HANDLEMAN CO /MI/
Form 10-K
August 13, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended May 3, 2008

or

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

Commission file number 1-7923

HANDLEMAN COMPANY

(Exact name of registrant as specified in its charter)

MICHIGAN	**38-1242806**
(State or other jurisdiction of incorporation or organization)	**(I.R.S.Employer Identification No.)**
500 Kirts Boulevard, Troy, Michigan	**48084-5225**
(Address of principal executive offices)	**(Zip Code)**

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

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

Title of each class	Name of each exchange on which registered
COMMON STOCK $.01 PAR VALUE	**PINK SHEET ELECTRONIC QUOTATION SERVICE**

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ¨ NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ¨NO x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. YES x NO ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer ¨ Accelerated filer ¨ Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act.). YES ¨ NO x

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant s most recently completed second fiscal quarter. The aggregate market value as of October 27, 2007 was $41,213,000.

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date. The number of shares of common stock outstanding as of July 11, 2008 was 20,450,893.

DOCUMENTS INCORPORATED BY REFERENCE

Handleman Company s definitive Proxy Statement to be filed for the 2008 Annual Meeting of Shareholders is incorporated by reference into Part III, with the exception of the Corporate Governance and Nominating Committee Charter and the Audit Committee Charter contained therein.

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PART I

Item 1. BUSINESS

Handleman Company, a Michigan corporation (herein referred to as the Company or Handleman or Registrant), which has its executive offices in Troy, Michigan, is the successor to a proprietorship formed in 1934, and to a partnership formed in 1937. Handleman Company operated as a category manager and distributor of prerecorded music and console video game hardware, software and accessories to leading retailers in the United States (U.S.), United Kingdom (UK) and Canada.

Copies of the Forms 10-K, Forms 10-Q, Forms 8-K, all amendments to those reports and certain other materials are available, as soon as reasonably practicable after said material is electronically filed with or furnished to the Securities and Exchange Commission, free of charge on the Registrant s website, www.handleman.com.

RECENT DEVELOPMENTS

In recent years, music industry sales have declined at double-digit rates as the industry was impacted by digital distribution, downloading and piracy. In addition, the Company s gross margins were compressed because lower-margin promotional products became a greater proportion of annual sales. This level of continued erosion of CD music sales is expected to continue into the foreseeable future. In response to this dramatic decline, the Company implemented significant cost reduction plans to reduce expenses and streamline operations. These plans included work force reductions; the consolidation of the operations of two U.S. automated distribution facilities into one facility; the reduction of benefits programs and realignment of medical plans; initiatives to reduce customer product returns; and various other cost cutting initiatives. However, the reduction in music sales volume and the loss of gross margin outpaced the Company s ability to reduce overhead costs; as a result, the Company experienced steep operating losses in the past two fiscal years.

The Company s customers have responded to the decline in music industry sales by contracting the amount of retail space devoted to music sales.

Additionally, the Company violated certain debt covenants within its credit agreements in the fourth quarter of fiscal 2008, which ended May 3, 2008. Those violations were cured soon thereafter by an amendment to the credit facilities. In recent months, trade creditors have expressed concern about whether the Company might be contemplating or be required to file a bankruptcy proceeding. As a result, the Company became concerned about whether it would have access to sufficient financing and vendor credit to meet its business needs.

As a result of concerns about the prospects for the music business and the availability of financing, in April 2008 the Board of Directors of the Company approved that management proceed with the sale of the U.S. and Canadian operations, which were actively being marketed as of May 3, 2008. On June 2, 2008, Handleman announced that it is exiting the music business in North America and that it had sold a portion of its U.S. inventory and its U.S. music business related to Wal-Mart Stores, Inc. (Wal-Mart) to Anderson Merchandisers L.P. (Anderson). Handleman also announced that it will work with its other non-Wal-Mart U.S. customers to achieve a smooth transition to other music suppliers, which is expected to occur by the end of August 2008. Further, Handleman executed a definitive agreement with Anderson in July 2008 for the sale of all of the inventory and fixed assets and all operations of its Canadian subsidiary, Handleman Canada. The closing on the sale of assets of Handleman Canada is subject to Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009; the closing will occur shortly thereafter.

Handleman s other operations include Crave Entertainment Group, Inc. (Crave), a full-service distributor of video game software, hardware and related accessories, and a specialty video game publisher; Handleman UK Limited (Handleman UK), a UK-based distributor and store merchandiser of music, video, books, computer games and other products; Artist to Market Distribution (A2M), an independent music distributor that works directly with branded artists and artists management to streamline the supply chain and deliver new music product to the marketplace at a lower cost; and REPS LLC (REPS), a national in-store merchandiser.

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Handleman retained the investment banking firm W.Y. Campbell & Company in April 2008 for the purpose of exploring a possible sale or other strategic options for Crave. In June 2008, an Offering Memorandum was completed and the Company began actively marketing Crave for sale at that time. In the first quarter of fiscal 2009, the Company also broadened the scope for W.Y. Campbell & Company to include strategic initiatives related to REPS as well.

Further, Handleman is in discussions and has reached an agreement in principle with Tesco Stores Limited (Tesco) in the UK regarding the sale of certain of its Handleman UK assets and operations. Handleman has also signed an agreement for the sale of A2M assets in July 2008 for $357,000, which primarily included inventory and intellectual property.

Handleman believes that its decision to exit the music business was the best strategic decision for its shareholders. Further, Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company s day-to-day operations provided the Company is able to sell its assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company s liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If the Company is able to generate cash proceeds in excess of what is needed to satisfy the Company s debt obligations, the Company is considering the possibility of distributing any such proceeds to shareholders rather than pursue reinvestment opportunities.

Credit Agreements

On April 30, 2007, Handleman and certain of its subsidiaries entered into two five-year credit agreements, as amended, that constituted a $250 million multi-tranche credit facility. These agreements contain several operating and financial covenants that include restrictions on dividends and share repurchases, acquisitions and investments, indebtedness, prepayments, liens and affiliate transactions, capital structure and business, guaranteed indebtedness and asset sales. In addition, Handleman must maintain a minimum excess availability in order to borrow under these agreements. The level of indebtedness and the associated covenants affect the Company s operations.

Management believes that cash provided from operations and asset sales could provide sufficient liquidity to fund the Company s day-to-day operations provided that the Company is able to sell its remaining assets within a reasonable period of time. If the Company receives substantially less than anticipated, the Company s liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If these actions are unsuccessful, then the Company s ability to continue as a going concern could be in doubt. See the discussion under Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources, and Note 8 of Notes to Consolidated Financial Statements for detailed information related to the new credit agreements.

Stock Delisting

Effective March 26, 2008, Handleman Company s stock began trading on the Pink Sheet Electronic Quotation Service, trading symbol HDLM.PK . Prior to March 19, 2008, Handleman s stock traded on the New York Stock Exchange Euronext (NYSE), under the symbol HDL. Handleman s stock was delisted by the NYSE prior to the NYSE market opening on March 25, 2008. The NYSE s determination resulted from the Company s average market capitalization over a consecutive thirty trading-day period being below the NYSE minimum quantitative continued listing criteria of $25 million.

Going Concern

The Company s financial statements have been presented on the basis that it is a going concern, which contemplates the continuity of operations, realization of assets and the satisfaction of liabilities in the ordinary course of business. As discussed in Notes 2 and 8 of Notes to Consolidated Financial

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Statements, the Company has been unable to obtain additional financing to satisfy its operating and capital requirements through May 2, 2009. In addition, in April 2008, the Company s Board of Directors approved exiting the music business in North America. The Company announced this decision in the first quarter of fiscal 2009, along with the announcement that it began marketing its Crave subsidiary, selling certain assets in the United Kingdom, as well as seeking other strategic alternatives for its remaining entities. These factors, among others, raise doubt about the Company s ability to continue as a going concern. The Company s independent registered public accounting firm issued a going concern audit opinion on the Company s financial statements as of May 3, 2008.

ASDA Supply Arrangements

During the third quarter of fiscal 2008, Handleman UK determined, in conjunction with its customer ASDA, a subsidiary of Wal-Mart Stores, Inc., that their business relationship related to the greeting cards business would terminate in May 2008. Under this arrangement, which began in October 2006, Handleman UK provided the distribution and servicing of greeting cards to ASDA stores. The Company was unable to negotiate a fee arrangement with ASDA that would be sufficient to cover the related operating costs. Greeting card sales to ASDA represented $71.4 million of the Company s consolidated revenues for the fiscal year ended May 3, 2008 (fiscal 2008) and $39.3 million of consolidated revenues for the fiscal year ended April 28, 2007 (fiscal 2007).

During the first quarter of fiscal 2008, the Company announced that Handleman UK and ASDA decided not to continue their music supply arrangement. Under this arrangement, Handleman UK provided category management and distribution of music CD s and, to a limited extent, DVD s to ASDA stores. The decision not to continue the music supply arrangement was due to the inability of Handleman UK and ASDA to reach terms that were mutually beneficial. Handleman UK continued to provide music category management and distribution services to ASDA through August 2007. Sales to ASDA under the music supply arrangement represented $57.3 million of the consolidated revenues for the first four months of fiscal 2008 (through the agreed upon termination date), and $268.0 million of the Company s consolidated revenues during fiscal 2007.

Tesco Supply Agreement

Handleman UK began providing distribution, replenishment and store merchandising services to Tesco in support of its entertainment business - specifically music, video and video games in the first quarter of fiscal 2008. Tesco, the largest supermarket and general merchandise retailer in the United Kingdom, is also one of the world s leading international retailers. Under the arrangement, Tesco retained ownership title to the inventory, which was housed in and distributed from a Handleman UK distribution facility. This arrangement was characterized as a fee-for-service model, whereby Handleman UK s revenue was based upon fee per unit charges related to distribution services and hourly rate charges related to merchandising services provided by Handleman UK s field sales organization. This agreement allowed Handleman Company to extend its core services to over 700 Tesco stores in the United Kingdom. Revenues for this new business model with Tesco generated $50.0 million of consolidated revenues for the Company since inception in the first quarter of fiscal 2008.

Subsequently, in the first quarter of fiscal 2009, Handleman began actively marketing for sale certain Handleman UK assets, began negotiations and reached an agreement in principle to sell certain assets and operations of Handleman UK related to the Tesco business, and certain of the Company s corporate intellectual properties to Tesco. Following its discontinuance of business with ASDA and Tesco, Handleman UK will have no on-going business operations and Handleman UK will be wound down as quickly as possible.

Change in Certifying Accountant

On March 20, 2008, the Company s Board of Directors approved Grant Thornton LLP as its new independent registered public accounting firm, replacing PricewaterhouseCoopers LLP. During the Company s fiscal years ended April 29, 2006 and April 28, 2007 and through March 20, 2008, Grant Thornton LLP served as the independent registered public accounting firm for the Company s benefit plans.

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Change in Executive Management

On November 28, 2007, Mr. Stephen Strome resigned from his position as Chief Executive Officer and as a Director for Handleman s Board of Directors. Handleman appointed Mr. Albert A. Koch as President and Chief Executive Officer, through Handleman s engagement of AP Services, LLC. AP Services is affiliated with Alix Partners, a financial advisory and consulting firm, where Mr. Koch is Vice Chairman, Managing Director and Partner.

On February 18, 2008, Thomas C. Braum resigned from his position as Executive Vice President and Chief Financial Officer. Handleman appointed Mr. Khaled Haram who served in that role until June 30, 2008. Mr. Haram had been with Handleman Company since April 2006 when he was hired as Senior Vice President and Chief Information Officer. In 2007, he assumed the responsibility for Handleman UK. On June 30, 2008, Handleman appointed Ms. Rozanne Kokko as Senior Vice President and Chief Financial Officer to replace Mr. Haram who had resigned. Ms. Kokko has been with Handleman since 1997 when she was hired as Director of Internal Audit. During her 11 years at Handleman, she has held positions in both business and finance including, Senior Vice President, Finance and National Team; Vice President General Manager for the Wal-Mart U.S. Customer Team in Bentonville, Arkansas; Vice President, General Manager for the National Customer Team, which included Kmart, Shopko and Pamida; and Vice President of Finance.

DESCRIPTION OF BUSINESS

During fiscal 2008, Handleman Company had the following reporting segments: category management and distribution operations, video game operations and all other. As a category manager and distributor of product, the Company created value for its customers by leveraging its core competencies of logistic services, field services and intellectual services. During fiscal 2008, the Company predominately provided full category management services for prerecorded music product to leading retail chains in the U.S., Canada and UK. As discussed previously, the Company has substantially exited or is exiting the music category management and distribution operations in the U.S. and Canada during fiscal 2009. In accordance with accounting guidance, the U.S. and Canadian operations have been classified as discontinued operations for financial reporting purposes. The video game operations are related to Crave and the all other segment primarily represents REPS.

The following table sets forth revenues from continuing operations and the percentage contribution to consolidated revenues for fiscal 2008 and 2007 (in millions of dollars):

	Fiscal Years Ended	
	May 3, 2008 (53 weeks)	**April 28, 2007 (52 weeks)**
Category management and distribution operations	$ 219.5	$ 322.7
% of Total	*44.4*	*57.8*
Video game operations	259.6	219.7
% of Total	*52.5*	*39.3*
All other	44.2	45.2
% of Total	*8.9*	*8.1*
Corporate income, including eliminations	(28.7)	(29.2)
% of Total	*(5.8)*	*(5.2)*

Total revenues from continuing operations	$ 494.6	$ 558.4

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Category Management and Distribution Operations

As a category manager and distributor of pre-recorded music, the Company created value for its customers by leveraging its core competencies of intellectual services, field services and logistic services. Using these competencies, the Company managed the selection, acquisition, delivery, retail ticketing, display and return of music product for the Company s retail customers (retailers) stores. The Company distributed throughout vast geographic regions, but adapted individual store selections to local tastes.

The music industry, in which the Company predominately operated, is seasonal in nature. As a result, certain working capital items have been higher at some interim reporting dates than at others. For example, inventory and accounts payable were typically higher at the end of the Company s second quarter as a result of increased inventory purchases in anticipation of higher holiday season shipments, whereas accounts receivable was typically higher at the end of the Company s third quarter due to holiday season shipments not yet paid by customers.

Vendors

The Company purchased from many different vendors. The volume of purchases from individual vendors fluctuated from year to year based upon the salability of selections being offered by such vendors. Though a small number of major, financially sound vendors accounted for a high percentage of purchases, Handleman selected product from a variety of additional vendors in order to maintain the appropriate product selection for its customer s consumers.

As the public s taste for the products the Company supplied was broad and varied, Handleman was required to maintain sufficient inventories to satisfy diverse tastes. The Company minimized the effect of obsolescence through planned purchasing methods and computerized inventory controls. Because substantially all vendors from which the Company purchased product offered some level of return allowances and price protection, Handleman reduced its exposure to markdown risk unless vendors were unable to fulfill their return obligations or non-salable product purchases exceeded vendor return limitations. Vendors offered a variety of charge-based return programs whereby, a penalty was charged based on a per unit rate or a percentage of product value. Accordingly, the Company may have possessed in its inventories non-salable product that could only be returned to vendors with cost penalties or may have been non-returnable until the Company could comply with the provisions of the vendors return policies.

The Company generally did not have distribution contracts with its vendors; consequently, either party could have discontinued the relationship without notice.

Customers

The Company s customers were leading retailers in the U.S., Canada and the UK, who benefited from the services Handleman provided for a variety of reasons. The Company selected products to be sold in their customers stores from a multitude of vendors that offered numerous titles, different formats (e.g., compact discs, music DVDs) and different payment and return arrangements. In addition, Handleman relieved its customers from the complexity of managing the numerous stock keeping units (SKUs) required per department, the variability of salable items among individual stores of a retailer, the wide array of programs offered by the multitude of vendors, the hits nature of the business and the risk of inventory obsolescence.

Operations

The Company distributed products from its facilities in North America and the United Kingdom. In addition to economies of scale and through-put considerations in determining the number of facilities it operated, the Company also considered freight costs to and from customers stores and the importance of timely delivery of new releases. Due to the nature of the music business, display of new releases close to vendor authorized street dates is an important driver of both retail sales and customer satisfaction.

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The Company utilized its proprietary systems and a third party Enterprise Resource Planning suite of software products to automate and integrate the functions of ordering product, receiving, warehousing, order fulfillment, ticket printing and perpetual inventory maintenance. The inventory management system also provided the basis for title specific billing that allowed the Company to better serve its customers.

The Company has automated distribution equipment in its distribution facilities located in Indianapolis, Indiana; Toronto, Ontario; Warrington, United Kingdom; and Bolton, United Kingdom. On May 4, 2007, the Company ceased operations at its automated distribution facility in Richmond, Virginia as part of its cost savings measures. Handleman began marketing the lease on the Indianapolis, Indiana distribution facility in the first quarter of fiscal 2009. The Toronto, Ontario facility lease is expected to be assigned to Anderson in connection with the Canadian asset purchase agreement, and Tesco is expected to assume the lease for the Bolton, United Kingdom facility at the close of that asset purchase agreement. Handleman is seeking a sub-lessor for the Warrington, United Kingdom facility.

Competition

Handleman was primarily a category manager of music products, whose business was highly competitive as to both price and alternative supply arrangements. Besides competition among the Company s customers, the Company s customers competed with alternative sources from which consumers could acquire the same product, such as (1) internet direct sales, including direct-to-home shipment and direct downloading through a consumer s home computer, (2) downloading through cellular telephones, (3) music product piracy via the internet, (4) specialty retail outlets, (5) electronic specialty stores, and (6) record clubs. The market is continually introducing new methods of in-home delivery of entertainment software products. The Company was also in direct competition for sales to its customers with (1) manufacturers that bypass wholesalers and sell directly to retailers, (2) independent distributors, and (3) other category managers. In addition, some large retailers have vertically integrated so as to provide their own category management and/or in-store merchandising. Some of these companies, however, also purchase from independent category managers.

Other Developments

On May 4, 2007, the Company ceased distribution operations at its Richmond, Virginia automated distribution center facility. In accordance with accounting guidelines, the Company recorded associated shut down costs during the first quarter of fiscal 2008. Additionally, the Company recorded related severance costs in the fourth quarter of 2007, the amount of which was immaterial. The Company planned to utilize the Richmond, Virginia fixed assets, including machinery and equipment, in its other U.S. distribution facility.

Video Game Operations

Video game operations, an operating segment for Handleman Company was added as a result of the Company s acquisition of Crave Entertainment Group, Inc. on November 22, 2005. As previously discussed, the Company has retained an investment banking firm for the purpose of exploring a possible sale or other strategic options for Crave.

Crave, through one of its subsidiary companies, purchases video game software, hardware and accessories from first and third party hardware and software manufacturers, which support all Sony, Nintendo and Microsoft video game platforms. Crave specializes in the value-priced game category, which carries retail prices ranging from $9.99 to $19.99. As a distributor, Crave may enter into exclusive distribution agreements with these video game suppliers. Under these exclusive distribution agreements, Crave has the right to sole distribution of the agreed upon video software games. During the past fiscal year, exclusive distribution arrangements represented a greater portion of Crave s video game business. The agreements vary by supplier and may obligate Crave to pay minimum distribution fees or purchase a specified number of units over a designated period of time. Payments under these exclusive distribution agreements are usually made at the time the agreements are signed, at the time of manufacturing, or in some instances, at the time of product receipt by Crave. Under certain of these exclusive distribution agreements, additional payments to these suppliers may be required if pre-defined minimum purchase volumes are exceeded.

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Products are distributed from the Company s automated distribution center in Indianapolis, Indiana and are shipped directly to major retailers throughout the United States. Many retailers utilize third-party distributors, like Crave, due to the flexibility offered for distribution and packaging needs that cannot always be satisfied dealing directly with the publisher. Crave also offers its retail customers:

- integrated vendor managed inventory;
- direct-to-store shipments of shelf ready products;
- assortment planning and product procurement;
- promotional planning and execution;
- merchandising and display support; and
- dedicated support personnel.

Crave, through another subsidiary company, also publishes video game titles under its Crave Entertainment brand. Titles are released in the value-price category and are distributed by Crave. As a publisher, Crave incurs obligations to contracted video game software developers and, in some cases obligations to intellectual property right holders.

Under its software development agreements, payments are typically based on the achievement of defined milestones, which vary by agreement. Such milestones include payments due at the signing of the agreements, design and/or technical achievements and delivery of completed product; these advances are typically not refundable. Certain software development agreements may require Crave to make additional payments based on pre-defined sales volumes. These developed games are the property of Crave.

Under Crave s intellectual property licensing agreements, payments are made to licensors in exchange for the rights to utilize intellectual properties owned by the licensors (e.g. popular animated characters, including all designs, themes and story lines) that may be used in the development of video game software. Payments to licensors allow Crave the limited right to use these intellectual properties, and at no time does Crave take ownership of these intellectual properties. Advances under these licensing agreements typically occur at the signing of the agreements and are not refundable. Certain intellectual property licensing agreements may require Crave to make additional payments based on sales volumes.

<u>All Other</u>

The all other segment primarily represents REPS LLC. The Company acquired REPS during fiscal 2006. REPS provides nationwide in-store merchandising for home entertainment and consumer product brand owners at mass merchant, warehouse club and specialty retailers. Following the acquisition, the Company integrated the field service operations of Handleman Company s category management and distribution operations in the U.S. with the REPS organization. This integration lent itself to cost savings through synergies and allowed the Company to more efficiently service its customers. As a result of this integration, REPS performed in-store field service associated with the Company s category management suite of services. The REPS field service representatives visit individual retail stores and meet with store management to discuss upcoming promotions, special merchandising efforts, department changes and current programs, which will increase revenues. They also manage inventory turns by monitoring inventory levels, identifying slow moving product and returning merchandise to their customer s distribution facilities. With the determination by the Company s Board of Directors in the fourth quarter of fiscal 2008 that Handleman Company will exit the music business in North America, REPS will continue to provide in-store merchandising for customers other than Handleman Company.

* * * * * * * * *

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

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As of May 3, 2008, Handleman Company had approximately 2,600 employees, with none belonging to a labor union.

Item 1A. RISK FACTORS

Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. The discussion in this document, in particular the discussion under Recent Developments and the related discussion of the Company s future plans, contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. There are risks associated with forward looking statements. Forward-looking statements are based on current expectations or beliefs concerning future events. Such statements can be identified by the use of terminology such as anticipate, believe, estimate, expect, intend, may, could, possible, plan, project, will, forecast and similar words or expressions. Do not place und forward-looking statements since actual results may vary significantly from forward-looking statements.

Handleman cannot assure that it will have adequate financing arrangements with its lenders.

Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company s day-to-day operations provided that the Company is able to sell its remaining assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company s liquidity would be dependent upon further amendments to its credit agreements or securing alternative funding. If these actions are unsuccessful, then the Company s ability to continue as a going concern would be in doubt.

Handleman cannot assure the successful sale of its remaining assets or that the sale of its assets will be at anticipated terms.

While Handleman is reasonably confident that it will be able to successfully sell its remaining assets, it cannot make any assurances that there will be a reasonable demand for these assets. With the decline in the music and video industries, Handleman faces risks that further declines of sales in its operating markets will hinder its ability to successfully sell its assets.

Handleman anticipates that sales of its remaining assets will be made on terms that are approved by the Board of Directors and may be conducted by competitive bidding, public sales or privately negotiated sales. The prices at which the Company will be able to sell these assets will depend largely on factors beyond the Company s control, including, without limitation, the condition of financial markets, the availability of financing to prospective purchasers of the assets, public market perceptions and limitations on transferability of certain assets. Because some of the Company s remaining assets, particularly intellectual property assets, may decline in value over time, the consummation of the sale of these assets in time to generate meaningful value is critical. In addition, the Company may not obtain as high a price for its illiquid assets as might have been obtained were the Company not seeking strategic alternatives for its various business operations.

Handleman cannot assure that there will not be any unanticipated complications in the transitions of its businesses.

While the transition of the U.S. Wal-Mart music business has been successful to date, Handleman cannot assure that there will not be unanticipated complications related to the transition of this business. Handleman may be subject to claims filed by Wal-Mart and/or Anderson related to the sale of the business, settling of accounts receivable disputes regarding customer music returns, accounts payable disputes regarding vendor claims or other related party claims. Similarly, as Handleman transitions its other non-Wal-Mart U.S. music customers to other suppliers, Handleman may be subject to similar risks. These risks include potential accounts receivable disputes with Handleman s former customers, accounts payable disputes with vendors and disputes with the music providers to which Handleman s former customers are transitioned.

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Handleman also faces risks related to the sale of its Canadian operations. One risk, while not anticipated, is that the Canadian Heritage Ministry could withhold its approval of the sale to a date that is later than the period in which the Canadian operation must purchase its holiday season music product. If this occurs, it could significantly impact the purchase price that Anderson is willing to offer for the Canadian business. Another risk is that the Canadian Heritage Ministry denies its approval of the transaction. This would force Handleman to identify another buyer willing to purchase the Canadian operation. If Handleman were unable to identify a purchaser, then it might be forced to liquidate the Canadian assets.

Further, Handleman faces certain risks related to the sale of its UK operations. While Handleman and Tesco have reached an agreement in principle for the sale of the UK assets, the parties negotiations may not reach a definitive agreement at terms that are favorable to Handleman. In addition, Tesco could assert its rights pursuant to its service agreement with Handleman related to the purchase of certain of Handleman s assets. Further, as Handleman ceases its operations in the UK, Handleman must resolve payment issues related to its former ASDA greeting cards business.

The Company s decision to exit the North American music business has resulted in the termination of employee relationships. Handleman is, therefore, subject to risk of employee lawsuits. While Handleman has made every effort to comply with laws related to these situations, there is a risk that an employee might assert that Handleman terminated his/her relationship in violation of certain laws, and that Handleman is required to pay the employee damages related to the employment termination. Even if Handleman were to prevail in such matters, Handleman would have to defend itself in matters related to employee rights and benefits.

Handleman must resolve matters related to its U.S. pension plan.

Handleman Company has certain risks related to its U.S. pension plan. Handleman s pension plan is at risk related to the current economic downturn. To the extent that Handleman s pension plan has investments in volatile instruments, Handleman is at risk that its pension plan will be underfunded at any given time. Handleman is currently in the process of immunizing its pension plan thereby removing a significant portion of the economic risk. The plan will move to an 80% long-bond portfolio and 20% equity exposure from 60% equity exposure and a 40% long-bond portfolio. This significantly reduces asset/liability mismatch risk. While immunization would significantly reduce Handleman s risk related to the fluctuating market, Handleman will still be subject to certain other risks. If Handleman elects to terminate its U.S. pension plan, Handleman faces the risk that the pension plan would be significantly underfunded. If the pension plan is underfunded, then Handleman would be required to contribute cash to meet the shortfall. If Handleman elects not to terminate the plan, but does not want to continue to actively fund the pension plan, then Handleman would be required to either find an interested investor willing to purchase the pension plan from Handleman or purchase a non-participating group annuity contract for all participants. As there is not an active market for pension plan purchasers, it might be very difficult to find an investor interested in purchasing its pension plan. If Handleman purchases a non-participating group annuity contract, Handleman would be required to pay a large amount of cash to do so. Handleman s options, with the exception of purchasing a non-participating group annuity contract, increase Handleman s regulatory risk that the Pension Benefit Guaranty Corporation (PBGC) may force the U.S. plan s termination, which would require a large cash contribution to the plan.

Handleman s foreign subsidiaries will have to pass a Solvency Test in order to remit a dividend to Handleman Company, the parent company.

As foreign operations are sold and cash is generated, Handleman must establish that its foreign subsidiaries are solvent prior to them paying a dividend to Handleman. To the extent that Handleman Company is relying on this dividend as part of its cash management efforts, a foreign subsidiary s inability to remit the dividend could create substantial financial risks for Handleman s liquidity. As the solvency test relates to Handleman Canada, Handleman may have to meet its obligations related to the Canadian

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pension plan prior to the Canadian subsidiary remitting a dividend. As it relates to Handleman UK, Handleman Company may have to resolve all outstanding vendor payment disputes prior to the UK subsidiary remitting a dividend to Handleman. If foreign subsidiaries remit a dividend to Handleman during a period when such foreign subsidiaries are considered insolvent, then the Directors of those subsidiaries may be subjected to legal consequences, for which Handleman would have to provide them with indemnification.

Handleman Company may eventually not have a business operation.

As Handleman Company pursues the sale of its assets, it may eventually not have a business operation and its principal asset may consist of its cash balances. As a result, Handleman may be considered a shell company as defined in Rule 12b-2 of the Securities Exchange Act of 1934, as amended. The Company s Board of Directors intends to consider the appropriate application of the remaining cash balances, if any, including a possible distribution to shareholders after Handleman has settled all, or substantially all, of its obligations. Handleman cannot, however, provide any assurance that it will have any remaining cash to make such a distribution.

Handleman s inability to retain the services of its current personnel may impact its ability to successfully sell the assets of the Company.

Handleman s ability to successfully sell the assets of the Company is dependent, in large part, upon its ability to retain its remaining personnel. The retention of qualified personnel is particularly difficult under the current circumstances. While Handleman has offered its critical employees retention and severance plans, there is no legal obligation that would require the employee to remain employed at Handleman. In the event critical employees decided to terminate their employee relationships with Handleman, Handleman would have to retain outside consultants to perform their duties or offer a premium salary in order to hire employees to work for the Company.

Handleman may eventually rely on outside consultants and advisors to perform critical functions.

As Handleman progresses in the sale of its assets, it may become more dependent on outside consultants and advisors to perform critical functions. While Handleman anticipates that it will maintain Handleman employees in certain critical accounting, finance and tax positions, Handleman may have to rely on consultants, outside legal counsel and other contractors to perform day-to-day tasks. There is a risk that these non-Handleman employees will have interests and arrangements that may be different from the Company s shareholders interests, including, but not limited to, other client priorities and relationships with entities that the Company may do business with in the future. Further, if the Company was unable to continue to employ qualified outside advisors and consultants to perform critical functions, the Company may be unable to meet its regulatory reporting obligations in a timely manner and the system of internal accounting controls may not function as intended.

Item 1B. UNRESOLVED STAFF COMMENTS

Handleman Company does not have any unresolved staff comments to report.

Item 2. PROPERTIES

As of May 3, 2008, Handleman Company occupied leased warehouses located in Indianapolis, Indiana; Toronto, Ontario; Warrington, United Kingdom; and Bolton, United Kingdom; as well as four leased satellite offices ranging in size from 1,400 square feet to 7,500 square feet, located in the states of Minnesota, Tennessee and Arkansas. Crave Entertainment Group leases its 9,000 square foot corporate office in Newport Beach, California.

The Company is evaluating its options and alternative uses for the Warrington, UK facility for the period following the discontinuance of the ASDA music and greeting card distribution arrangements. Additionally, based on the Company s decision to exit the music business in North America, the Company

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is marketing the leases on the distribution facility in Indianapolis, Indiana and the unoccupied sales offices in Minnesota and Montreal, Quebec. Furthermore, the Company anticipates that the leases on the Toronto, Ontario and Bolton, United Kingdom distribution facilities will be assumed by Anderson and Tesco, respectively, at the close of the previously mentioned sales transactions in each of those countries.

The Company owns its 130,000 square foot corporate office building located in Troy, Michigan. During the first quarter of fiscal 2009, the Company began actively marketing the building for sale.

Item 3. LEGAL PROCEEDINGS

See Note 12 of Notes to Consolidated Financial Statements for a discussion of the Company s contingencies.

Handleman Company is not currently involved in any legal proceedings that are material or for which it does not believe it has adequate reserves. Any other legal proceedings in which the Company is involved are routine legal matters that are incidental to the business and the ultimate outcome of which is not expected to be material to future results of consolidated operations, financial position and cash flows. The Company establishes reserves for all claims and legal proceedings based on its best estimate of the amounts it expects to pay.

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

During the fourth quarter of fiscal 2008, Handleman Company did not submit any matters to a vote of its security holders.

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PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Effective March 26, 2008, Handleman Company s stock began trading on the Pink Sheet Electronic Quotation Service, trading symbol HDLM.PK. Prior to March 19, 2008, Handleman s stock traded on the New York Stock Exchange Euronext (NYSE), under the symbol HDL. Handleman s stock was delisted by the NYSE prior to the NYSE market opening on March 25, 2008. The NYSE s action resulted from the Company s average market capitalization over a consecutive thirty trading-day period being below the NYSE minimum quantitative continued listing criteria of $25 million.

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

	Fiscal Years Ended					
	May 3, 2008			April 28, 2007		
Quarter	Low	High	Close	Low	High	Close
First	$ 4.81	$ 7.60	$ 4.84	$ 6.78	$ 9.18	$ 7.02
Second	2.45	5.00	2.51	6.70	8.40	8.04
Third	1.21	2.56	1.40	6.50	8.97	7.50
Fourth	0.18	1.64	0.77	6.60	7.99	7.51

As of July 11, 2008, the Company had 2,603 shareholders of record.

During the fourth quarter of fiscal 2007, the Company announced that it has suspended indefinitely its quarterly cash dividends of $0.08 per share of common stock in connection with amending its credit agreements. Pursuant to Handleman Company s credit agreements, as described in Note 8 of Notes to Consolidated Financial Statements, the Company has restrictions on its payment of cash dividends and, therefore, the suspension of quarterly cash dividend payments remains indefinite.

Below is a summary of the dividends declared during the past two fiscal years:

	Fiscal Years Ended	
Quarter	May 3, 2008	April 28, 2007
First	$	$ .08

Second	.08
Third	.08
Fourth	

On February 23, 2005, the Company s Board of Directors authorized a share repurchase program. Under this authorization, which has no expiration date, the Company can repurchase up to 15% of its then outstanding balance of 21,787,611 shares. The Company did not repurchase any shares of its common stock during the fiscal years ended May 3, 2008 or April 28, 2007 due to the Company s cash position. The Company has repurchased 2,044,000 shares or 63% of the shares authorized under the current share repurchase program, as of May 3, 2008. Pursuant to Handleman Company s credit agreements, as previously discussed and as described in Note 8 of Notes to Consolidated Financial Statements, the Company is prohibited from repurchasing its common stock.

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company s fiscal year 2008, which consisted of 53 weeks, ended on May 3, 2008 and its fiscal year 2007, which consisted of 52 weeks, ended on April 28, 2007.

During fiscal 2008, Handleman Company had the following reporting segments: category management and distribution operations, video game operations and all other. As a category manager and distributor of product, the Company created value for its customers by leveraging its core competencies of logistic services, field services and intellectual services. During fiscal 2008, the Company predominately provided full category management services for prerecorded music product to leading retail chains in the United States (U.S.), United Kingdom (UK) and Canada.

In recent years, music industry sales have declined at double-digit rates as the industry was impacted by digital distribution, downloading and piracy. In addition, the Company s gross margins were compressed because lower-margin promotional products became a greater proportion of annual sales. This level of continued erosion of CD music sales is expected to continue into the foreseeable future. In response to this dramatic decline, the Company implemented significant cost reduction plans to reduce expenses and streamline operations. These plans included work force reductions; the consolidation of the operations of two U.S. automated distribution facilities into one facility; the reduction of benefit programs and the realignment of medical plans; initiatives to reduce customer product returns; and various other cost cutting initiatives. However, the reduction in music sales volume and loss of gross margin outpaced the Company s ability to reduce overhead costs, and as a result, the Company experienced steep operating losses in the past two fiscal years.

The Company s customers have responded to the decline in music industry sales by contracting the amount of retail space devoted to music sales.

Additionally, the Company violated certain debt covenants within its credit agreements in the fourth quarter of fiscal 2008. Those violations were cured soon thereafter by an amendment to the credit facilities. In recent months, trade creditors have expressed concern about whether the Company might be contemplating or be required to file a bankruptcy proceeding. As a result, the Company became concerned about whether it would have access to sufficient financing and vendor credit to meet its business needs.

As a result of concerns about the prospects for the music business and the availability of financing, in April 2008 the Board of Directors of the Company approved that management proceed with the sale of the U.S. and Canadian operations, which were actively being marketed as of May 3, 2008. On June 2, 2008, Handleman announced that it is exiting the music business in North America and that it had sold a portion of its U.S. inventory and its U.S. music business related to Wal-Mart to Anderson Merchandisers L.P. (Anderson). Handleman also announced that it will work with its other non-Wal-Mart U.S. customers to achieve a smooth transition to other music suppliers by the end of August 2008. Further, Handleman has reached a definitive agreement with Anderson for the sale of all of the inventory and fixed assets and all operations of its Canadian subsidiary, Handleman Canada. The closing on the sale of assets of Handleman Canada is subject to Canadian regulatory approval, which the parties expect to receive in the second quarter of fiscal 2009.

In accordance with accounting guidance, the U.S. and Canadian operations have been classified as discontinued operations in the Company s Consolidated Statements of Operations for all periods presented. In addition, the U.S. and Canadian assets and liabilities have been classified as held for sale in the Company s Consolidated Balance Sheet as of May 3, 2008.

Handleman believes that its decision to exit the music business was the best strategic decision for its shareholders. Further, Handleman believes that cash provided from operations and the sale of assets could provide sufficient liquidity to fund the Company s day-to-day operations provided the Company is able to sell its assets within a reasonable period of time. If the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company s

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liquidity would be dependent on further amendments to its credit agreements or securing alternative funding. If the Company is able to generate cash proceeds in excess of what is needed to satisfy the Company s debt obligations, the Company is considering the possibility of distributing any such proceeds to shareholders rather than pursue reinvestment opportunities. Whether there will be any excess cash proceeds for distribution to shareholders is subject to a number of material risks and uncertainties that may prevent any such distribution from occurring. Accordingly, while the Company believes that a cash distribution is possible, actual results may differ from current estimates, perhaps materially.

Within the category management and distribution operations segment, the Company s revenues were categorized as follows: (i) Category Management Revenues sales to customers who received the full suite of category management services included with their purchase of Handleman-owned tangible products (primarily music); this suite of services included assortment management, product warehousing, ticketing, direct to store shipments, in-store field service and customer returns management; (ii) Greeting Cards Revenues sales to customers who received only certain category management serv