

HANDLEMAN CO /MI/
Form 10-Q
March 13, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 31, 2009

or

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

Commission file number 1-7923

HANDLEMAN COMPANY

(Exact name of registrant as specified in its charter)

MICHIGAN
(State or other jurisdiction of incorporation or organization)

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

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

48084-5225
(Zip Code)

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

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

YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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.

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Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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

YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. The number of shares of common stock outstanding as of March 6, 2009 was 20,533,597.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

HANDLEMAN COMPANY

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS (LIQUIDATION BASIS)

FOR THE PERIOD OCTOBER 5, 2008 TO JANUARY 31, 2009

(in thousands of dollars)

| | |
|--|-----------------|
| Shareholders' Equity at October 4, 2008 | \$ 67,226 |
| Liquidation basis adjustments: | |
| Adjust assets and liabilities to fair value | (6,143) |
| Accrued liquidation costs | (30,669) |
| Net Assets (liquidation basis) as of October 5, 2008 | 30,414 |
| Net revenues incurred from October 5, 2008 to November 1, 2008 | 14,483 |
| Net costs incurred from October 5, 2008 to November 1, 2008 | (14,475) |
| Adjust assets and liabilities to fair value | (26,660) |
| Adjustment to accrued liquidation costs | (490) |
| Net Assets (liquidation basis) as of November 1, 2008 | 3,272 |
| Net revenues incurred from November 2, 2008 to January 31, 2009 | 63,746 |
| Net costs incurred from November 2, 2008 to January 31, 2009 | (63,919) |
| Adjust assets and liabilities to fair value | 4,963 |
| Adjustment to accrued liquidation costs | (4,999) |
| Net Assets (liquidation basis) as of January 31, 2009 (available to shareholders) | \$ 3,063 |

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

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENT OF NET ASSETS AS OF JANUARY 31, 2009 (LIQUIDATION BASIS)

CONSOLIDATED BALANCE SHEET AS OF MAY 3, 2008 (GOING CONCERN BASIS)

(in thousands of dollars except share data)

| | January 31, 2009 (Unaudited) | May 3, 2008 |
|--|------------------------------------|----------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 18,428 | \$ 1,043 |
| Accounts receivable | 15,735 | 62,479 |
| Merchandise inventories | 5,131 | 29,404 |
| Other current assets | 13,221 | 10,221 |
| Assets held for sale | | 139,943 |
| Total current assets | 52,515 | 243,090 |
| Property and equipment: | | |
| Land, buildings and improvements | | 13,885 |
| Display fixtures | | 1 |
| Computer hardware and software | | 21,641 |
| Equipment, furniture and other | | 24,711 |
| | | 60,238 |
| Less accumulated depreciation | | 31,368 |
| | | 28,870 |
| Goodwill, net | | 6,903 |
| Intangible assets, net | | 35,062 |
| Other assets, net | | 14,779 |
| Total assets | \$ 52,515 | \$ 328,704 |
| LIABILITIES | | |
| Current liabilities: | | |
| Debt | \$ | \$ 63,706 |
| Accounts payable | 5,893 | 31,023 |
| Accrued and other liabilities | 15,102 | 23,548 |
| Accrued liquidation costs | 28,457 | |
| Liabilities held for sale | | 62,298 |
| Total current liabilities | 49,452 | 180,575 |
| Other liabilities | | 6,456 |
| Commitments and contingencies (Note 9) | | |
| Total liabilities | 49,452 | 187,031 |

SHAREHOLDERS EQUITY

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| | | |
|--|-----------|------------|
| Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued | | |
| Common stock, \$.01 par value; 60,000,000 shares authorized; 20,526,000 and 20,464,000 shares issued and outstanding at January 31, 2009 and May 3, 2008, respectively | | 205 |
| Additional paid-in capital | | 788 |
| Accumulated other comprehensive income | | 17,099 |
| Retained earnings | | 123,581 |
| Total shareholders' equity | | 141,673 |
| Total liabilities and shareholders' equity | \$ 49,452 | \$ 328,704 |
| Net assets (liquidation basis - available to shareholders) | \$ 3,063 | |

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

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE FIVE-MONTH PERIOD ENDED OCTOBER 4, 2008

AND THE THREE AND NINE-MONTH PERIODS ENDED JANUARY 31, 2008

(GOING CONCERN BASIS, UNAUDITED)

(in thousands of dollars except per share data)

| | For the Three Months Ended January 31, 2008 | For the Five Months Ended October 4, 2008 | For the Nine Months Ended January 31, 2008 |
|--|---|---|--|
| Revenues | \$ 30 | \$ 20 | \$ 76 |
| Costs and expenses: | | | |
| Direct product costs | | | |
| Selling, general and administrative expenses | (12,850) | (26,808) | (50,346) |
| Operating loss | (12,820) | (26,788) | (50,270) |
| Interest expense | (1,119) | (3,678) | (2,816) |
| Investment (expense) income | (306) | 127 | (2,376) |
| Loss before income taxes | (14,245) | (30,339) | (55,462) |
| Income tax benefit | 832 | 699 | 2,044 |
| Net loss from continuing operations | \$ (13,413) | \$ (29,640) | \$ (53,418) |
| Discontinued operations (Note 4): | | | |
| Income (loss) from operations of discontinued companies (including net loss on disposal of subsidiary assets of \$24,478 for the five- month period ended October 4, 2008) | 18,581 | (15,350) | 27,103 |
| Income tax expense | (2,763) | (5,788) | (4,873) |
| Net income (loss) from discontinued operations | \$ 15,818 | \$ (21,138) | \$ 22,230 |
| Net income (loss) | \$ 2,405 | \$ (50,778) | \$ (31,188) |
| (Loss) income per share: | | | |
| Continuing operations basic | \$ (0.66) | \$ (1.45) | \$ (2.63) |
| Continuing operations diluted | \$ (0.66) | \$ (1.45) | \$ (2.63) |
| Discontinued operations basic | \$ 0.78 | \$ (1.03) | \$ 1.09 |
| Discontinued operations diluted | \$ 0.78 | \$ (1.03) | \$ 1.09 |

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| | | | | | | |
|---|----|--------|----|--------|----|--------|
| Net income (loss) basic | \$ | 0.12 | \$ | (2.48) | \$ | (1.54) |
| Net income (loss) diluted | \$ | 0.12 | \$ | (2.48) | \$ | (1.54) |
| Weighted average number of shares outstanding during the period: | | | | | | |
| Basic | | 20,357 | | 20,472 | | 20,315 |
| Diluted | | 20,357 | | 20,472 | | 20,315 |

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

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HANDLEMAN COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE FIVE-MONTH PERIOD ENDED OCTOBER 4, 2008 and THE NINE-MONTH PERIOD ENDED JANUARY 31, 2008

(GOING CONCERN BASIS, UNAUDITED)

(in thousands of dollars)

| | For the Five Months Ended October 4, 2008 | For the Nine Months Ended January 31, 2008 |
|---|---|--|
| Cash flows from operating activities: | | |
| Net loss | \$ (50,778) | \$ (31,188) |
| Adjustments to reconcile net loss to net cash provided from operating activities: | | |
| Depreciation | 2,126 | 12,114 |
| Amortization of definite-lived intangible assets | 2,630 | 5,711 |
| Recoupment of development costs/licensed rights | 1,533 | 7,727 |
| Amortization of financing related fees | 5,581 | |
| Goodwill impairment adjustment | (1,294) | |
| Net loss on disposal of subsidiary assets | 24,478 | |
| Impairment of equity investment | | 3,805 |
| Gain on sale of investment | | (957) |
| Loss on disposal of property and equipment | 88 | 2,332 |
| Foreign currency translation adjustment | (15,598) | |
| Unrealized investment income | | (215) |
| Stock-based compensation | 96 | 866 |
| Retirement plans curtailment/settlement charges | | 395 |
| Changes in operating assets and liabilities: | | |
| Decrease in accounts receivable | 120,714 | 60,873 |
| Decrease (increase) in merchandise inventories | 23,395 | (375) |
| (Increase) decrease in other operating assets | (6,801) | 6,859 |
| Decrease in accounts payable | (62,208) | (14,898) |
| (Decrease) increase in other operating liabilities | (1,396) | 1,549 |
| Total adjustments | 93,344 | 85,786 |
| Net cash provided from operating activities | 42,566 | 54,598 |
| Cash flows from investing activities: | | |
| Additions to property and equipment | (553) | (5,955) |
| Software development costs and acquired rights | (4,026) | (13,824) |
| Proceeds from sale of subsidiary assets | 51,778 | |
| Adjustment of cash investment in Crave Entertainment Group | 1,294 | |
| Proceeds from sale of investment | | 1,217 |
| Proceeds from disposition of property and equipment | 239 | 1 |
| Net cash provided from (used by) investing activities | 48,732 | (18,561) |
| Cash flows from financing activities: | | |
| Issuances of debt | 176,472 | 3,852,971 |
| Repayments of debt | (240,178) | (3,869,880) |

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| | | |
|--|-----------|-----------|
| Financing related fees | (2,540) | (6,834) |
| Cash (payments) proceeds from stock-based compensation plans | (62) | 151 |
| Net cash used by financing activities | (66,308) | (23,592) |
| Effect of exchange rate changes on cash | (2,423) | 1,504 |
| Net increase in cash and cash equivalents | 22,567 | 13,949 |
| Cash and cash equivalents at beginning of period | 1,043 | 18,457 |
| Cash and cash equivalents at end of period | \$ 23,610 | \$ 32,406 |

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Unless otherwise noted, the following Notes to Consolidated Financial Statements relate only to results from continuing operations, which includes the Company's corporate function only.

1. **Basis of Presentation**

At the annual shareholders' meeting on October 1, 2008, the Company's shareholders approved a Plan of Final Liquidation of the Company. Accordingly, the Company's Board of Directors ("Board") now have the authority to determine when a certificate of dissolution should be filed with the state, which provides the Board the ability to assess whether suitable value can be attained for the Company's remaining assets. Through the liquidation period, if the Company is able to generate cash proceeds in excess of what is needed to satisfy all of the Company's obligations, the Company will distribute any such proceeds to shareholders. The actual amount and timing of future liquidating distributions, if any, to shareholders, will depend upon a variety of factors, including, but not limited to, the disposal of the REPS LLC ("REPS") subsidiary company, the sale of the Company's corporate headquarters facility, collection of the proceeds from the sale of Crave Entertainment Group, Inc. ("Crave"), ultimate settlement amounts of the Company's liabilities and obligations, and actual costs incurred in connection with carrying out the Company's Plan of Final Liquidation, including administrative costs during the liquidation period. As a result of the Company's shareholders' approval of the Plan of Final Liquidation, the Company adopted the liquidation basis of accounting as of October 5, 2008, which was the beginning of the fiscal month closest to the shareholders' approval date.

The consolidated financial statements for the period ending October 4, 2008 were prepared on the going concern basis of accounting, which contemplated realization of assets and satisfaction of liabilities in the normal course of business. In the opinion of management, the accompanying Consolidated Statements of Operations and Cash Flows contain all adjustments, including normal recurring adjustments, necessary to present fairly the financial position of the Company as of October 4, 2008, and the results of operations and changes in cash flows for the five months then ended on a going concern basis. The Consolidated Balance Sheet as of May 3, 2008 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's fiscal year 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended May 3, 2008, including the discussion of the Company's critical accounting policies. The year-end balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Liquidation Basis of Accounting

The liquidation basis of accounting is appropriate when the liquidation of a company appears imminent and the net realizable value of its assets is reasonably determinable. Under this basis of accounting, assets and liabilities are stated at their net realizable value and estimated costs through the liquidation date are provided to the extent reasonably determinable.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The transition from the going concern basis of accounting to the liquidation basis of accounting required management to make significant estimates and judgments. The recording of assets at estimated net realizable value and liabilities at estimated settlement amounts under the liquidation basis of accounting required the Company to record the following adjustments as of October 5, 2008, the date of adoption of the liquidation basis of accounting (in thousands of dollars):

| Adjustments of assets and liabilities: | Amount |
|---|-----------------|
| Prepaid pension adjustment | \$ 3,248 |
| Write down of real estate | 1,435 |
| Write down of other fixed assets | 689 |
| Prepaid assets adjustment | 771 |
| Total | \$ 6,143 |

The adjustment of prepaid pension costs of \$3,248,000 resulted from the write off of prepaid pension related balances in the United States (U.S.) and Canada, recorded under the going concern basis of accounting in accordance with Statement of Financial Accounting Standards (SFAS) No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.

The Company reduced the carrying value of its corporate headquarters by \$1,435,000 to its liquidation value based on recent sales and current market conditions.

The adjustments of other fixed assets (computer software) and prepaid assets in the amounts of \$689,000 and \$771,000, respectively, were the result of these assets not having a net realizable value upon the Company's adoption of liquidation accounting.

The Company is required to make significant estimates and exercise judgment in determining accrued liquidation costs. The Company accrued costs expected to be incurred in liquidation and recorded payments made related to the accrued liquidation costs as follows (in thousands of dollars):

| | As Booked | Adjustments | | Balance at |
|----------------------------------|------------------|--------------------|-------------------|-------------------|
| | Oct. 5, | to | Payments | Jan. 31, |
| Accrued Liquidation Costs | 2008 | Reserves | 2009 | 2009 |
| Pension costs | \$ 11,508 | \$ 1,856 | \$ | \$ 13,364 |
| Outside services | 6,701 | 87 | (1,423) | 5,365 |
| Contractual commitments | 4,699 | 426 | (1,897) | 3,228 |
| Payroll related costs | 4,216 | 2,365 | (2,582) | 3,999 |
| Other | 3,545 | 755 | (1,799) | 2,501 |
| Total | \$ 30,669 | \$ 5,489 | \$ (7,701) | \$ 28,457 |

The Company's Consolidated Statement of Changes in Net Assets for the second quarter of fiscal 2009 has been conformed to the presentation adopted in the third quarter of fiscal 2009.

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The Company has a qualified defined benefit pension plan that covers substantially all full-time U.S. employees. This pension plan is at risk related to the current economic downturn, which could result in the pension plan being under funded at any given time. The Company assumed that it will purchase a non-participating group annuity contract for all participants. The Company performed an actuarial valuation analysis assuming the plan would be terminated through the purchase of annuity contracts. This resulted in an estimated cost of \$11,508,000 at October 5, 2008, which was included in accrued liquidation costs as of October 5, 2008. The estimated cost

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

to settle the pension plan as of November 1, 2008 ranged from \$8.2 million to \$15.0 million based on discount rates of 7.1% and 6.1%, respectively. The Company received an estimate to settle the pension plan as of November 1, 2008 and accordingly, increased the liability by \$490,000 to \$11,998,000 as of November 1, 2008.

The Company increased the estimated pension cost by \$1,366,000 in the third quarter of fiscal 2009. The increase was mainly attributable to a decrease in the average discount rate to 6.0% at January 31, 2009. The U.S. pension plan assets at January 31, 2009 increased to \$43,860,000 from \$42,755,000 at November 1, 2008 and the U.S. pension plan termination liability increased to \$57,224,000 at January 31, 2009 from \$54,336,022 at November 1, 2008. The accrued liquidation cost related to the pension plan totals \$13,364,000 as of January 31, 2009.

The Company reviewed all other remaining operating expenses and contractual commitments such as payroll and related expenses, lease termination costs, professional fees and other outside services to determine the estimated costs to be incurred during the liquidation period. The payroll and related expenses are principally expected to occur through July 2009 and all other expenses are expected to occur through January 2010. The initial estimate of payroll related costs in the accrued costs of liquidation has been increased by \$2,365,000. This increase was principally due to Crave related severance and retention costs totaling \$1,255,000 based upon the terms of the asset purchase agreement, effective February 10, 2009, for the sale of certain Crave assets only. Additionally, estimated payroll costs increased \$557,000 primarily due to REPS and corporate employees being retained beyond their originally scheduled departure dates due to the sale of Company assets taking significantly longer than anticipated. See Note 14 of Notes to Consolidated Financial Statements for additional information related to the Crave sales transaction.

The Company will continue to operate its REPS subsidiary during the liquidation period until this business unit is sold. As a result, it will receive revenue and incur operating costs associated with this business. On a regular basis, the Company will evaluate its assumptions, judgments and estimates related to accrued liquidation costs, which could have a significant impact on the reported net assets in liquidation based on the most recent information available to management; the Company will record adjustments as required. Actual revenues, costs, proceeds from sales and other items may differ from the Company's estimates, perhaps materially, which may reduce net assets available in liquidation to be distributed to shareholders.

The following table summarizes adjustments to fair value for the periods October 5, 2008 through November 1, 2008 and November 2, 2008 through January 31, 2009 under the liquidation basis of accounting (in thousands of dollars):

| | One Month Ended November 1, 2008 | Three Months Ended January 31, 2009 |
|---|---|--|
| Adjustments to fair value: | | |
| Adjust Crave subsidiary to fair value | \$ 24,081 | \$ (8,557) |
| Adjust REPS subsidiary to fair value | 1,960 | 2,440 |
| Adjust real estate to fair value | 619 | 480 |
| Adjust other fixed assets to fair value | | 674 |
| Total loss (gain) | \$ 26,660 | \$ (4,963) |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The table below summarizes the losses (gain) related to the carrying value of Crave recorded during fiscal 2009 (in thousands of dollars):

| | Going Concern Accounting | | Liquidation Accounting One | |
|----------------------------|--|---|---------------------------------------|--|
| | Three Months Ended August 2, 2008 | Two Months Ended October 4, 2008 | Month Ended November 1, 2008 | Three Months Ended January 31, 2009 |
| Adjust Crave to fair value | \$ 16,349 | \$ 10,285 | \$ 24,081 | \$ (8,557) |

In accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the Company considered Crave held for sale and adjusted its carrying value at August 2, 2008 and October 4, 2008 under the going concern basis of accounting. The \$16,349,000 loss recorded in the first quarter of fiscal 2009, under the going concern basis of accounting, was calculated based on estimated proceeds to be received upon sale based on an average of Letters of Intent received by the Company from prospective buyers. The \$10,285,000 loss recorded in the second quarter of fiscal 2009, under the going concern basis of accounting, was calculated using projected cash flows prepared by the Company. These losses were recorded in discontinued operations in the Company's Consolidated Statements of Operations.

The Company recorded a loss of \$24,081,000 on the carrying value of Crave in the second quarter of fiscal 2009, under the liquidation basis of accounting, based on a probability weighted average of updated Letters of Intent received by the Company from prospective buyers, as well as, the projected liquidation value of the entity should an entity sale not occur. The Company assumed a 90% probability of an entity sale and a 10% probability of an asset liquidation. In determining the projected liquidation value of Crave, the Company valued accounts receivable at 65% of carrying value, merchandise inventories at 50% of carrying value and accounts payable and accrued liabilities at 100% and 85% of settlement value, respectively.

The Company recorded a gain of \$8,557,000 on the carrying value of Crave in the third quarter of fiscal 2009 based on the asset purchase agreement that was entered into during the beginning of the fourth quarter of fiscal 2009. This gain was calculated based on proceeds received at closing and estimated future proceeds to be received in accordance with the terms of the agreement. See Note 14 of Notes to Consolidated Financial Statements for additional information related to the sale of Crave.

The table below summarizes the losses related to the carrying value of REPS recorded during fiscal 2009 (in thousands of dollars):

| | Going Concern Accounting | Liquidation Accounting | |
|---------------------------|---|---|--|
| | Two Months Ended October 4, 2008 | One Month Ended November 1, 2008 | Three Months Ended January 31, 2009 |
| Adjust REPS to fair value | \$ 7,577 | \$ 1,960 | \$ 2,440 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

In accordance with SFAS No. 144, the Company considered REPS held for sale and adjusted its carrying value at October 4, 2008 under the going concern basis of accounting. The \$7,577,000 loss recorded for the two months ended October 4, 2008, under the going concern basis of accounting, was calculated based on estimated proceeds to be received upon sale based on an average of Expression of Interest Letters received by the Company from prospective buyers. This loss was recorded in discontinued operations in the Company's Consolidated Statements of Operations.

The Company recorded losses of \$1,960,000 and \$2,440,000 on the carrying value of REPS in the second and third quarters of fiscal 2009, respectively, under the liquidation basis of accounting. These adjustments were based on a probability weighted average of Expression of Interest Letters and a draft asset purchase agreement received by the Company from prospective buyers for the second and third quarters of fiscal 2009, respectively, as well as, the projected liquidation value of the entity should an entity sale not occur. The Company assumed a 75% probability of an entity sale and a 25% probability of asset liquidation. The Company estimated that the liquidation value of REPS would approximate zero at the end of the second quarter of this fiscal year and \$700,000 at the end of the third quarter of this fiscal year (as accounts receivable increased following the holiday selling season).

The Company recorded additional adjustments to write down the carrying value of its corporate headquarters in the amounts of \$619,000 and \$480,000 during the second and third quarters of fiscal 2009, respectively, under the liquidation basis of accounting. These write downs were mainly driven by further deterioration in financial market conditions. The Company also recorded an additional write down of other fixed assets of \$674,000 in the third quarter of fiscal 2009 (mainly computer hardware) due to lack of interest from third party buyers, as well as a further decline in overall economic conditions.

2. New Accounting Pronouncements

SFAS No. 157

In September 2006, SFAS No. 157, Fair Value Measurements, was issued by the Financial Accounting Standards Board (FASB). This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements; however, this pronouncement does not require any new fair value measurements. The effective date for SFAS No. 157 has been delayed by the FASB for nonfinancial assets and nonfinancial liabilities; the Company will adopt this portion of the Statement for the fiscal year beginning May 3, 2009. SFAS No. 157 was effective for the Company for the fiscal year beginning May 4, 2008 for items that are recognized or disclosed at fair value in an entity's financial statements on a recurring basis and did not have a significant impact on the Company's consolidated financial statements.

SFAS No. 159

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an amendment of FASB Statement No. 115. SFAS No. 159 allows companies to irrevocably elect to recognize most financial assets and financial liabilities at fair value on an instrument-by-instrument basis. Unrealized gains and losses will be reported in earnings at each reporting date. The cumulative effect of re-measuring such instruments to fair value at adoption is accounted for as an adjustment to the beginning balance of retained earnings. SFAS No. 159 was effective for the Company's fiscal year beginning May 4, 2008 and did not have a significant impact on the Company's consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

3. Financial Position

The Company incurred losses of \$96.8 million and \$53.4 million in the fiscal years ended May 3, 2008 (fiscal 2008) and April 28, 2007 (fiscal 2007), respectively. Industry wide music sales have been declining at double-digit rates over the past few years, impacted by digital distribution, downloading and piracy. As a result, many mass retailers have reduced the amount of floor space dedicated to physical music product. The Company implemented cost cutting initiatives during fiscal years 2008 and 2007 in response to these waning music sales, but was unable to return to profitability. The Company determined that there were not enough further cost reduction opportunities to offset margin reductions from the continuing decline in sales volumes. On June 2, 2008, the Company announced its decision to exit the music business in North America, which was approved by the Company's Board of Directors in April 2008. The Company's decision to exit the music business in North America was further impacted by reluctance from its customers to maintain relationships with multiple music distributors in a declining market, uncertainty whether vendor terms would allow the Company to service its customers during the calendar 2008 holiday season and uncertainty whether the Company's credit agreements would provide sufficient liquidity to fund operations through fiscal 2009. Concurrent with this announcement, the Company sold its United States music business on June 2, 2008. Subsequently, on September 2, 2008, the Company sold its Canadian music operations.

During the first quarter of fiscal 2009, the Company also entered into an agreement in principle to sell certain assets and operations related to Handleman United Kingdom (Handleman UK or UK). On September 16, 2009, the Company completed the sale of the remaining Handleman UK business to Tesco. Also, the Company began actively marketing Crave and exploring opportunities related to the REPS business in the first quarter of fiscal 2009.

The Company 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, (which consist primarily of REPS and the Company's corporate headquarters in Troy, Michigan) at anticipated selling prices and 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 ability to settle its liabilities and obligations in full while incurring necessary wind down costs would be in doubt. During the fourth quarter of fiscal 2009, the Company entered into an asset purchase agreement related to the sale of certain assets of its Crave Entertainment subsidiary. See Note 14 of Notes to Consolidated Financial Statements for additional information related to this transaction.

Through the liquidation period, if the Company is able to generate cash proceeds in excess of what is needed to satisfy all of the Company's obligations, the Company will distribute any such proceeds to shareholders. 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, possibly resulting in no excess cash proceeds available for distribution to shareholders.

Plan of Liquidation

The Company filed a definitive proxy statement with the Securities and Exchange Commission in connection with its proposed Plan of Final Liquidation and dissolution of the Company on September 2, 2008. At the annual shareholders' meeting on October 1, 2008, the Company's shareholders approved the Plan of Final Liquidation. Accordingly, the Company's Board of Directors now has the authority to determine when a certificate of dissolution should be filed with the state, which provides the Board the ability to assess whether suitable value can be attained for

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

the Company's assets. As a result, the Company adopted the liquidation basis of accounting as of October 5, 2008, whereby assets and liabilities are stated at liquidation value. See Note 1 of Notes to Consolidated Financial Statements for additional information related to liquidation accounting. This change in accounting methodology resulted in material adjustments.

Settlement of Debt Agreements

In the second quarter of fiscal 2009, the Company repaid all of its obligations to, and terminated its secured credit agreements with, its lender.

4. Disposal of Long-Lived Assets

Assets Held for Sale

Music Business in North America

During the fourth quarter of fiscal 2008, management committed to a plan that was approved by the Company's Board of Directors in April 2008, to exit the North American music category management and distribution business, and entered into negotiations with Anderson Merchandisers L.P. (Anderson) for the sale of certain U.S. and Canadian assets and operations. The Company began classifying the assets and liabilities of its U.S. and Canadian music operations as held for sale in its Consolidated Balance Sheet as of May 3, 2008, in accordance with the guidance provided in SFAS No. 144.

Pursuant to this decision, Handleman Company entered into separate arrangements with Anderson related to its U.S. and Canadian operations during the first quarter of fiscal 2009. The Company announced on June 2, 2008 that it entered into a definitive Asset Purchase Agreement (APA) with Anderson to purchase a portion of the U.S. music inventory and all of the store display fixtures related to its Wal-Mart Stores, Inc. (Wal-Mart) business in the U.S. The APA was effective on June 2, 2008, at which time the Company ceased providing music category management and distribution services to Wal-Mart in the U.S. Pursuant to this agreement, an initial purchase of U.S. music inventory was delivered to Anderson, FOB shipping point, from the Company's Indianapolis, Indiana automated distribution center.

The price paid by Anderson for the initial purchase of U.S. music inventory was \$10,783,000, which equaled Handleman's supplier invoice cost. The price paid by Anderson for the purchase of the Wal-Mart retail display fixtures was \$3,629,000, which equaled the net book value of the fixtures as of June 2, 2008. Anderson also paid Handleman \$175,000 for transition related services and \$5,000,000 as compensation for costs related to handling, packaging, shipping, warehousing, billing and management costs incurred by Handleman in connection with the closing. The Anderson APA related to the U.S. sale of assets resulted in a gain on the sale of \$5,124,000 and generated net cash proceeds of \$19,536,000 during the first quarter of fiscal 2009. The gain on the sale was recognized in the first quarter of fiscal 2009 and was included in discontinued operations in the Company's Consolidated Statements of Operations; all of the proceeds from the U.S. sale were used to pay Handleman's lenders and reduce outstanding loan balances.

Also, in accordance with the APA, an additional inventory purchase by Anderson occurred in early September 2008. The additional U.S. inventory purchase by Anderson totaled \$1,255,000. This was the final purchase of U.S. music inventory by Anderson. The proceeds were received during the second quarter of fiscal 2009 and were used to pay Handleman's lenders and reduce outstanding loan balances.

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In July 2008, the Company signed a definitive agreement with Anderson to sell all of the music inventory, fixed assets and operations of its Canadian subsidiary, inclusive of customer relationships. This sale was completed on September 2, 2008. Anderson paid Handleman Canada \$10,800,000 for the music inventory, \$2,738,000 for the net book value of fixed assets, \$10,000 for prepaid expenses, plus \$1,000,000, less \$1,753,000 in assumed liabilities. The total net proceeds of \$12,602,000 were received in the second quarter of fiscal 2009, less \$750,000, which is being held in escrow for certain representations and warranties. The sale of this Canadian subsidiary resulted in a gain of \$419,000 in the second quarter of fiscal 2009 and was included in discontinued operations in the Company's Consolidated Statements of Operations. The net cash proceeds received at closing were used to pay Canadian trade accounts payable and reduce outstanding loan balances.

Anderson also agreed to pay the Company a \$4,000,000 incentive fee if Handleman identified, sold or transitioned to Anderson any other Handleman business that adds value to the U.S. music transaction. The sale of the Canadian subsidiary on September 2, 2008 fulfilled this incentive requirement. The \$4,000,000 incentive fee was received during the second quarter of fiscal 2009 upon completion of the Canadian sale and was included in discontinued operations in the Company's Consolidated Statements of Operations.

Handleman United Kingdom

Handleman UK began providing distribution, replenishment and store merchandising services to Tesco Stores Limited (Tesco) in support of its entertainment businesses specifically music, video and video games at the beginning of fiscal 2008. Under this arrangement, Tesco retained title to the inventory, which was housed in and distributed from a Handleman UK distribution facility. During the first quarter of fiscal 2009, the Company began actively marketing the Tesco related assets of Handleman UK by initiating conversations with Tesco and reached an agreement in principle with Tesco to sell certain assets and assume all of the operations related to the Tesco category management and distribution operations, as well as to transfer certain of the Company's intellectual properties to Tesco. The Handleman UK operations have been reclassified to discontinued operations in the Company's Statements of Operations for all periods presented in accordance with the guidance provided in SFAS No. 144.

The sale to Tesco was completed on September 16, 2008. The purchase price paid by Tesco totaled \$16,687,000 and related to all of the fixed assets located in the Tesco-dedicated distribution center; certain licensed assets; proprietary computer software held by the Company's corporate subsidiary; certain business contracts; and certain leased assets and motor vehicles. The sale of assets to Tesco resulted in a gain of \$188,000 in the second quarter of fiscal 2009, which was recorded in discontinued operations in the Company's Consolidated Statements of Operations. The proceeds from this sale, net of \$1,465,000 which is held in escrow for certain indemnifications, were also received in the second quarter of fiscal 2009 and were used to pay UK trade accounts payable, reduce outstanding loan balances and provide cash for operations. At the time of this sale all related assets and services of Handleman UK were transitioned to Tesco. Following its discontinuance of business with Tesco, Handleman UK had no on-going operations other than winding down its former business relationship with ASDA, which is complete. Handleman UK has begun a plan to undergo a members voluntary liquidation, which is a formal process by which solvent companies wind down their operations in the UK.

Crave Entertainment

During the fourth quarter of fiscal 2008, the Company announced that it retained the investment banking firm of W.Y. Campbell & Company for the purpose of exploring possible strategic options

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

for Crave. An Offering Memorandum for Crave was completed in June 2008 and the Company decided, upon Board approval, to begin actively marketing Crave for sale at that time. The Crave operations have been reclassified to discontinued operations in the Company's Statements of Operations for all periods presented in accordance with the guidance provided in SFAS No. 144.

See Note 1 of Notes to Consolidated Financial Statements for a more detailed discussion on the adjustments recorded related to the carrying value of Crave.

During the fourth quarter of fiscal 2009, the Company entered into an asset purchase agreement related to the sale of certain assets of its Crave Entertainment subsidiary. See Note 14 of Notes to Consolidated Financial Statements for additional information related to this transaction.

REPS LLC

In July 2008, the Company retained the investment banking firm of W.Y. Campbell & Company to explore strategic options for REPS. An Offering Memorandum for REPS was completed late in the first quarter of fiscal 2009, and the Company began actively marketing REPS for sale early in the second quarter of fiscal 2009. The REPS operation has been reclassified to discontinued operations in the Company's Statements of Operations for all periods presented, in accordance with SFAS No. 144. See Note 1 of Notes to Consolidated Financial Statements for a more detailed discussion on the losses recorded related to the carrying value of REPS.

The U.S., Canadian and Handleman UK music operations were previously included in the category management and distribution operations reporting segment, whereas Crave and REPS were previously included in the video game operations and all other reporting segments, respectively. All of the assets and liabilities classified as held for sale in the Company's Consolidated Balance Sheet as of May 3, 2008 were in the category management and distribution operations reporting segment.

Discontinued Operations

The results of operations for the U.S., Canada and Handleman UK music category management and distribution businesses, as well as Crave and REPS, are reported in discontinued operations in the Company's Consolidated Statements of Operations for all periods presented in accordance with the guidance in SFAS No. 144. After completion of these sales transactions and the wind down of the remaining business activities, the operations and cash flows of these business units were eliminated from the ongoing operations of the Company, and the Company will not have any continuing involvement in the operations of these businesses.

Upon completion of the U.S. asset purchase agreement on June 2, 2008, the buyer assumed all category management and distribution operations related to the Company's U.S. music business with Wal-Mart. The Company's remaining non-Wal-Mart category management and distribution customers were substantially transitioned to other suppliers by the end of August 2008. Upon completion of the Canadian and Handleman UK asset purchase agreements, all of their music category management and distribution operations were transitioned to the buyers in the second quarter of fiscal 2009. As a result, in accordance with SFAS No. 52, Foreign Currency Translation, the Company recorded foreign currency translation gains of \$4,321,000 and \$11,320,000 related to the Canadian and UK operations, respectively, offset in part by a foreign currency translation loss of \$43,000 related to other foreign operations, resulting from the substantial liquidation of the investments in these businesses. These amounts were recorded in discontinued operations in the Company's Consolidated Statements of Operations in the second quarter of fiscal 2009 under going concern accounting.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

The table below summarizes the discontinued operations included in the Company's Consolidated Statements of Operations, by segment, for the five months ended October 4, 2008 and the three and nine months ended January 31, 2008 (in thousands of dollars):

| | Three Months Ended January 31, 2008 | | |
|--|--|--------------------------------------|------------------|
| | Category Management and Distribution Operations | Video Game Operations | All Other |
| Revenues | \$ 245,612 | \$ 95,807 | \$ 5,440 |
| Pre-tax income (loss) from operations | 14,792 | 5,314 | (1,525) |
| | Five Months Ended October 4, 2008 | | |
| Revenues | \$ 117,895 | \$ 89,561 | \$ 5,207 |
| Per-tax income (loss) from operations, excluding net loss on disposal of subsidiary assets for the five months ended October 4, 2008 | 8,475 | 3,866 | (3,213) |
| | Nine Months Ended January 31, 2008 | | |
| Revenues | \$ 717,891 | \$ 205,978 | \$ 12,658 |
| Pre-tax income (loss) from operations | 28,389 | 5,617 | (6,903) |

5. Other Current Assets

The other current assets line item in the Company's Consolidated Statement of Net Assets as of January 31, 2009 consisted of property and equipment, net of \$4,192,000, prepaid inventory deposits of \$1,721,000, a letter of credit of \$2,845,000, taxes receivable of \$2,432,000, refundable deposits of \$584,000 and other various current assets of \$1,447,000.

6. Goodwill and Intangible Assets*Goodwill*

The Company accounted for goodwill and intangible assets in accordance with SFAS No. 142, Goodwill and Other Intangible Assets. Accordingly, the Company performed annual impairment tests for goodwill in the fourth quarter of each fiscal year or as business conditions warranted a review. Goodwill included in the Consolidated Balance Sheet as of May 3, 2008 was \$6,903,000, all of which related to REPS and was included in the all other reporting segment.

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Intangible Assets

Intangible assets as of May 3, 2008 related to REPS and Crave. The Company performed annual impairment analyses in the fourth quarter, or as business conditions warranted a review, comparing the carrying value of its intangible assets with the future economic benefit of these assets. Based on such analyses, the Company adjusted, as necessary, the value of its intangible assets.

The following information relates to intangible assets subject to amortization as of May 3, 2008 (in thousands of dollars):

| Amortized Intangible Assets | May 3, 2008 | |
|--|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization |
| Trademarks | \$ 7,900 | \$ 3,550 |
| Customer relationships | 28,100 | 12,350 |
| Non-compete agreements | 4,770 | 3,466 |
| Software development costs and distribution/license advances | 35,522 | 21,864 |
| Total | \$ 76,292 | \$ 41,230 |

| Amortized Intangible Assets | May 3, 2008 | |
|--|------------------|---|
| | Net Amount | Weighted Average Amortization Period |
| Trademarks | \$ 4,350 | 180 months |
| Customer relationships | 15,750 | 227 months |
| Non-compete agreements | 1,304 | 37 months |
| Software development costs and distribution/license advances | 13,658 | 18 months |
| Total | \$ 35,062 | 113 months |

7. Debt

Handleman Company has no outstanding debt. The credit agreement with Silver Point Finance was terminated on October 31, 2008 and the credit agreement with General Electric Capital Corporation was terminated on August 1, 2008. As a result of reductions in the size of the Company's credit facility and ensuing termination, the Company accelerated the write-off of financing related fees in accordance with Emerging Issues Task Force (EITF) 98-14, Debtor's Accounting for Changes in Line of Credit or Revolving-Debt Arrangements, and EITF 96-19, Debtor's Accounting for a Modification or Exchange of Debt Instruments. During the five months ended October 4, 2008, financing related fees expensed were \$5,580,000, compared to \$563,000 and \$2,193,000, respectively, for the third quarter and first nine months of fiscal year 2008.

Total interest expense from both continuing and discontinued operations for the five months ended October 4, 2008 was \$15,243,000, compared to \$3,489,000 and \$9,863,000 for the three and nine months ended January 31, 2008, respectively. In accordance with EITF 87-24,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

Allocation of Interest to Discontinued Operations, the Company allocated a portion of its interest expense related to its debt agreements from continuing operations to discontinued operations for fiscal years 2009 and 2008.

8. Pension Plan

The Company has two qualified defined benefit pension plans (pension plans) that cover substantially all full-time U.S. and Canadian employees. During the fourth quarter of fiscal 2008 and the first quarter of fiscal 2007, the Company s Board approved amendments to freeze the Canadian and U.S. pension plans, respectively. In addition, the Company had two non-qualified defined benefit plans, U. S. and Canadian Supplemental Executive Retirement Plans (SERP), which covered select employees. During the fourth quarter of fiscal 2008 and the first quarter of fiscal 2007, the Company s Board of Directors approved amendments to freeze the Canadian and U.S. SERPs, respectively.

On July 31, 2008, the Company s Compensation Committee of the Board of Directors approved the termination of the Canadian pension plan. The estimated settlement amount of \$1,444,000 was accrued in the second quarter of fiscal 2009, under the going concern basis of accounting. In the third quarter of fiscal 2009, this Canadian pension plan liability decreased by \$218,000 to \$1,226,000. This liability is included in Accrued and other liabilities in the Company s Consolidated Statement of Net Assets as of January 31, 2009. Final settlement of the Canadian pension plan will occur when termination is approved by the Financial Services Commission of Ontario.

During the third quarter of fiscal 2008, the Company paid \$4,200,000 in lump sum payments to certain U.S. SERP executive and non-executive participants from the U.S. SERP Rabbi Trust. These payments represented final distribution of the plan assets and the U.S. SERP was no longer in existence at the end of January 2008. Accordingly, a settlement loss of \$135,000 was recorded in the third quarter of fiscal 2008. During the first quarter of fiscal 2008, the Company paid \$495,000 in lump sum payments to certain non-executive active and terminated employees from the U.S. SERP Rabbi Trust. Accordingly, a settlement loss of \$260,000 was recorded in the first quarter of fiscal 2008. In accordance with SFAS No. 88, Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits, the Company calculated these settlement losses and remeasured the plan assets and benefit obligations resulting from the lump sum payments to the plan participants. As a result of remeasurement, the Company recorded an increase of \$101,000 to the unfunded status of the U.S. SERP in the first quarter of fiscal 2008. The Company also paid \$341,000 in lump sum payments to all participants in the Canadian SERP during the fourth quarter of fiscal 2008. These payments represented a complete distribution of the Canadian SERP and the SERP was no longer in existence at May 3, 2008.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

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

| | Three Months Ended January 31, 2008 | Pension Plans Five Months Ended October 4, 2008 | Nine Months Ended January 31, 2008 |
|--|--|--|---|
| Service cost | \$ 120 | \$ | \$ 326 |
| Interest cost | 828 | 1,440 | 2,575 |
| Expected return on plan assets | (1,853) | (1,566) | (3,615) |
| Amortization of unrecognized prior service cost, actuarial loss and other | 8 | 10 | 53 |
| Net periodic benefit cost | \$ (897) | \$ (116) | \$ (661) |

| | Three Months Ended January 31, 2008 | SERPs Five Months Ended October 4, 2008 | Nine Months Ended January 31, 2008 |
|--|--|--|---|
| Service cost | \$ 5 | \$ | \$ 14 |
| Interest cost | 60 | | 207 |
| Amortization of unrecognized prior service cost, actuarial loss and other | 9 | | 24 |
| Settlement/curtailment loss | 135 | | 395 |
| Net periodic benefit cost | \$ 209 | \$ | \$ 640 |

During the first five months of fiscal 2009 there were contributions of \$161,000 to the Canadian pension plan. Contributions to the Canadian pension plan for the remainder of fiscal 2009 will not be determined until the plan's termination is approved by the Financial Services Commission of Ontario and the assets are distributed. There were no contributions made to the U.S. pension plan during the first five months of fiscal 2009.

Handleman Company has certain risks related to its pension plans. The Company's pension plans are at risk related to the current economic downturn. To the extent that these pension plans have investments in volatile instruments, the Company is at risk that its pension plans will be under funded at any given time. The risk exists that the pension costs estimated as of January 31, 2009 may be insufficient for the purchase of annuity contracts or lump sum payments (Canada only) if market conditions continue to fluctuate.

On March 11, 2009, the Company's Board of Directors elected to terminate the Company's U.S. pension plan effective July 1, 2009. The Company will purchase a non-participating group annuity contract for all participants following regulatory approval. This purchase will require a significant amount of cash.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS, continued

9. Contingencies
Contingencies

The Company has a contingent liability with a certain state taxing authority related to the filing and payment of franchise taxes. The Company feels it has filed and paid these taxes appropriately and has filed a protest with this taxing authority. The state court ruled in the Company's favor on this matter in February 2009 and the Company's remaining exposure is estimated to be approximately \$500,000. This estimated amount was recorded in the third quarter of fiscal 2009. It is unknown whether the state taxing authority will appeal this state court decision.

During fiscal 2006, the Company recorded investment income of approximately \$4,300,000 related to a gain on the sale of an investment in PRN, a company that provides in-store media networks. Under the terms of the sale agreement, the Company received additional proceeds of \$957,000 that were recorded in investment income during the first quarter of fiscal 2008 and may receive an additional \$400,000 through September 2009, subject to general and tax indemnification claims.

On May 22, 2007, Handleman Company's Compensation Committee adopted Handleman Company's Key Employee Retention Plan (KERP) for executive officers and certain other employees. Management identified 53 key employees for the KERP based on (i) a high risk of the employee terminating his/her employment relationship with Handleman; (ii) the employee being critical to Handleman's success; (iii) the employee's job performance rating of good or better; (iv) the difficulty for management to replace the knowledge, skills and abilities the employee provides Handleman; and (v) the impact suffered by Handleman as a result of the employee terminating his/her employment relationship with Handleman exceeding the cost of retaining the employee. Management determined each employee's total KERP potential payout by taking a percentage, ranging from 20% to 75%, of the employee's base salary as of May 22, 2007. The key employees received 25% of the total payout if the employee was employed by Handleman up to and on December 15, 2007. On December 17, 2007, \$764,000 was paid out to eligible employees. During the first quarter of fiscal 2009, the KERP program was discontinued for a majority of the originally identified employees who still remained employed by the Company. The employees who remain covered by this program are due to receive the final pay out if they remain employed by the Company, with payments being made if certain milestones are achieved, but no later than March 15, 2009. The cost associated with the final KERP installment payment to these remaining key employees is expected to total \$82,000.

The Company had approximately \$2,845,000 in a standby letter of credit primarily associated with the requirement to fund certain expenditures related to workers compensation benefits as of January 31, 2009.

The Company had tax indemnification agreements with Anchor Bay Entertainment and Madacy Entertainment as a result of the sale of those business units in fiscal 2004 and fiscal 2003, respectively. Under the terms of the agreements, the Company may be responsible for any tax liabilities identified subsequent to the sale of those companies.

Litigation

The 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.

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10. Comprehensive Loss

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

| | Five Months Ended October 4, 2008 | Nine Months Ended January 31, 2008 |
|--|--|---|
| Net loss | \$ (50,778) | \$ (31,188) |
| Changes in: | | |
| Foreign currency translation adjustments, net of tax | (21,441) | 823 |
| Employee benefit related, adjustments, net of tax | (2,261) | 103 |
| Total comprehensive loss, net of tax | \$ (74,480) | \$ (30,262) |

The table below summarizes the components of accumulated other comprehensive income included in the Company's Consolidated Balance Sheet as of May 3, 2008 (in thousands of dollars):

| | May 3, 2008 |
|---|------------------|
| Foreign currency translation adjustments | \$ 21,441 |
| Employee benefit plan related adjustments | (4,342) |
| Total accumulated other comprehensive income | \$ 17,099 |

11. Common Stock - Basic and Diluted Shares

No additional shares related to stock options issued by the Company were included in the computation of diluted weighted average shares because the options' exercise prices were greater than the average market price of the common shares or as a result of the net losses for the periods presented.

12. Income Taxes

In accordance with Accounting Principles Board Opinion No. 28, Interim Financial Reporting, the Company is required to adjust its effective tax rate for each quarter to be consistent with the estimated annual effective tax rate and record the tax impact of certain discrete items, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim periods in which they occur.

In addition, income taxes are allocated between continuing operations, discontinued operations and other comprehensive income in accordance with paragraph 140 of SFAS No. 109, Accounting for Income Taxes, which states that all items, including discontinued operations, should be considered for purposes of determining the amount of tax benefit that results from a

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loss from continuing operations and that could be allocated to continuing operations. SFAS No. 109 is applied by tax jurisdiction and, in periods in which there is a pre-tax loss from continuing operations and pre-tax income in another category, such as discontinued operations or other comprehensive income, tax expense is first allocated to the other sources of income, with a related benefit recorded in continuing operations. For the five-month period ended October 4, 2008, the Company reported a loss from continuing operations and a loss from discontinued operations. Pursuant to SFAS No. 109, paragraph 140, the Company allocated income taxes between continuing operations, discontinued operations and other comprehensive income.

Income tax benefit of \$832,000 was recorded from continuing operations for the three months ended January 31, 2008. An income tax benefit of \$699,000 was recorded for the first five months of fiscal 2009, compared to an income tax benefit of \$2,044,000 for the first nine months of the prior fiscal year.

Income tax expense of \$2,763,000 was recorded from discontinued operations for the three months ended January 31, 2008. Income tax expense of \$5,788,000 was recorded for the first five months of fiscal 2009, compared to income tax expense of \$4,873,000 for the first nine months of the prior fiscal year.

The Company recorded a full valuation allowance as of October 4, 2008 against deferred tax assets for those tax jurisdictions in which it believes it is more likely than not that the deferred taxes will not be realized.

The Company's estimates of tax implications related to the liquidation of the Company are subject to change. Accordingly, the amount of liability, if any, will be included in the Company's financial statements as changes in estimates occur.

13. Related Party Transactions

In November 2007, the Board of Directors appointed Mr. Albert A. Koch as Handleman's President and Chief Executive Officer (CEO) through Handleman's engagement of AP Services, LLC (APS). AP Services is affiliated with AlixPartners, a financial advisory and consulting firm, where Mr. Koch is a Vice Chairman, Managing Director and Partner.

In addition to an hourly rate and time commitment for services, Handleman's original agreement called for it to pay AP Services a success fee that is equal to 5% of the increase in shareholder market capitalization from the inception of the agreement through the payment due date upon the completion of the engagement.

On May 29, 2008, the Company and APS amended their original agreement. The amendment provides that in lieu of the success fee previously agreed to by Handleman and APS, Handleman will pay APS a success fee based on 5% of the fair value of cash and/or other assets that is distributed to shareholders if such a distribution is approved by the Company's Board of Directors. The success fee shall be paid in cash, concurrent with the date or dates that distributions are made to Handleman Company's shareholders.

In addition to Mr. Koch, the Managing Director of Handleman UK and one of Handleman's Vice Presidents of Finance are also employees of AlixPartners and were retained by Handleman Company after Mr. Koch's appointment. This additional staffing was approved, in advance of them joining Handleman, by the CEO Governing Committee, which is a three-person Committee of the Board that was formed to oversee the AlixPartners engagement.

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In accordance with SFAS No. 57, Related Party Disclosures, these relationships are viewed as related party transactions because the APS consultants may control or significantly influence the management and operating policies of the Company.

The Company recorded \$1,589,000 of costs related to the APS agreement during the first five months of fiscal 2009 under going concern accounting. These amounts were included in Selling, general and administrative expenses in the Company's Consolidated Statements of Operations, and were related to labor and expenses. The Company had \$484,000 accrued in Accounts Payable in the Company's Consolidated Balance Sheet as of May 3, 2008. In addition, the Company had prepaid \$250,000 related to the CEO retainer, which is included in Other current assets for all periods presented. For the nine months ended January 31, 2009, the Company has recorded total costs of \$2,135,000 related to the APS agreement and has another \$1,025,000 included in accrued liquidation costs in the Company's Consolidated Statement of Net Assets as of January 31, 2009. All invoices from AlixPartners to the Company are reviewed and approved by a member of the CEO Governing Committee prior to their payment.

14. Subsequent Events**Sale of Crave**

During the fourth quarter of fiscal 2009, the Company entered into an asset purchase agreement with Fillpoint LLC (Fillpoint) related to the sale of certain assets of the Crave Entertainment subsidiary companies. The sale was completed on February 10, 2009 and the buyer purchased or obtained by license certain assets including: (i) all accounts receivable; (ii) all prepayments and prepaid expenses transferable and related to exclusive distribution or publishing contracts; (iii) all inventory, including goods returned by Crave's customers following the closing; (iv) all furniture, equipment, office supplies and data processing equipment; (v) all transferable Government Licenses; (vi) certain contracts, including Crave's exclusive distribution and publishing agreements; (vii) all proprietary rights and (viii) all choses in action, rights and benefits under any warranties, rights and benefits under any indemnity provision other than those arising under the asset purchase agreement. Liabilities assumed as part of the transaction were: (i) obligations relating to assumed contracts arising after the closing date; and (ii) certain trade and other payables.

The cash received at closing totaled \$8,103,000, which consisted of payments for accounts receivable of \$4,625,000; for inventory of \$3,518,000; and for property, plant and equipment of \$100,000; less accrued employee vacation liabilities assumed by Fillpoint of \$140,000. Of the total purchase price for accounts receivable, 75% of current accounts receivable, net of reserves and allowances, and excluding the current accounts receivable owed by a certain customer, was paid with the remaining balance of the purchase price to be paid by Fillpoint only as such accounts receivable are collected. Of the total inventory purchase price, half of the purchase price for the inventory on hand at close was paid and the remaining balance is to be paid subsequent to the closing date. Following the closing, the Company will receive: (i) periodic cash payments related to the collection of a certain customer's current accounts receivable, the collection of other current accounts receivable in excess of the amount received by the Company at closing and the collection of non-current accounts receivable in excess of the amount received by the Company at closing, less collection fees; and (ii) 12.50% of the inventory purchase price (in addition to payment for inventory returned to Fillpoint from customers after closing, less a 5% restocking fee) on each of April 10, 2009, June 10, 2009, August 10, 2009 and October 10, 2009. Fillpoint also agreed to pay the Company 50% of the net profit in excess of \$300,000 realized during the 24-month period following the closing with respect to the sale of video games published by Fillpoint and acquired as part of exclusive distribution or publishing agreements assumed by Fillpoint as part of the transaction.

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The Company has provided representations and warranties as of the closing date related to the assets purchased and the liabilities assumed by Fillpoint, and has agreed to indemnify Fillpoint against certain liabilities.

After the completion of this sale agreement, Handleman Company does not have any continuing involvement in the operations of Crave.

Pension Plan

Handleman faces the risk that the U.S. pension plan could become under funded based on market fluctuations and changes in the discount rate. On March 11, 2009, the Company's Compensation Committee of the Board of Directors approved the termination of the U.S. pension plan effective July 1, 2009. Upon approval from the Internal Revenue Service and the Pension Benefit Guaranty Corporation, which is expected late in calendar 2009, the Company will replace the U.S. pension plan with the purchase of a non-participating group annuity contract for all participants, thereby reducing the risk of under funding. The Company has \$13,364,000 accrued in the costs of liquidation for the purchase of this annuity contract.

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Handleman Company

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

Item 2.

At the Company's annual shareholders' meeting on October 1, 2008, the Company's shareholders approved a Plan of Final Liquidation of the Company. As a result of this approval, the Company adopted the liquidation basis of accounting as of October 5, 2008. This basis of accounting is considered when the liquidation of a company appears imminent and the net realizable value of its assets is reasonably determinable. Under this basis of accounting, assets and liabilities are stated at their net realizable value, and estimated costs through the liquidation date are provided to the extent reasonably determinable.

On June 2, 2008, Handleman announced that it was exiting the music business in North America and that it had sold a portion of its United States (U.S.) inventory and its U.S. music business related to Wal-Mart Stores, Inc. (Wal-Mart) to Anderson Merchandisers L.P. (Anderson). Handleman worked with its other non-Wal-Mart U.S. customers to transition them to other music suppliers; these transitions were completed by the end of August 2008. Further, during the second quarter of fiscal 2009, Handleman sold all of the inventory, fixed assets and all operations of its Canadian subsidiary, Handleman Canada, to Anderson. Following the completion of these sales transactions and the transition to other suppliers, the Company has no ongoing music operations in North America.

Additionally, the Company sold to Tesco Stores Limited (Tesco) certain assets and operations of Handleman United Kingdom (Handleman UK or UK) related to the Tesco category management business and certain of the Company's corporate intellectual properties. The transaction was completed in the second quarter of fiscal 2009. Following the completion of this sales transaction, Handleman UK has no on-going business operations in the UK. The wind down of Handleman UK is nearing completion.

On February 10, 2009, the Company sold certain assets of Crave Entertainment Group, Inc. (Crave) to Fillpoint LLC (Fillpoint). Following the completion of this sales transaction the Company does not have any continuing involvement in the operations of this business.

The remaining assets of the Company to be disposed of are the REPS LLC (REPS) subsidiary and the Company's corporate office building in Troy, Michigan, both of which are being actively marketed for sale. In addition, the Company must complete the termination of the U.S. and Canadian pension plans. Pursuant to the Board of Directors' approval on March 11, 2009 for the termination of the U.S. pension plan, the Company will terminate this pension plan and will purchase a non-participating group annuity contract for all of its participants. The Canadian pension plan, which received Board of Directors approval for termination early in fiscal 2009, will be fully paid to participants, either by lump sum payout or through the purchase of an annuity contract, dependent upon the participant's selection of payment. These pension initiatives are expected to be completed late in calendar 2009 following regulatory approval.

The Company 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 at anticipated selling prices and within a reasonable period of time and that it collects the proceeds on the sale of Crave as anticipated. If the Company is unable to sell the remaining assets in a reasonable period of time, or if the Company receives substantially less than anticipated, the Company's ability to settle its liabilities in full while incurring necessary wind down costs would be in doubt. If the Company is able to generate cash proceeds in excess of what is needed to satisfy all of the Company's obligations, the Company will distribute any such proceeds to shareholders. 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, possibly resulting in no excess cash proceeds available for distribution to shareholders.

Table of Contents**Critical Accounting Estimates**

The Company's critical accounting estimates under going concern accounting for the third quarter of fiscal 2009 are consistent with those included in its annual report on Form 10-K for the fiscal year ended May 3, 2008. See Note 1 of Notes to Consolidated Financial Statements in this Form 10-Q for a discussion of accounting estimates and judgments made under the liquidation basis of accounting related to accrued liquidation costs and adjustments related to the carrying value of assets and liabilities.

The Company estimated the fair value for REPS based on a probability weighted average of Expression of Interest Letters and a draft asset purchase agreement received by the Company from prospective buyers for the second and third quarters of fiscal 2009, respectively, as well as, the projected liquidation value of the entity should an entity sale not occur. The Company estimated that the liquidation value of REPS would approximate zero at the end of the second quarter of this fiscal year and \$700,000 at the end of the third quarter of this fiscal year (as accounts receivable increased following the holiday selling season).

The Company estimated the fair value for its corporate headquarters building in Troy, Michigan based upon recent sales and current market conditions. These estimates are subject to change based upon the timing of potential sales and further deterioration in market conditions.

Accrued Liquidation Costs

Based upon the Company's estimates and judgments of future costs under the liquidation basis of accounting, the following summarizes the amounts recorded for the known or expected costs to be incurred in liquidation, as well as payments made through January 31, 2009 (in thousands of dollars):

| | As Booked Oct. 5, 2008 | Adjustments to Reserves | Payments | Balance at Jan. 31, 2009 |
|----------------------------------|------------------------------|-------------------------------|----------------|--------------------------------|
| Accrued Liquidation Costs | | | | |
| Pension costs | \$ 11,508 | \$ 1,856 | \$ | \$ 13,364 |
| Outside services | 6,701 | 87 | (1,423) | 5,365 |
| Contractual commitments | 4,699 | 426 | (1,897) | 3,228 |
| Payroll related costs | 4,216 | 2,365 | (2,582) | 3,999 |
| Other | 3,545 | 755 | (1,799) | 2,501 |
| Total | \$ 30,669 | \$ 5,489 | \$ (7,701) | \$ 28,457 |

The Company will continue to receive income and incur operating costs, from REPS, during the liquidation period. On a regular basis, the Company will evaluate its assumptions, judgments and estimates that can have a significant impact on the reported net assets in liquidation based on the most recent information available to management, and will make adjustments as required. Actual revenue and costs may differ from the Company's estimates, perhaps materially, which may reduce net assets available in liquidation to be distributed to shareholders.

Results of Operations

Unless otherwise noted, the following discussion relates only to results from continuing operations, which primarily includes the Company's corporate function.

Revenues for all periods presented in the Company's Consolidated Statements of Operations are classified in discontinued operations because all operations of the Company have either ceased or are being marketed for sale.

Direct product costs for all periods presented in the Company's Consolidated Statements of Operations are classified in discontinued operations because all operations of the Company have either ceased or are being marketed for sale.

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Selling, general and administrative (SG&A) expenses were \$12.9 million for the third quarter of fiscal 2008. SG&A expenses for the first five months of this fiscal year were \$26.8 million, compared to \$50.3 million for the first nine months of last fiscal year. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

Loss before interest expense, investment income and income taxes (operating loss) was \$12.8 million for the third quarter of fiscal 2008. Operating loss for the first five months of this fiscal year was \$26.8 million, compared to a loss of \$50.3 million for the first nine months of last fiscal year. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

Interest expense was \$1.1 million for the third quarter of fiscal 2008. Interest expense was \$3.7 million for the first five months of fiscal 2009, compared to \$2.8 million for the first nine months of last fiscal year. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

Investment expense was \$0.3 million for the third quarter of fiscal 2008. Investment income for the first five months of fiscal 2009 was \$0.1 million, compared to investment expense of \$2.4 million for the first nine months of fiscal 2008. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

Income tax benefit of \$0.8 million was recorded in the third quarter of the prior fiscal year. Income tax benefit of \$0.7 million was recorded for the five months ended October 4, 2008, compared to income tax benefit of \$2.0 million for the first nine months of last fiscal year. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

The Company had a net loss from continuing operations of \$13.4 million, or \$0.66 per diluted share, for the third quarter of fiscal 2008. The Company had a net loss from continuing operations for the first five months of fiscal 2009 of \$29.6 million, or \$1.45 per diluted share, compared to a net loss of \$53.4 million, or \$2.63 per diluted share, for the first nine months of fiscal 2008. Due to the shortened time period during fiscal 2009, as a result of the adoption of the liquidation basis of accounting effective October 5, 2008, these amounts are not comparable.

Other

During the first nine months of fiscal 2009, the Company did not repurchase any shares of its common stock and has not repurchased shares since fiscal 2006. As of January 31, 2009, the Company has repurchased 2,044,000 shares, or 63% of the shares authorized under the current 15% share repurchase program authorized by the Board of Directors.

The 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.

Liquidity and Capital Resources

Handleman Company has no outstanding debt and has repaid all its obligations to, and terminated its secured credit agreements with, Silver Point Finance and General Electric Capital Corporation. The credit agreement with Silver Point Finance was terminated on October 31, 2008 and the credit agreement with

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General Electric Capital Corporation was terminated on August 1, 2008. The Company entered into these agreements on April 30, 2007. Borrowings as of May 3, 2008 were \$63.7 million.

On October 1, 2008, Handleman Company shareholders approved the Company's Plan of Final Liquidation and dissolution. The Company intends to liquidate its remaining assets, which primarily consist of REPS and the Company's corporate office building in Troy, Michigan. The Company is hopeful that sales of its remaining assets will occur with favorable terms and in a reasonable period of time. The prices at which the Company may 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. 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. If the Company is not able to sell its assets in a reasonable period of time, collect the remaining estimated proceeds from the sale of Crave, or if the Company receives substantially less than anticipated, then the Company's ability to settle its liabilities and obligations in full while incurring necessary wind down costs would be in doubt.

On February 10, 2009, during the Company's fourth quarter of fiscal 2009, the Company entered into an asset purchase agreement related to the sale of certain assets of the Crave Entertainment subsidiary companies. The cash received at closing related to this sale totaled \$8,103,000, which consisted of payments for accounts receivable of \$4,625,000; inventory of \$3,518,000; and property, plant and equipment of \$100,000, less accrued employee vacation liabilities assumed by buyer of \$140,000. For a more detailed discussion on this transaction see Note 14 of Notes to Consolidated Financial Statements.

Through the liquidation period, if the Company is able to generate cash proceeds in excess of what is needed to satisfy all of the Company's obligations, the Company will distribute any such proceeds to shareholders. The actual amount and timing of future liquidating distributions to shareholders will depend upon a variety of factors, including, but not limited to, the disposal of the REPS business unit and the corporate office building, the collection of the remaining proceeds related to the sale of Crave, the ultimate settlement amounts of the Company's liabilities and obligations, and actual costs incurred in connection with carrying out the Company's Plan of Final Liquidation, including administrative costs during the period. The aggregate amount of distributions to shareholders is currently expected to be approximately \$0.15 per share of common stock based on net assets as of January 31, 2009; however, the actual amount of cash remaining for distribution to shareholders following completion of the liquidation and dissolution of the Company could vary significantly from current estimates and could even result in no excess cash available for distribution.

Included in net assets of \$3.1 million as of January 31, 2009, was \$18.4 million of cash and cash equivalents, and \$1.9 million in cash held in escrow related to the sales of certain assets of the Company's Canadian and UK subsidiaries. The net assets available to shareholders could change significantly if the Company is unable to sell its assets in a reasonable period of time, or if the Company receives substantially less than anticipated. Working capital as of May 3, 2008 was \$62.5 million, of which \$1.0 million was cash and cash equivalents.

At January 31, 2009, accounts receivable and merchandise inventories relate to the Crave and REPS operations.

Net cash provided from operating activities for the five months ended October 4, 2008 was \$42.6 million. The net cash changes in operating assets and liabilities was primarily related to the reduction in accounts receivable and merchandise inventories of \$120.7 million and \$23.4 million, respectively. These changes were offset, in part, by a decrease in accounts payable of \$62.2 million, an increase in other operating assets of \$6.8 million and a decrease in other operating liabilities of \$1.4 million.

Net cash provided from investing activities for the five months ended October 4, 2008 was \$48.7 million, consisting primarily of cash proceeds of \$19.5 million related to the sale of certain U.S. music inventory and Wal-Mart fixtures to Anderson, \$15.9 million in proceeds related to the sale of Canadian music

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inventory and Wal-Mart Canada fixtures to Anderson and \$16.4 million in proceeds related to the sale of fixed assets as part of the sale of the Tesco business. The Company also received \$1.3 million in proceeds which was previously held in escrow at the time Handleman had purchased Crave in November 2005. These cash proceeds were offset, in part, by cash payments related to software and development costs and acquired rights of \$4.0 million.

Net cash used by financing activities for the five months ended October 4, 2008 was \$66.3 million. This use of cash was predominately due to net debt repayments of \$63.7 million as a result of the Company paying all outstanding debt under its credit facility and incurring \$2.5 million in financing related fees.

The Company had no significant off-balance sheet arrangements as of January 31, 2009.

* * * * *

Information in this Form 10-Q contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties and are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements including, without limitation, collection of the remaining estimated proceeds related to the sale of Crave, successfully selling the REPS business and the Company's corporate headquarters for amounts reasonably consistent with the Company's valuation of those assets, maintaining satisfactory working relationships with REPS customers and vendors, maintaining sufficient liquidity to fund day-to-day operations, retaining key personnel, satisfactory resolution of any outstanding claims or claims which may arise, finding and capitalizing on opportunities to maximize the value of the Company's non-music operations, selling certain other Company's assets in a timely manner, and other factors discussed in this document and those detailed from time to time in the Company's filings with the Securities and Exchange Commission. Handleman Company notes that the preceding conditions are not a complete list of risks and uncertainties. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this document.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is not subject to risk resulting from interest rate fluctuations, as the Company has no debt or credit facility.

The Company is not subject to material foreign currency exchange exposure for operations with assets and liabilities that are denominated in currencies other than U.S. dollars. Normally, the Company does not attempt to hedge the foreign currency translation fluctuations in the net investments in its foreign subsidiaries.

The Company does not enter into market instruments for trading purposes. Handleman Company does not have any additional market risk from derivative instruments that would have a material effect on the Company's financial position, results of operations or cash flows.

Item 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. The Company completed an evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Act")) as of January 31, 2009, under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and other members of the Company's senior management. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this quarterly report on Form 10-Q.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable and not absolute assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of certain events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

During the third fiscal quarter ended January 31, 2009, the Company eliminated the internal audit function in accordance with its liquidation plan. The internal audit function was replaced with a self-certification process as it relates to internal control over financial reporting.

There were no other changes in internal control over financial reporting (as defined in Rule 13a-15(f) of the Act), other than those stated above, that occurred during the third fiscal quarter ended January 31, 2009, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings

The 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 1A. Risk Factors

Cautionary Statement for Purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995 The 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 expressions. Do not place undue reliance on forward-looking statements since actual results may vary significantly from forward-looking statements.

Handleman cannot assure that it will have adequate cash to complete an orderly liquidation of the Company.

The Company 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, (which consist primarily of REPS and the Company's corporate office building in Troy, Michigan) at anticipated selling prices and 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 ability to settle its liabilities and obligations in full while incurring necessary wind down costs 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 hopeful 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 at what Handleman believes is a fair market value. With the significant competition in the service industry, Handleman faces risks that a reduction in sales in its operating markets will hinder its ability to successfully sell its assets. Further, Handleman faces risk related to the significant pressures on the financial market. If these current conditions continue, a potential investor's ability to secure funding to purchase assets may be constrained. This may limit the number of investors expressing an interest in purchasing Handleman's assets and/or the price they are willing to pay.

Handleman is hopeful 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 may 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. 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.

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

Handleman cannot assure that there will not be unanticipated complications related to the transition of its North American and UK divested businesses. Handleman may be subject to claims filed by customers Anderson, Tesco and/or Fillpoint related to the sale of those businesses, settling of accounts receivable disputes regarding customer music returns, accounts payable disputes regarding vendor claims or other related party claims. 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.

The Company's decision to exit the North American music businesses and its UK operations 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. and Canadian pension plans.

Handleman Company has certain risks related to its pension plans. Handleman's pension plans are at risk related to the current economic downturn. To the extent that Handleman's pension plans have investments in volatile instruments, Handleman is at risk that its pension plans will be underfunded at any given time. Handleman immunized its pension plans thereby removing a significant portion of the economic risk. The Handleman U.S. pension, which is significantly larger than the Canadian pension plan, moved 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. Handleman has elected to terminate its pension plans and will purchase a non-participating group annuity contract for all participants in the U.S. pension plan and purchase either non-participating annuity contracts or make lump sum payments to participants in the Canadian pension plan following regulatory approval. These purchases will require a large amount of cash. The risk exists that the amount accrued in the costs of liquidation may be insufficient for this purchase if market conditions continue to fluctuate.

Handleman Company will eventually not have a business operation and a shareholder distribution may not occur.

As Handleman Company pursues the sale and final liquidation of its assets, it will 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 will consider the appropriate application of the remaining cash balances, if any, including a 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 partially dependent upon its ability to retain its remaining personnel. The retention of qualified personnel is 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.

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

As Handleman progresses in the sale of its remaining 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

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

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

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

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

HANDLEMAN COMPANY

DATE: March 13, 2009

BY: /s/ A. A. Koch
A. A. KOCH
President and
Chief Executive Officer
(Principal Executive Officer)

DATE: March 13, 2009

BY: /s/ Rozanne Kokko
ROZANNE KOKKO
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer)