
| Change in plan assets: | | | |
| Fair value of plan assets at beginning of year | $ 20,174,000 | $ 20,373,000 | $ 20,413,000 |
| Actual return on plan assets | 113,000 | 1,385,000 | 1,422,000 |
| Net realized gain on the sale of assets | 1,117,000 | 1,295,000 | 1,462,000 |
| Unrealized depreciation | (1,125,000) | (1,556,000) | (1,564,000) |
| Company contribution | 1,160,000 | 17,000 | 16,000 |
| Benefits paid | (1,009,000) | (1,340,000) | (1,376,000) |
| Fair value of plan assets at end of year | $ 20,430,000 | $ 20,174,000 | $ 20,373,000 |
| Funded status at end of year | $ (13,044,000) | $ (4,510,000) | $ (6,180,000) |
| Unrecognized net (gain)/loss from past experience different from that assumed | 5,834,000 | (982,000) | 2,039,000 |
| Unrecognized net gain from excess funding | (252,000) | (371,000) | (490,000) |
| Unrecognized prior service cost | 1,705,000 | 644,000 | 708,000 |
| Accrued benefit cost included other liabilities | $ (5,757,000) | $ (5,219,000) | $ (3,923,000) |

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

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Components of net periodic benefit cost: | | | |
| Service cost | $ 1,148,000 | $ 1,206,000 | $ 1,109,000 |
| Interest cost | 2,159,000 | 1,820,000 | 1,650,000 |
| Expected return on plan assets | (1,744,000) | (1,696,000) | (1,701,000) |
| Amortization of unrecognized transition asset, prior service cost and actuarial gain | 135,000 | (16,000) | 65,000 |
| Net periodic benefit cost | $ 1,698,000 | $ 1,314,000 | $ 1,123,000 |

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

**5. Debt:**

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

In fiscal 1995, the Company entered into a $100,000,000 senior note agreement, as amended, with a group of insurance companies. These notes bear interest at rates of 8.51% or 8.84%.

Scheduled maturities for the senior note agreement as of April 28, 2001 are as follows:

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

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

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

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

**6. Income Taxes:**

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

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

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

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

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

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

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

| | April 28, 2001 | | April 29, 2000 | | May 1, 1999 | |
|---|---|---|---|---|---|---|
| | Deferred Tax Assets | Deferred Tax Liabilities | Deferred Tax Assets | Deferred Tax Liabilities | Deferred Tax Assets | Deferred Tax Liabilities |
| Allowances | $ 14,146,000 | $ 5,202,000 | $ 13,585,000 | $ 6,618,000 | $ 13,615,000 | $ 8,783,000 |
| Carryforward losses | 14,594,000 | — | 10,600,000 | — | 8,300,000 | — |
| Employee benefits | 4,795,000 | 56,000 | 2,251,000 | 95,000 | 4,788,000 | — |
| Property & equipment | 1,163,000 | 5,666,000 | 2,802,000 | 6,075,000 | 8,327,000 | 6,656,000 |
| Inventory | 178,000 | 538,000 | 271,000 | 374,000 | 366,000 | 1,587,000 |
| Other | 3,710,000 | 347,000 | 1,531,000 | 83,000 | 1,734,000 | — |
| | 38,586,000 | 11,809,000 | 31,040,000 | 13,245,000 | 37,130,000 | 17,026,000 |
| Valuation allowance | (11,600,000) | — | (8,600,000) | — | (6,300,000) | — |
| Net | $ 26,986,000 | $ 11,809,000 | $ 22,440,000 | $ 13,245,000 | $ 30,830,000 | $ 17,026,000 |

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

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

**7. Property and Equipment:**

Property and equipment consists of the following:

| | 2001 | 2000 | 1999 |
|---|---|---|---|
| Land | $ 1,233,000 | $ 3,078,000 | $ 3,354,000 |
| Buildings and improvements | 14,621,000 | 17,126,000 | 16,227,000 |
| Display fixtures | 34,627,000 | 52,362,000 | 45,486,000 |
| Computer hardware and software | 34,110,000 | 22,475,000 | 12,607,000 |
| Equipment, furniture and other | 34,192,000 | 27,207,000 | 31,223,000 |
| | 118,783,000 | 122,248,000 | 108,897,000 |
| Less accumulated depreciation | 61,896,000 | 70,396,000 | 55,478,000 |
| | $ 56,887,000 | $ 51,852,000 | $ 53,419,000 |

**8. Stock Plans:**

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

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

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

| | Number of Shares | Weighted Average Price |
|---|---|---|
| Balance, May 2, 1998 | 1,407,419 | $ 10.24 |
| Granted | 292,100 | 12.06 |
| Terminated | (278,919) | 11.60 |
| Exercised | (257,962) | 9.61 |
| Balance, May 1, 1999 | 1,162,638 | 10.53 |
| Granted | 450,200 | 11.30 |
| Terminated | (88,597) | 16.42 |
| Exercised | (117,214) | 8.89 |
| Balance April 29, 2000 | 1,407,027 | 10.55 |
| Granted | 499,594 | 10.31 |
| Terminated | (171,899) | 12.39 |
| Exercised | (55,069) | 6.96 |
| Balance April 28, 2001 | 1,679,653 | $ 10.42 |
| Number of shares exercisable at April 28, 2001 | 851,614 | $ 10.59 |

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

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

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

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

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

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

**9. Quarterly Financial Summary (unaudited):**
(amounts in thousands except per share data)

| | For the Three Months Ended | | | |
|---|---|---|---|---|
| **Fiscal Year 2001** | **July 29, 2000** | **Oct. 28, 2000** | **Jan. 31, 2001** | **April 28, 2001** |
| Revenues | $231,435 | $297,593 | $348,974 | $314,977 |
| Income before income taxes and minority interest | 2,983 | 23,609 | 23,284 | 19,256 |
| Net income | 1,742 | 14,142 | 16,256 | 9,891 |
| Earnings per share - basic and diluted | .06 | .51 | .60 | .37 |

| **Fiscal Year 2000** | **July 31, 1999** | **Oct. 30, 1999** | **Jan. 31, 2000** | **April 29, 2000** |
|---|---|---|---|---|
| Revenues | $226,357 | $288,855 | $343,246 | $279,147 |
| Income before income taxes and minority interest | 1,686 | 23,487 | 25,131 | 15,669 |
| Net income | 682 | 13,479 | 14,660 | 9,828 |
| Earnings per share - basic and diluted | .02 | .45 | .50 | .35 |

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

## Directors

**John M. Barth** [1, 3]
*President and Chief Operating Officer*
Johnson Controls, Inc.

**Elizabeth A. Chappell** [1, 2]
*Business Consultant*
Private Practice

**Richard H. Cummings** [1]
*Retired Senior Vice Chairman*
NBD Bancorp, Inc. and NBD Bank

**David Handleman**
*Chairman Emeritus of the Board*

**James B. Nicholson** [2, 3]
*President and Chief Executive Officer*
PVS Chemicals, Inc.

**Sandra E. Peterson** (Elected May 3, 2001)
*Senior Vice President, Health Businesses*
Merck-Medco, wholly owned subsidiary of
Merck & Co.

**Lloyd E. Reuss** [2, 3]
*Retired President*
General Motors Corporation

**Alan E. Schwartz** [3]
*Partner*
Honigman Miller Schwartz and Cohn
which serves as General Counsel to the Company

**Stephen Strome**
*Chairman of the Board and Chief Executive Officer*

1. Audit Committee 2. Compensation and Stock Option Committee 3. Corporate Governance and Nominating Committee

## Senior Corporate Management

**Stephen Strome**
*Chairman of the Board and Chief Executive Officer*

**Peter J. Cline**
*President and Chief Operating Officer*

**Mark J. Albrecht**
*Senior Vice President, Human Resources and Orgazinational Development*

**Leonard A. Brams***
*Senior Vice President, Finance, Chief Financial Officer and Secretary*

**Gerardo I. Lopez**
*Senior Vice President,*
*General Manager of Customer Teams, H.E.R.*

**Samuel Milicia**
*Senior Vice President, Music Product*

**Stephen Nadelberg**
*Senior Vice President, President of North Coast Entertainment*

**Bob Sausa**
*Senior Vice President, Chief Information Officer*

*Effective July 12, 2001, Thomas C. Braum, Jr. was elected Senior Vice President and Chief Financial Officer.

## Corporate Directory

### Executive Offices
500 Kirts Boulevard
Troy, Michigan 48084-4142
248-362-4400

### Investor Relations Contact
Greg Mize
*Assistant Vice President,*
*Investor Relations*
248-362-4400, Ext. 211

### Form 10-K
A copy of the Form 10-K filed with the Securities and Exchange Commission for the year ended April 28, 2001 is available free of charge on our website, www.handleman.com. Written requests for Form 10-K may be directed to Investor Relations at the Executive Offices.

### Annual Meeting
The Annual Meeting of Shareholders will be held September 10, 2001 at 2:00 p.m. at the Somerset Inn, 2601 West Big Beaver Road, Troy, Michigan 48084.

### Independent Accountants
PricewaterhouseCoopers LLP
Detroit, Michigan

### General Counsel
Honigman Miller Schwartz and Cohn
Detroit, Michigan

### Registrar of Stock and Stock Transfer Agent
Fifth Third Bank
Corporate Trust Administration
38 Fountain Square Plaza MD 10AT60-3212
Cincinnati, Ohio 45263

Should you wish to communicate with Fifth Third Bank about your common stock holdings by telephone, you may do so by calling: 800-837-2755.

## Location of Facilities

United States, Canada, United Kingdom, Mexico and Brazil

## Stock Listing

Common shares of the Company are traded on the New York Stock Exchange under the symbol **HDL**. Following is a summary of the market price of the Company's common stock:

| | Fiscal Year Ended | | | |
|---|---|---|---|---|
| | **April 28, 2001** | | **April 29, 2000** | |
| **Quarter** | *Low* | *High* | *Low* | *High* |
| First | $8.75 | $12.88 | $10.75 | $14.50 |
| Second | 9.81 | 13.44 | 9.38 | 16.38 |
| Third | 6.44 | 10.75 | 9.75 | 17.00 |
| Fourth | 8.57 | 11.60 | 8.50 | 12.88 |
| **Year End Close Price** | **11.29** | | **12.00** | |

Designed and Produced by Handleman Company

Handleman Company

NYSE: HDL

www.handleman.com