K TEL INTERNATIONAL INC
Form 10-K/A
January 05, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(MARK ONE)

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended June 30, 2003

OR

o 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 1-07115

K-TEL INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Minnesota	**41-0946588**
(State or other jurisdiction of	(I.R.S. Employer Identification No.)

incorporation or organization)

2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota	**55447**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(763) 559-5566**

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

None

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

Common Stock, par value $0.01

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes o No ý

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 the past 90 days. Yes o No ý

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act)

Yes o No ý

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

Yes o No ý

As of October 11, 2005, the aggregate market value of voting stock held by non-affiliates of the registrant based on the last sale price as reported by the Over-the-Counter Bulletin Board on such date was $234,165.

As of October 11, 2005, the registrant had 13,653,738 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

PURPOSE OF AMENDMENT

In September 2004, the Company discovered that the former Chief Financial Officer of its UK subsidiary misappropriated funds from the Company s UK subsidiary and a customer of such subsidiary. The Company terminated the employee, undertook a full-scale investigation of the matter, retained a forensic auditing firm and dismissed the accounting firm in the UK that audited the UK subsidiary s financial books and records. Based upon the estimates of the Company s forensic auditor, it was determined that the former employee misappropriated approximately $914,200 from the Company s UK subsidiary and approximately $343,588 from a customer of such subsidiary beginning approximately in January 2001 and continuing until September 2004. Further, the Company spent approximately $150,862 investigating the misappropriation. Through negotiations with the former employee, the Company s UK subsidiary and its customer have recovered an aggregate of approximately $1,493,076 and interest of approximately $1,919. Approximately $99,640 remains outstanding. The Company s UK subsidiary has received a deed of guarantee in connection with this remaining obligation and it expects to collect the remaining amount owed on or before February 15, 2008.

The effect of the misappropriation was to overstate product costs by $9,000, $21,000, $24,000 and $27,000 and selling and general and administrative expenses by $14,000, $10,000, $32,000 and $13,000 for the quarters ending September 30, 2002, December 31, 2002, March 31, 2003 and June 30, 2003, respectively.

For the fiscal year ending June 30, 2002, the misappropriation understated sales by $16,000 in the quarter ending September 30, 2001. Product costs were overstated by $74,000, $10,000, $35,000 and $13,000 and selling and general and administrative expenses by $102,000, $9,000, $16,000 and $11,000 for the quarters ending September 30, 2001, December 31, 2001, March 31, 2002 and June 30, 2002, respectively.

Items 6-9 and 13-15 are amended in this Form 10K/A to reflect the foregoing.

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SAFE HARBOR STATEMENT UNDER THE
PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain statements of a non-historical nature under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may be identified by the use of terminology such as may, will, expect, anticipate, estimate, should, or continue or the negative thereof or other variations thereon or comparable ter Such forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or from those results currently anticipated or projected. Such factors include, among other things, the following: changes in consumer purchasing; demand for and market acceptance of new and existing products; the impact from competition for recorded music; the outcome of legal proceedings; dependence on suppliers and distributors; the outcome of our subsidiaries bankruptcy and liquidation; success of marketing and promotion efforts; technological changes and difficulties; availability of financing; foreign currency variations; general economic, political and business conditions; and other matters. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements, except as required by law.

ITEM 6: SELECTED FINANCIAL DATA

The following summary of consolidated operations and certain balance sheet information includes the consolidated results of operations of K-tel and its subsidiaries as of and for the five years ended June 30, 2003. This summary should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this filing. All share and per share amounts are based on the weighted average shares issued. All amounts are in thousands of dollars, except per share data.

	2003 (RESTATED)	**2002 (RESTATED)**	**2001**	**2000**	**1999**
Net sales	$ 7,234	$ 6,891	$ 17,514	$ 29,092	$ 44,650
Operating income (loss)	$ 149	$ (46)	$ (9,480)	$ (12,980)	$ (8,356)
Loss from discontinued operations	$ (581)	$ (180)	$ (4,315)	$ (5,541)	$ (2,260)
Extraordinary item:					
Gain on bankruptcies	$	$ 894	$ 16,185	$	$
Net income (loss)	$ (892)	$ 300	$ 1,369	$ (15,738)	$ (11,547)
Net loss per share:					
Continuing operations	$ (.02)	$ (.03)	$ (.77)	$ (1.02)	$ (1.01)
Total assets	$ 5,301	$ 4,610	$ 3,832	$ 17,941	$ 32,249
Long-term debt	$	$	$ 4,000	$ 4,000	$ 4,000

ITEM 7: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Through its operating subsidiaries, K-tel licenses its music catalog internationally and markets entertainment products mainly derived from its catalog in the United States and Europe through retail and direct response marketing channels.

For this analysis, the following changes in the Company s business should be considered: K-tel closed the operations of its German subsidiary, Dominion Vertriebs GmbH, in June 2000; one of its subsidiaries in the United Kingdom, K-tel Marketing Ltd., in November 2000; and a United States subsidiary, K-tel Consumer Products, Inc., in February 2001. These three closings represent the discontinuation of the Company s consumer products division and accordingly have been presented in the accompanying financial statements as discontinued operations. In addition, in March 2001, the Company s music distribution subsidiary in the United States, K-tel (USA) ceased operations and filed for protection under Chapter 7 of the United States Bankruptcy Code.

Through another subsidiary, K-tel Entertainment, Inc., K-tel has a focused method of distribution that targets the strengths of fewer individual retailers and supplies products suited to each retailer s specific needs. These new products are derived from the Company s master recordings music catalog with the objective of realizing more competitive profit margins. As well, the Company seeks to license its name and marks to other businesses for a royalty or fee.

A. RESULTS OF OPERATIONS

The following sections discuss the results of operations by business segment. See Note 8 to the consolidated financial statements for additional segment information. General corporate expenses of $860,000 in the year ended June 30, 2003, $1,049,000 in the year ended June 30, 2002 and $2,689,000 in the year ended June 30, 2001 have been allocated to the segments.

FISCAL 2003 VERSUS FISCAL 2002

Net sales for the year ended June 30, 2003 were $7,234,000, an increase of 5.0% from fiscal 2002 sales of $6,891,000. This sales increase was attributed to increased domestic music sales partially offset by a decrease in licensing revenue. The net loss for fiscal 2003 was $892,000, or $.06 per share, compared to a net income of $300,000, or $.02 per share (after an extraordinary gain of $894,000 related to the K-tel Marketing liquidation), in fiscal 2002.

The following sections discuss the results of continuing operations by business segment.

BUSINESS SEGMENT RESULTS

Music

Sales in the music segment were $4,454,000 for the year ended June 30, 2003 compared to $3,773,000 for the year ended June 30, 2002, an increase of 18.1%. The increase was primarily related to increased sales to Handleman who became a customer late in fiscal 2002 and to an increased number of products available for sale during fiscal 2003.

Cost of goods sold in the music segment increased to 61.4% of sales for the year ended June 30, 2003 compared to 50.4% of sales for the year ended June 30, 2002. Advertising expenses within the segment, which consists primarily of co-operative advertising payments, trade advertising and promotions, increased to $200,000 for the year ended June 30, 2003 compared to $172,000 for the year ended June 30, 2002.

Selling, general and administrative expenses for the segment decreased $545,000, or 17.9%, to $2,585,000 for the year ended June 30, 2003 compared to $3,130,000 for the year ended June 30, 2002. The primary reasons for the decrease were related the closing of the Company s office in Germany in fiscal 2002 and efforts to reduce overhead costs in the Company s office in England. As a result, the music segment incurred an operating loss of $1,010,000 for the year ended June 30, 2003 compared to an operating loss of $1,439,000 for the year ended June 30, 2002.

Licensing

Licensing revenues were $2,780,000 for fiscal 2003 compared to $3,118,000 for fiscal 2002, a decrease of 10.8%. While European revenue decreased $405,000, domestic revenue from licensing activity increased $67,000. The decrease in Europe reflected a reduced level of licensing in the music industry. While domestic licensing experienced this as well, licensing revenue from the Company s main licensee increased significantly. In fiscal 2002, the Company undertook a program to audit licensees of the music catalog in order to verify compliance with the terms of license agreements. One of the audits undertaken determined that a significant amount of revenue had not been reported to the Company. During the year ended June 30, 2003 the licensee subject to this audit made the royalty payments required under the license, and the Company s revenue increased accordingly. Operating income in the licensing segment was $1,159,000 for the year ended June 30, 2003 and $1,393,000 for the year ended June 30, 2002, a decrease of 16.8%.

FISCAL 2002 VERSUS FISCAL 2001

Net sales for the year ended June 30, 2002 were $6,891,000, a decrease of 61% from the year ended June 30, 2001 sales of $17,514,000. The sales decrease was primarily attributed to the cessation of operations of the Company s domestic music distribution subsidiary, K-tel (USA), which had sales of $11,948,000 during fiscal 2001. For the fiscal year ended June 30, 2002, approximately 43% of the Company s net sales were derived in Europe. Net income for the year ended June 30, 2002 was $300,000, or $.02 per share (after an extraordinary gain of $894,000 related to the K-tel Marketing liquidation), compared to a net income of $1,369,000, or $.10 per share (after an extraordinary gain of $16,185,000 related to the K-tel (USA) bankruptcy filing) in the year ended June 30, 2001.

The following sections discuss the results of continuing operations by business segment.

BUSINESS SEGMENT RESULTS

Music

Sales in the music segment were $3,773,000 for the year ended June 30, 2002 compared to $14,202,000 for the year ended June 30, 2001, a decline of 73.4%. European sales decreased $658,000 and domestic music sales decreased $9,965,000. The domestic business had been comprised primarily of sales of music compilations produced by K-tel and the sales and distribution of other record labels. Sales declined as K-tel (USA) ceased operations and filed for bankruptcy in March 2001. Sales during the year ended June 30, 2002 were in another domestic subsidiary (K-tel Entertainment, Inc.) that markets products derived from the Company s proprietary master music catalog.

Cost of goods sold in the music segment decreased to 50.4% of sales for the year ended June 30, 2002 compared to 106.9% of sales for the year ended June 30, 2001. The cost of goods in excess of net sales for the year ended June 30, 2001 reflected the disposal of slow-moving and obsolete inventory at prices less than cost during the period. Advertising expenses within the segment, which consist primarily of co-operative advertising payments, trade advertising and promotions, decreased to $172,000 for the year ended June 30, 2002 compared to $513,000 for the year ended June 30, 2001. The decrease in advertising spending was primarily the result of reduced levels of advertising during the year ended June 30, 2002.

Selling, general and administrative expenses for the segment decreased $3,131,000, or 50.0%, to $3,130,000 for the year ended June 30, 2002 compared to $6,261,000 for the year ended June 30, 2001. The primary reasons for the decrease were related to general overall spending reductions and nine months of operations of the domestic music distribution subsidiary in the year ended June 30, 2001. As a result, the music segment incurred an operating loss of $1,439,000 for the year ended June 30, 2002 compared to an operating loss of $7,749,000 for the year ended June 30, 2001.

In connection with the K-tel Marketing Ltd. creditors liquidation in the year ended June 30, 2002, the assets and liabilities of the subsidiary have been removed from the books of the Company and the remaining net liability has been shown as a gain on liquidation. During the fiscal year ended June 30, 2002, this subsidiary was not operating. During the fiscal year ended June 30, 2001, this subsidiary had net sales of $3,179,000 and sustained an operating loss of $3,220,000. Management believes the Company will have no ongoing liability related to this subsidiary as a result of the filing and the outcome of the liquidation proceeding.

In connection with the K-tel (USA) bankruptcy filing in the year ended June 30, 2001, the assets and liabilities of the subsidiary were removed from the books of the Company and the remaining net liability has been shown as a gain on liquidation. During the fiscal year ended June 30, 2002, this subsidiary was not operating. During the fiscal year ended June 30, 2001, this subsidiary had net sales of $11,948,000 and sustained an operating loss $5,229,000. Management believes the Company will have no ongoing liability related to this subsidiary as a result of the filing and the outcome of the bankruptcy proceeding.

Licensing

Licensing revenues were $3,118,000 for the year ended June 30, 2002 compared to $3,710,000 for the year ended June 30, 2001, a decrease of 15.9%. Included in the segment revenue in the year ended June 30, 2001 was approximately $763,000 of inter-company revenue, which was eliminated on the accompanying consolidated financial statements. Operating income in the licensing segment was $1,393,000 for the year ended June 30, 2002 and $425,000 for the year ended June 30, 2001, an increase of 228%, which was a result of operational productivity improvements.

Other

The Other segment of the business was comprised of the e-commerce business, which was closed in the fourth quarter of 2001. The Company had neither revenue nor losses from this segment in the years ended June 30, 2002 and 2003. Revenue from this segment was $365,000 in the year ended June 30, 2001. Operating losses from this segment were $2,156,000 in the year ended June 30, 2001.

Critical Accounting Policies

Revenue Recognition The Company derives its revenue mainly from two sources: the sale of music compilations (predominately compact discs) produced by the Company, and license revenue from the licensing of Company-owned masters. Revenue from music sales is recognized at the time of shipment to the customer, while license revenue is recognized when payment is received from customers or when known amounts are receivable, as prior to that date collection is not considered probable. Most music sales are made with a right of return of unsold goods. Estimated reserves for returns are established by management based upon historical experience and product mix and are subject to ongoing review and adjustment by the Company. These reserves are recorded at the time of sale and are reflected as a reduction in revenues. The Company s reserve for returns was $220,000 at June 30, 2003 and $46,000 at June 30, 2002.

Rights to Use Music Product - Certain of the Company s compilation products are master recordings under license from record companies and publishers. In most instances, minimum guarantees or non-refundable advances are required to obtain the licenses and are realized through future sales of the product. The amounts paid for minimum guarantees or non-refundable advances are capitalized and charged to expense as sales are made. The unrealized portion of guarantees and advances is included in royalty advances in the accompanying consolidated balance sheets. Licenses are subject to audit by licensors. When anticipated sales appear to be insufficient to fully recover the minimum guarantees or non-refundable advances, a provision against current operations is made for anticipated losses.

Royalties - The Company has entered into license agreements with various record companies and publishers under which it pays royalties on units sold. The Company accrues royalties using contractual rates and certain estimated rates on applicable units sold. The contractual royalty liability is computed quarterly and the accrued royalty balance is adjusted accordingly. The royalty agreements are subject to audit by licensors.

Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146 (SFAS 146), *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 provides financial accounting and reporting guidance for costs associated with exit or disposal activities, including one-time termination benefits, contract termination costs other than for a capital lease, and costs to consolidate facilities or relocate employees. This statement is effective for exit or disposal activities that are initiated after December 31, 2002. Management does not believe this pronouncement will have a material effect on the Company s consolidated financial position and results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 addresses the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that is has issued. FIN 45 also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of FIN 45 were effective for the Company for its quarter ended December 31, 2002. The liability recognition requirement is applicable prospectively to all guarantees issued or modified after December 31, 2002. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

In December 2002, the FASB issued Statement 148 (FAS 148), *Accounting for Stock-Based Compensation Transition and Disclosure.* FAS 148 amends the disclosure and certain transition provisions of Statement 123, *Accounting for Stock-Based Compensation.* Its disclosure provisions, which apply to all entities with employee stock-based compensation, are effective for fiscal years ending after December 15, 2002. New interim period disclosures were required in financial statements for interim periods beginning after December 15, 2002. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

In December 2003, the FASB issued Interpretation (FIN 46R), *Consolidation of Variable Interest Entities.* FIN 46R is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and addresses consolidation by business enterprises of variable interest entities. FIN 46R applies to variable interest entities created or obtained after January 31, 2003 and it applies in the first fiscal year or interim period beginning after March 15, 2004, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement will have an effect on the Company s consolidated financial position and results of operations as the Company will consolidate a variable interest entity in the quarter ending March 31, 2004.

In May 2003, the FASB issued Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. Statement 150 changes the classifications in the statement of financial position of certain common financial instruments from either equity or mezzanine presentation to liabilities and requires an issuer of those financial statements to recognize changes in fair value or redemption amount, as applicable, in earnings. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of Statement 150 is not anticipated to have an impact on the Company s consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*, which replaced SFAS No. 123 and superseded APB 25. SFAS No. 123R addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company s equity instruments or that may be settled by the issuance of such equity instruments. Under SFAS No. 123R, companies will no longer be able to account for the share-based compensation transactions using the intrinsic method in accordance with APB 25 but will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of operations. SFAS No. 123R is effective beginning in the Company s first quarter of fiscal year 2006. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. The Company has begun, but has not completed, evaluating the impact of the adoption of SFAS 123R on its results of operations. In connection with evaluating the impact of SFAS 123R, the Company is considering the potential implementation of different valuation methods to determine the fair value of share-based compensation. The Company believes the adoption of SFAS 123R will not have a material impact on our results of operations, regardless of the valuation method used.

B. LIQUIDITY AND CAPITAL RESOURCES

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of the agreement (the K-5 Facility), K-5 has agreed to make available up to $8,000,000 to K-tel on a revolving basis. The loan bears interest at a variable rate based upon the base rate of a nationally recognized lending institution (4.0% at June 30, 2003), expired July 20, 2005, and is subordinated to the Foothill loan (see below). The Company is currently in negotiations to extend the Line of Credit Agreement until July 20, 2006.The K-5 Facility contains the same covenants as the Foothill loan agreement. K-tel has pledged the stock of its foreign subsidiaries as collateral for the loan, and the loan carries a subordinated position to the Foothill loan on all other assets of the Company. K-tel had outstanding balances of $7,282,000 and $6,026,000 as of June 30, 2003 and 2002 respectively under the K-5 Facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

In addition, K-tel has a second loan agreement with K-5, under which K-5 assumed rights and obligations under a loan from the Company s former banker (Foothill Capital Corporation) pursuant to an Assignment and Acceptance Agreement dated February 27, 2001. This Foothill loan, which had been extended through July 20, 2005, (the Company is currently in negotiations to extend the loan agreement until July 20, 2006) provides for a $10,000,000 credit facility consisting of a $4,000,000 term loan due upon expiration, and a $6,000,000 revolving facility under which borrowings are limited to a percent of eligible receivables. Borrowings under the facility bear interest at a variable rate based on a base rate of a nationally recognized lending institution plus 1% (5.0% at June 30, 2003) and are collateralized by the assets of certain Company subsidiaries in the United States, including accounts receivable, inventories, equipment, music library and general intangibles. The loan agreement contains certain financial and other covenants or restrictions, including the maintenance of a minimum shareholders equity by K-tel, limitations on capital expenditures, restrictions on music library acquisitions, limitations on other indebtedness and restrictions on dividends paid by K-tel. As of June 30, 2003 and 2002, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel has an overdraft privilege borrowing facility with The Royal Bank of Scotland in the United Kingdom. This facility is secured by a standby letter of credit for $260,000 provided by K-tel International Ltd., a Canadian company controlled by Philip Kives and is payable on demand in accordance with normal banking practices. Borrowings bear interest of 2.0% per annum over the base rate (a total of 5.75% at June 30, 2003) but are subject to a minimum of 6% per annum. K-tel had outstanding balances of $233,000 and $227,000 as of June 30, 2003 and 2002, respectively.

K-tel has primarily funded its operations to date through internally generated capital, proceeds from stock option exercises and secured loans from K-5. Management currently believes that K-tel has sufficient cash and borrowing capacity to ensure the Company will continue operations in the near term. Although K-5 continues to advance funds sufficient to meet the Company s needs at this time, there can be no assurance that this will be adequate or continue in the future or that K-tel will be able to obtain additional financing upon favorable terms when required.

The Company s ability to continue its present operations and implement future expansion plans successfully is contingent mainly upon its ability to maintain its line of credit arrangements with K-5, increase its revenues and profit margins, and ultimately attain and sustain profitable operations. Without increased revenues and sustained profitability beyond the near term, the cash generated from the Company s current operations will likely be inadequate to fund operations and service its indebtedness on an ongoing basis. Management is focusing its efforts on music licensing and limited music distribution. However, there can be no assurance that the Company will achieve profitable operations through these efforts. In the event the Company is unable to fund its operations and implement its current business plan properly, it may be unable to continue operations. The financial statements do not include any adjustments that might result from the outcome of these uncertainties. The report of the Company s independent registered public accounting firm as of June 30, 2003 and 2002 and for the three years in the period ended June 30, 2003 includes an explanatory paragraph expressing doubt about our ability to continue as a going concern.

CAUTIONARY STATEMENT

Certain information of a non-historical nature contained in this Form 10-K include forward-looking statements. Words such as anticipates , believes , expects , intends , future , and similar expressions identify forward-looking statements. Any such forward-looking statements reflect the Company s current views with respect to future events and financial performance, and are subject to a variety of factors that could cause the actual results or performance to differ materially from historical results or from the anticipated results or performance expressed or implied by such forward-looking statements. Because of such factors, the Company cannot assure you that the actual results or developments that it anticipates will be realized or, even if substantially realized, that they will have the anticipated results.

The risks and uncertainties that may affect the Company s business include, but are not limited to, those set forth below. The risks and uncertainties set forth below incorporate both historical and 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. You should not place undue reliance on such forward-looking statements, which speak only as of the date hereof. You should also be aware that, except as the law may otherwise require, the Company undertakes no obligation to publicly revise any such forward-looking statements to reflect events or circumstances that may arise after the date of this report. The following information is not intended to limit in any way the characterization of other statements or information under other captions as cautionary statements for such purpose. The order in which such factors appear below should not be construed to indicate their relative importance or priority.

The Company incurred a loss in the fiscal year ended June 30, 2003 and expects to continue incurring losses in the near future.

Continuation and expansion of the Company s operations will require additional working capital and continued access to financing to meet working capital requirements and develop new business opportunities.

The Company has primarily funded its operations to date through internally generated capital, proceeds from stock option exercises and secured loans from K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel, and there can be no assurance that K-5 will continue to advance funds sufficient to meet the Company s needs or that the Company will be able to obtain additional financing upon favorable terms when required.

Approximately 30.1% of the Company s revenue for the year ended June 30, 2003, was derived from two major customers, and the loss of any such customer could have a material adverse effect on the Company.

The music business is highly competitive and dominated by several major record companies that dominate the market for pre-recorded music, have greater financial resources than the Company and have a larger depth and breadth of catalog, distribution capabilities and current repertoire than the Company, making it difficult to compete in this market.

The major pre-recorded music companies, either directly or through subsidiaries, now manufacture or distribute pre-recorded music compilations in direct competition with the Company s music compilation products.

ITEM 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

K-tel is exposed to various market risks, including changes in interest rates and foreign currency exchange rates. Market risk is the potential loss arising from adverse changes in market rates and prices, such as interest rates and foreign currency exchange rates. K-tel does not enter into derivatives or other financial instruments for trading or speculative purposes.

K-tel s exposure to market risk for changes in interest rates relates to K-tel s short-term borrowings. K-tel s short-term credit facilities carry a variable interest rate that does have an impact on future earnings and cash flows. At June 30, 2003, K-tel had variable rate debt of $11,515,000.

If the interest rate were to change 100 basis points or 1% while K-tel was borrowing under the credit facilities, interest expense would change by $115,000.

Approximately 32% of K-tel s revenues during the year ended June 30, 2003 were derived from operations in Europe. The results of operations and financial position of K-tel s operations in Europe were principally measured in their respective currencies and translated into U.S. dollars. The effect of foreign currency fluctuations in these European countries is somewhat mitigated by the fact that expenses are generally incurred in the same currencies in which the revenue is generated. The reported income of these subsidiaries will be higher or lower depending on the weakening or strengthening of the U.S. dollar against the respective foreign currency. If the U.S. dollar foreign currency rate were to change by 1%, the effect on income would be $4,000. Additionally, approximately 27% of K-tel s assets at June 30, 2003 were based in its foreign operations and were translated into U.S. dollars at foreign currency exchange rate in effect as of the end of each accounting period, with the effect of such translation reflected as a separate component of consolidated shareholders equity (deficit). Accordingly, K-tel s consolidated shareholders equity (deficit) will fluctuate depending on the weakening or strengthening of the U.S. dollar against the respective foreign currency.

ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and related notes and schedules required by this Item are set forth in Part IV, Item 15, and identified in the Index to Consolidated Financial Statements and Schedules.

ITEM 9A: CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were not effective because of the following material weakness in internal control over financial reporting.

The Company did not maintain effective controls over cash disbursements and payroll transactions at its UK subsidiary. In September 2004, the Company discovered that the former Chief Financial Officer of its UK subsidiary misappropriated funds from the subsidiary and one of its customers. Adjustments related to the reversal of overstated expenses and recovery of amounts misappropriated were included in the restatement of the Company s consolidated financial statements for the years ended June 30, 2002 and 2003.

In response to the material weakness above, the Company terminated the employee, undertook a full-scale investigation of the matter, retained a forensic auditing firm and dismissed the accounting firm in the UK that audited the UK subsidiary s financial books and records. In addition the Company hired a new Financial Controller and stringent internal control procedures were created and implemented for the Company s purchasing, accounts payable, check signing, payroll, petty cash and financial reporting policies. Management believes that these procedures, implemented upon the discovery of the misappropriation of funds, will allow the Company to maintain internal control over financial reporting.

During the Company s most recent fiscal quarter (September 30, 2005), there has been no change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B: OTHER INFORMATION

Not applicable.

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of the agreement (the K-5 Facility), K-5 has agreed to make available up to $8,000,000 to K-tel on a revolving basis. The loan bears interest at a variable rate based upon the base rate of a nationally recognized lending institution (4.0% at June 30, 2003), expired July 20, 2005, and is subordinated to the Foothill loan (see below). The Company is currently in negotiations to extend the Line of Credit Agreement until July 20, 2006. The K-5 Facility contains the same covenants as the Foothill loan agreement. K-tel has pledged the stock of its foreign subsidiaries as collateral for the loan, and the loan carries a subordinated position to the Foothill loan on all other assets of the Company. K-tel had outstanding balances of $7,282,000 and $6,026,000 as of June 30, 2003 and 2002 respectively under the K-5 Facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

In addition, K-tel has a second loan agreement with K-5, under which K-5 assumed rights and obligations under a loan from the Company s former banker (Foothill Capital Corporation) pursuant to an Assignment and Acceptance Agreement dated February 27, 2001. This Foothill loan, which had been extended through July 20, 2005, (the Company is currently in negotiations to extend the loan agreement until July 20, 2006), provides for a $10,000,000 credit facility consisting of a $4,000,000 term loan due upon expiration, and a $6,000,000 revolving facility under which borrowings are limited to a percent of eligible receivables. Borrowings under the facility bear interest at a variable rate based on a base rate of a nationally recognized lending institution plus 1% (5.0% at June 30, 2003) and are collateralized by the assets of certain Company subsidiaries in the United States, including accounts receivable, inventories, equipment, music library and general intangibles. The loan agreement contains certain financial and other covenants or restrictions, including the maintenance of a minimum shareholders equity by K-tel, limitations on capital expenditures, restrictions on music library acquisitions, limitations on other indebtedness and restrictions on dividends paid by K-tel. As of June 30, 2003 and 2002, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel has an overdraft privilege borrowing facility with The Royal Bank of Scotland in the United Kingdom. This facility is secured by a standby letter of credit for $260,000 provided by K-tel International Ltd., a Canadian company controlled by Philip Kives and is payable on demand in accordance with normal banking practices. Borrowings bear interest of 2.0% per annum over the base rate (a total of 5.75% at June 30, 2003) but are subject to a minimum of 6.0% per annum. K-tel had outstanding balances of $233,000 and $227,000 as of June 30, 2003 and 2002, respectively.

The Company purchased approximately $463,000 in the year ended June 30, 2003, $366,000 in the year ended June 30, 2002 and $574,000 in the year ended June 30, 2001 of music entertainment and consumer convenience products from K-5, which represented 14.6%, 14.7% and 3.7% of cost of goods sold, respectively. There were trade payables to K-5 of $371,000 at June 30, 2003, $ 291,000 at June 30, 2002 and $285,000 at June 30, 2001, or 31.9%, 23.0% and 22.2% of total trade payables, respectively.

The Company had no sales of consumer convenience products to K-5 during fiscal years 2003 and 2002 and sales of $13,000 during fiscal 2001. There was a balance receivable from K-5 at June 30, 2003 of $73,000, June 30, 2002 of $129,000 and June 30, 2001 of $109,000. No interest was charged on the related outstanding balances during fiscal years 2003, 2002 and 2001.

During the fiscal year ended June 30, 2003, the Company licensed certain marks to K-tel Drug Mart Ltd., a Canadian direct marketer of prescription drugs owned by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. The terms of the license agreement between the Company and K-tel Drug Mart have not been finalized, but will involve payment of a royalty to the Company by K-tel Drug Mart for use of the trademark. The agreement is currently under consideration by the Company, and will be subject to approval by the Company s independent directors.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Audit fees

The following table shows the aggregate fees billed to the Company by Grant Thornton for services rendered during fiscal years ended June 30, 2003 and June 30, 2002:

Description of Fees		Fiscal 2003 Amount		Fiscal 2002 Amount
Audit Fees	$	127,500(1)	$	97,500(1)
Audit Related fees				
Tax Fees		54,600(2)		40,150(2)
Other Fees		500(3)		16,725(3)
Total	$	182,600	$	154,375

(1) Audit fees consisted of fees for audit work of the Company s annual financial statements and review of the quarterly financial statements included in the Company s Quarterly Reports on Form 10-Q for the fiscal years 2003 and 2002 and related audit committee meeting attendance.

(2) Tax fees consisted of fees for federal, state and international tax return preparation and tax planning and tax advice related to various tax matters including state tax notices and other tax research related matters.

(3) Other fees included fees related to statutory audit work performed in Germany, an audit of an employee benefit plan in 2002, and other financial consulting assistance.

Auditor Independence

The audit committee requires that all audit and permissible non-audit services provided by our independent auditors be pre-approved by the audit committee or a designated member of the audit committee. These services may include audit services, audit-related services, tax services and other services. Any pre-approval is detailed as to the particular service or category of services. The audit committee reviews all non-audit services to be provided and assesses the impact of the services on the auditor s independence.

The audit committee pre-approved 100% of the services described in the Principal Accountant Fees and Services table pursuant to engagements that occurred in fiscal 2003.

PART IV

ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Financial Statements and Schedules

The consolidated statements and schedules listed in the accompanying Index to Consolidated Financial Statements and Schedules hereof are filed as part of this report.

(b) Exhibits

Reference is made to the Exhibit Index.

(c) Excluded Financial Statements

Not applicable.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf on January 5, 2006, by the undersigned, thereunto duly authorized.

K-TEL INTERNATIONAL, INC.

By /s/ Philip Kives
(Philip Kives - Chairman of the Board,
Chief Executive Officer and President)

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated and on the dates indicated.

Signatures	Title	Date
/s/ Philip Kives Philip Kives	Chairman, Chief Executive Officer, (Principal Executive Officer) President and Director	January 5, 2006
/s/ Larry Dunmall Larry Dunmall	Chief Financial Officer (Principal Financial Officer)	January 5, 2006
/s/ Jay William Smalley Jay William Smalley	Director	January 5, 2006
/s/ Wesley C. Hayne Wesley C. Hayne	Director	January 5, 2006
/s/ Richard Marklund Richard Marklund	Director	January 5, 2006

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission have been omitted as not required, not applicable or the information required has been included elsewhere in the consolidated financial statements and notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of K-tel International, Inc.

We have audited the accompanying consolidated balance sheets of K-tel International, Inc. (a Minnesota corporation) and subsidiaries as of June 30, 2003 and 2002 and the related consolidated statements of operations, shareholders equity (deficit), and cash flows for each of the three years in the period ended June 30, 2003. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of K-tel International, Inc. and subsidiaries as of June 30, 2003 and 2002 and the results of their operations and their cash flows for the each of the three years in the period ended June 30, 2003 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 11, the consolidated financials have been restated.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has incurred significant recurring losses from operations and has a net working capital deficit that raises substantial doubt about the Company s ability to continue as a going concern. Management s plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

We have also audited Schedule II for each of the three years in the period ended June 30, 2003. In our opinion, this schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information therein.

/S/ GRANT THORNTON LLP

Minneapolis, Minnesota,
December 15, 2005

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

JUNE 30,

(in thousands - except share data)

	2003	2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,219	$ 75
Accounts receivable, net of allowance for doubtful accounts of $25 and $68	2,134	2,045
Inventories	522	637
Royalty advances	220	268
Prepaid expenses and other	304	378
Total Current Assets	4,399	3,403
Property and equipment, net of accumulated depreciation and amortization of $1,506 and $1,418	83	147
Owned catalog masters, net of accumulated amortization of $2,755 and $2,829	819	1,060
	$ 5,301	$ 4,610
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current Liabilities:		
Notes payable to affiliate and other	$ 11,515	$ 10,253
Accounts payable	1,160	1,261
Accrued royalties	2,394	2,301
Reserve for returns	220	46
Net liabilities of discontinued operations	116	92
Total Current Liabilities	15,405	13,953
Shareholders Deficit:		
Common Stock 50,000,000 shares authorized, par value $.01; 13,653,738 issued and outstanding	136	136
Additional paid-in capital	21,292	21,292
Accumulated deficit	(31,377)	(30,485)
Accumulated other comprehensive loss	(155)	(286)
Total Shareholders Deficit	(10,104)	(9,343)
	$ 5,301	$ 4,610

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

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K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

YEARS ENDED JUNE 30,

(in thousands - except per share data)

	2003	2002	2001
Net Sales	$ 7,234	$ 6,891	$ 17,514
Costs and Expenses:			
Cost of goods sold	3,100	2,353	15,658
Advertising	200	172	618
Selling, general and administrative	3,785	4,412	10,718
Total Costs and Expenses	7,085	6,937	26,994
Operating Income (Loss)	149	(46)	(9,480)
Other Income (Expense):			
Interest income			155
Interest expense	(534)	(472)	(912)
Foreign currency transaction loss			(360)
Other income (expense)	74	(37)	
Total Other Income (Expense)	(460)	(509)	(1,117)
Income (Loss) from Continuing Operations Before Income Taxes	(311)	(555)	(10,597)
Benefit for Income Taxes		141	96
Income (Loss) from Continuing Operations	(311)	(414)	(10,501)
Discontinued Operations:			
Loss from Discontinued Operations	(581)	(180)	(4,315)
Loss before Extraordinary Item	(892)	(594)	(14,816)
Extraordinary Item:			
Gain on Subsidiary Liquidations		894	16,185
Net Income (Loss)	$ (892)	$ 300	$ 1,369
Income (Loss) per Share Basic and Diluted:			
Continuing Operations	$ (.02)	$ (.03)	$ (.77)
Discontinued Operations	(.04)	(.01)	(.32)
Extraordinary Item		.06	1.19
Net Income (Loss)	$ (.06)	$ .02	$ .10
Shares used in the calculation of loss per share Basic and Diluted:	13,654	13,654	13,654
Comprehensive Income (Loss)			
Net income (loss)	$ (892)	$ 300	$ 1,369
Translation adjustment	131	(3)	476
Comprehensive Income (Loss)	$ (761)	$ 297	$ 1,845

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY (DEFICIT)

YEARS ENDED JUNE 30, 2003, 2002 AND 2001

(in thousands)

	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss)	Total
	Shares	Amount				
Balance at June 30, 2000	10,321	$ 103	$ 20,213	$ (32,154)	$ (759)	$ (12,597)
Net income				1,369		1,369
Conversion of debt to equity	3,333	33	467			500
Translation adjustment					476	476
Balance at June 30, 2001	13,654	136	20,680	(30,785)	(283)	(10,252)
Net income				300		300
Reduction of notes payable to affiliate			612			612
Translation adjustment					(3)	(3)
Balance at June 30, 2002	13,654	136	21,292	(30,485)	(286)	(9,343)
Net income				(892)		(892)
Translation adjustment					131	131
Balance at June 30, 2003	13,654	$ 136	$ 21,292	$ (31,377)	$ (155)	$ (10,104)

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30,

(in thousands)

	2003	2002	2001
Operating Activities:			
Net income (loss)	$ (892)	$ 300	$ 1,369
Adjustment to reconcile net income (loss) to cash used in operating activities:			
Depreciation and amortization	315	380	408
Loss on disposal of property and equipment	3	18	349
Gain on liquidation		(894)	(16,185)
Discontinued operations	7	(109)	3,630
Write down of long lived asset			417
Changes in operating assets and liabilities:			
Accounts receivable, net	(147)	(1,078)	3,217
Inventories	135	(199)	2,378
Royalty advances	68	(70)	(82)
Prepaid expenses and other current assets	89	295	(225)
Accounts payable	(10)	(695)	2,421
Accrued royalties	87	213	230
Income taxes		(130)	
Reserve for returns	173	(18)	(370)
Cash used in operating activities	(172)	(1,987)	(2,443)
Investing Activities:			
Purchases of property and equipment	(18)	(124)	(62)
Music catalog additions			(63)
Other	15	27	27
Cash used in investing activities	(3)	(97)	(98)
Financing Activities:			
Borrowings on notes payable	2,278	3,676	13,946
Payments on notes payable	(1,033)	(1,629)	(12,508)
Cash provided by financing activities	1,245	2,047	1,438
Effect of exchange rates on cash	74	(61)	478
Net increase (decrease) in cash equivalents	1,144	(98)	(625)
Cash and equivalents at beginning of period	75	173	798
Cash and equivalents at end of period	$ 1,219	$ 75	$ 173
Supplemental Cash Flow Information			
Cash Paid For -			
Interest	$ 396	$ 598	$ 483
Income Taxes	$	$	$ 4
Non-cash Information			
Reduction of notes payable to affiliate through debt forgiveness, recorded as a capital contribution	$	$ 612	$
Music Catalogs reclassified to prepaid assets	$	$ 173	$

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2003, 2002 AND 2001

1. BUSINESS AND LIQUIDITY

K-tel International, Inc. (the Company or K-tel) was incorporated in 1968 and currently has its corporate offices located in Plymouth, Minnesota. Through its operating subsidiaries, K-tel licenses its music catalog internationally and markets entertainment products mainly derived from its catalog through retail and direct response marketing channels in the United States and Europe. The Company has a focused method of distribution that targets the strengths of fewer individual retailers and supplies products suited to each retailer s needs. These new products are derived mainly from the Company s master recordings music catalog with the objective of realizing more competitive profit margins. K-tel seeks to license its trademarks to other companies in businesses unrelated to K-tel s current operations. Licenses are granted for a royalty or fee, with no cost to the Company. The Company has licensed certain marks to K-tel Drug Mart Ltd., a Canadian direct marketer of prescription drugs beneficially owned by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. K-tel Drug Mart, offers prescription drugs from its pharmacy in Canada to persons in the United States. K-tel is merely a licensor of its mark to K-tel Drug Mart. To date, K-tel Drug Mart s operations have not generated any significant licensing revenues for the Company.

Subsidiaries Bankruptcy and Liquidation

In March 2001, the Company s music distribution subsidiary in the United States, K-tel International (USA), Inc. ceased operations and filed for protection under Chapter 7 of the U. S. bankruptcy code. In connection with this filing, the assets and liabilities of this subsidiary were removed from the books of the Company as control of the subsidiary was transferred to the bankruptcy trustee. The net liability at the time of this filing was shown as a gain on the Chapter 7 liquidation. Management believes the Company will have no ongoing liability related to this subsidiary as a result of the filing and the outcome of the bankruptcy proceeding. During the fiscal year ended June 30, 2001, this subsidiary had net sales of $11,948,000 and an operating loss of $5,299,000.

In November 2000, the Company s consumer products subsidiary in the United Kingdom, K-tel Marketing Ltd., ceased operations and began voluntary liquidation proceedings. At the initial meeting of the creditors on November 24, 2000, the creditors voted for the liquidation to become a creditors liquidation under English law. The Company has not been informed by the liquidators or their counsel of any plan to attempt to hold it or any of its subsidiaries liable for any of the commitments of K-tel Marketing Ltd. Management believes the Company will have no ongoing material liability related to K-tel Marketing Ltd. as a result of the liquidation proceeding. K-tel Marketing Ltd. had no operations during the fiscal years ended June 30, 2003 and 2002. During fiscal 2001, this subsidiary had net sales of $3,179,000 and an operating loss of $3,220,000. Losses in the year ended June 30, 2003 of $581,000 and $180,000 in the year ended June 30, 2002 related mainly to legal fees incurred in the Tristar litigation (See Note 6.)

Discontinued Operations

The Company s consumer products business, which was concentrated in Europe, consisted primarily of housewares, consumer convenience items and exercise equipment. The Company discontinued its consumer products operations in Germany, the United Kingdom and the United States in

June 2000, November 2000 and January 2001, respectively. Accordingly, these activities have been presented in the accompanying financial statements as discontinued operations. Net sales for these operations were $3,818,000 for the fiscal year ended June 30, 2001. The accompanying consolidated financial statements have been prepared to reflect the consumer products division as a discontinued operation. The net liabilities of discontinued operations at June 30, 2003 and 2002 consist of assets of $19,000 and $14,000 and liabilities of $135,000 and $106,000.

Going Concern

For the year ended June 30, 2003, 2002 and 2001, the Company incurred net losses from continuing operations of $311,000, $414,000 and $10,501,000, respectively, and used $172,000, $1,987,000, and $2,443,000 of cash in operating activities. Additionally, the Company had a working capital deficit of $11,006,000 at June 30, 2003.

The Company s ability to continue its present operations and implement future expansion plans successfully is contingent mainly upon its ability to maintain its line of credit arrangements with K-5 Leisure Products, Inc. (See Note 3), increase its revenues and profit margins, and ultimately attain and sustain profitable operations. Without increased revenues and sustained profitability, the cash generated from the Company s current operations will likely be inadequate to fund operations and service its indebtedness on an ongoing basis. Management is focusing its efforts on music licensing and limited music distribution. However, there can be no assurance that the Company will achieve profitable operations through these efforts. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation - The accompanying consolidated financial statements include the accounts of K-tel International, Inc. and its domestic and foreign subsidiaries, all of which are wholly owned. All significant intercompany accounts and transactions have been eliminated.

Revenue Recognition The Company derives its revenue mainly from two sources: the sale of music compilations (predominately compact discs) produced by the Company, and license revenue from the licensing of Company-owned masters. Revenue from music sales is recognized at the time of shipment to the customer, while license revenue is recognized when payment is received from customers or when known amounts are receivable, as prior to that date collection is not considered probable. Most music sales are made with a right of return of unsold goods. Estimated reserves for returns are established by management based upon historical experience and product mix and are subject to ongoing review and adjustment by the Company. These reserves are recorded at the time of sale and are reflected as a reduction in revenues. The Company s reserve for returns was $220,000 at June 30, 2003 and $46,000 at June 30, 2002.

Cost of Goods Sold The Company expenses all product manufacturing, distribution and royalty costs associated with music sales as cost of goods sold. The Company also expenses royalties, commissions and amortization of its owned master recordings associated with its license revenue as costs of goods sold.

Shipping and Handling Costs The Company expenses within cost of goods sold all shipping and handling costs incurred in the shipment of goods.

Cash and Equivalents Cash and equivalents consist principally of cash and short-term, highly liquid investments with original maturities of less than ninety days.

Inventories Inventories, which consists of finished goods that include all direct product costs, are valued at the lower of cost, determined on a first-in, first-out basis, or net realizable value.

Owned Catalog Masters The Company capitalizes the costs to purchase owned master recordings at the time of acquisition. These costs are amortized over the estimated useful life of these master recordings, which is generally seven years and represents management s best estimate of the average period of value.

Rights to Use Music Product - Certain of the Company s compilation products are master recordings under license from record companies and publishers. In most instances, minimum guarantees or non-refundable advances are required to obtain the licenses and are realized through future sales of the product. The amounts paid for minimum guarantees or non-refundable advances are capitalized and charged to expense as sales are made. The unrealized portion of guarantees and advances is included in royalty advances in the accompanying consolidated balance sheets. Licenses are subject to audit by licensors. When anticipated sales appear to be insufficient to fully recover the minimum guarantees or non-refundable advances, a provision against current operations is made for anticipated losses.

Property and Equipment - Property and equipment are stated at cost. Depreciation and amortization is provided using straight line or declining balance methods over the estimated useful lives of the assets, which range from three to nine years.

Long Lived-Assets The Company evaluates its long-lived assets quarterly, or earlier if a triggering event occurs, to determine potential impairment by comparing the carrying value of those assets to the related undiscounted future cash flows of the assets. If an asset is determined to be impaired, it is written down to its estimated fair value. During the quarter ended March 31, 2001, the Company suspended its online business to relocate these operations to the Company s offices in Minnesota and update the website to reflect the Company s continuing operations. The Company wrote down the assets of that business to its estimated fair value, resulting in a charge during the quarter ended March 31, 2001 of approximately $240,000. In addition, during the quarter ended June 30, 2001, the Company wrote down approximately $177,000 of trademarks related to its European operations, which were determined to have no remaining value as the Company is no longer marketing the products benefited by those trademarks. These charges were included within general and administrative expense.

Royalties - The Company has entered into license agreements with various record companies and publishers under which it pays royalties on units sold. The Company accrues royalties using contractual rates and certain estimated rates on applicable units sold. The contractual royalty liability is computed quarterly and the accrued royalty balance is adjusted accordingly. The royalty agreements are subject to audit by licensors.

Advertising - The Company expenses the costs of advertising when the advertising takes place, except for direct response advertising, which is capitalized and amortized over its expected period of future benefits (usually the period remaining under a related contract, which is generally less than one year). Direct response advertising consists primarily of television advertising whereby customers respond specifically to the advertising and where the Company can identify the advertising that elicited the response. Advertising expenses were $200,000, $172,000, and $618,000 for the years ended June 30, 2003, 2002 and 2001, respectively.

Foreign Currency - The operations of foreign subsidiaries are measured in local currencies. Assets and liabilities are translated into U.S. dollars at period-end exchange rates. Revenues and expenses are translated at the average exchange rates prevailing during the period. Adjustments resulting from translating the financial statements of foreign entities into U.S. dollars are recorded as a component of accumulated other comprehensive income or loss.

Stock-based Compensation The Company accounts for stock-based awards to employees using the intrinsic value method prescribed in APB No. 25, Accounting for Stock Issued to Employees, whereby the options are granted at market price, and therefore no compensation costs are recognized. The Company has elected to retain its current method of accounting as described above and has adopted the SFAS Nos. 123 and 148 disclosure requirements. If compensation expense for the Company s various stock option plans had been determined based upon the projected fair values at the grant dates for awards under those plans in accordance with SFAS No. 123, the Company s pro-forma net earnings, basic and diluted earnings per common share would have been as follows:

	Fiscal Year Ended June 30,		
	2003	**2002**	**2001**
Net income (loss) (in thousands):			
As reported	$ (892)	$ 300	$ 1,369
Pro forma	$ (907)	$ (172)	$ (496)
Basic and Diluted EPS:			
As reported	$ (.06)	$ .02	$ .10
Pro forma	$ (.06)	$ (.01)	$ (.04)

Income Taxes - Deferred income taxes are provided for temporary differences between the financial reporting basis and tax basis of the Company s assets and liabilities at currently enacted tax rates. A valuation allowance equal to the aggregate amount of deferred tax assets is established when realization is not likely.

Net Income (Loss) Per Share - Basic and diluted net income (loss) per share have been computed by dividing net income (loss) by the weighted average number of shares outstanding during the period. For all periods presented, common stock equivalents were excluded from the per share calculation as the net effect would be antidilutive. For the fiscal years ended June 30, 2003, 2002 and 2001, weighted average options to purchase 442,900, 2,273,839, and 2,336,889 shares of common stock, with weighted average exercise prices of $1.95, $5.89, and $5.77 were excluded from the computation of common share equivalents for the respective periods as they were antidilutive.

Use of Estimates - Preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (US GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Principal estimates include allowances for bad debt, inventory valuation, return reserves, royalty obligations, purchase commitments and product replacement costs. Actual results could differ from those estimates used by management.

3. LOANS PAYABLE TO AFFILIATE

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of the agreement (the K-5 Facility), K-5 has agreed to make available up to $8,000,000 to K-tel on a revolving basis. The loan bears interest at a variable rate based upon the base rate of a nationally recognized lending institution (4.0% at June 30, 2003), expired July 20, 2005, and is subordinated to the Foothill loan (see below). The Company is currently in negotiations to extend the Line of Credit Agreement until July 20, 2006. The K-5 Facility contains the same covenants as the Foothill loan agreement. K-tel has pledged the stock of its foreign subsidiaries as collateral for the loan, and the loan carries a subordinated position to the Foothill loan on all other assets of the Company. K-tel had outstanding balances of $7,282,000 and $6,026,000 as of June 30, 2003 and 2002, respectively, under the K-5 Facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

In addition, K-tel has a second loan agreement with K-5, under which K-5 assumed rights and obligations under a loan from the Company s former banker (Foothill Capital Corporation) pursuant to an Assignment and Acceptance Agreement dated February 27, 2001. This Foothill loan, which had been extended through July 20, 2005, (the Company is currently in negotiations to extend the loan agreement until July 20, 2006), provides for a $10,000,000 credit facility consisting of a $4,000,000 term loan due upon expiration, and a $6,000,000 revolving facility under which borrowings are limited to a percent of eligible receivables. Borrowings under the facility bear interest at a variable rate based on a base rate of a nationally recognized lending institution plus 1% (5.0% at June 30, 2003) and are collateralized by the assets of certain Company subsidiaries in the United States, including accounts receivable, inventories, equipment, music library and general intangibles. The loan agreement contains certain financial and other covenants or restrictions, including the maintenance of a minimum shareholders equity by K-tel, limitations on capital expenditures, restrictions on music library acquisitions, limitations on other indebtedness and restrictions on dividends paid by K-tel. As of June 30, 2003 and 2002, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2003, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel has an overdraft privilege borrowing facility with The Royal Bank of Scotland in the United Kingdom. This facility is secured by a standby letter of credit for $260,000 provided by K-tel International Ltd., a Canadian company controlled by Philip Kives and is payable on demand in accordance with normal banking practices. Borrowings bear interest of 2.0% per annum over the base rate (a total of 5.75% at June 30, 2003) but are subject to a minimum of 6.0% per annum. K-tel had outstanding balances of $233,000 and $227,000 as of June 30, 2003 and 2002, respectively.

4. INCOME TAXES

The Company operates in several countries and is subject to various tax regulations and tax rates. The provisions for income taxes are computed based on income reported for financial statement purposes in accordance with the tax rules and regulations of the taxing authorities where the income is earned.

The provision (benefit) for income taxes consists of the following for the years ended June 30 (in thousands):

	2003	2002	2001
Income (loss) before provision (benefit) for income taxes:			
United States	$ 196	$ (295)	$ 2,871
Foreign	(1,088)	454	(1,598)
Total	$ (892)	$ 159	$ 1,273
Provision (benefit) for income taxes:			
Current			
United States	$	$ (141)	$ (100)
Foreign			4
Total provision (benefit) for income taxes	$	$ (141)	$ (96)

A reconciliation of the U.S. Federal statutory rate to the effective tax rate for the years ended June 30 was as follows:

	2003	2002	2001
Federal statutory rate	34%	34%	34%
State Taxes, net of Federal benefit	0	2	2
Valuation allowance	(34)	(36)	(36)

Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company s assets and liabilities. Temporary differences, which are all deferred tax assets, were as follows (in thousands):

	June 30, 2003	June 30, 2002
Net operating loss carryfowards	$ 20,875	$ 17,661
Alternative minimum tax credits	432	432
Foreign tax credit	325	325
Reserve for returns	852	761
Depreciation and amortization	199	238
Royalty reserves	145	105
Inventory reserves	36	40
Nondeductible accruals	286	310
Allowance for bad debts	19	29
Valuation allowance	(23,169)	(19,901)

	$	$

A valuation allowance equal to the aggregate amount of deferred tax assets has been established until such time as realizability is more likely than not.

For U.S. tax reporting purposes, the Company has net operating loss carryforwards (NOL) of approximately $58,000,000. However, of the amount available through 2013 and 2020, $20,100,000 of the NOL relates to deductions associated with the exercise of stock options. The tax benefit of approximately $7,236,000 associated with this stock option deduction will be recorded as additional paid-in capital when realized. The NOL carryforwards may be reduced in future years, without financial statement benefit, to the extent of intercompany dividends received from foreign subsidiaries. Also, the NOL carryforwards are subject to review and possible adjustment by taxing authorities. In addition, the Company has approximately $432,000 in U.S. federal alternative minimum tax credits and $325,000 in foreign tax credits, which may be utilized in the future to offset any regular corporate income tax liability.

5. CAPITAL TRANSACTIONS

Stock Option Plan

The Company has a Stock Option Plan for officers, directors, and employees of the Company. Under the terms of this plan the Board of Directors has the sole authority to determine the employees to whom options and awards are granted, the type, size and terms of the awards, the timing of the grants, the duration of the exercise period and any other matters arising under the plan. The common stock incentives may take the form of incentive stock options and nonqualified stock options. The Company s 1987 plan, which has expired, covered a maximum of 700,000 shares of common stock, of which options for the purchase of 2,000 shares remain outstanding and exercisable. In February 1997, the Company s Board of Directors approved a new stock option plan covering a maximum of 600,000 shares of common stock, which was subsequently amended to 5,000,000 through shareholder amendments in February 1999, January 2000 and November 2000. There were options on 2,613,011 net shares granted under this plan as of June 30, 2003. Of these options granted, 2,472,111 have been exercised. Any options cancelled are available for future grants. No options granted have expired.

Stock Option Exchange

On March 18, 2003, a committee of the Company s board of directors comprised solely of independent directors, approved a Stock Option Exchange Program. The program provides for a small number of optionees who were previously awarded options to purchase shares of common stock under the Company s 1997 Stock Option Plan to exchange them for options to purchase an equal number of shares outside the Company s Stock Option Plan. The options to purchase an aggregate 2,137,939 shares of common stock have a weighted average price per share of $5.95. Replacement options were issued six months and one day after the date of cancellation on November 18, 2003 of the existing options and were issued at an exercise price per share equal to the fair market value of the Company s common stock as quoted on the OTC Bulletin Board on the date of grant of $.08 per share and expire ten years after the date of grant. No compensation expense was recognized as a result of this exchange.

Restricted and Non-Qualified Stock Options

In addition to stock options granted under the terms of the Stock Option Plan, the Board of Directors has the sole authority to grant employees, officers and directors incentive stock options and non-qualified stock options outside the Stock Option Plan. The Board of Directors determines the type, size and terms of the grants, timing of the grants, the duration of the exercise period and any other matters pertaining to options or awards granted outside of the Stock Option Plan. There were options on 355,000 net shares granted outside the Stock Option Plan as of June 30, 2003.

The share information for all plans is summarized below:

	Incentive Stock Options	Non-Qualified Stock Options		Weighted Average Exercise Price
Outstanding June 30, 2000	2,210,556	497,000	$	6.72
Granted	310,000	75,000		1.06
Cancelled	(228,167)	(527,500)		6.49
Outstanding June 30, 2001	2,292,389	44,500	$	5.77
Adjustment (1)	(2,105,045)	2,105,045		
Cancelled	(36,050)	(27,000)		5.86
Outstanding June 30, 2002	151,294	2,122,545	$	5.89
Granted	10,000	300,000		.05
Cancelled	(73,394)	(2,067,545)		5.86
Outstanding June 30, 2003	87,900	355,000	$	1.95

(1) Adjustment reflects options disclosed previously as incentive that should have been recorded as non-qualified.

The following tables summarize information concerning currently outstanding and exercisable stock options at June 30, 2003:

Options Outstanding

Exercise Prices					
Range		Weighted Average		Number of Shares	Weighted Average Remaining Contractual Life
$	0.05	$	0.05	310,000	9.4 years
$	1.75	$	1.75	1,000	3.3 years
$	3.06 - 3.38	$	3.29	1,400	3.6 years
$	5.51 - 6.00	$	5.66	97,500	6.6 years
$	8.73	$	8.73	33,000	5.7 years
				442,900	

Options Exercisable

Exercise Prices				
Range		Weighted Average		Number of Shares
$	0.05	$	0.05	310,000
$	1.75	$	1.75	1,000
$	3.06 - 3.38	$	3.29	1,400
$	5.51 - 6.00	$	5.66	97,500
$	8.73	$	8.73	33,000
				442,900

The weighted average fair value of options granted in fiscal 2003 was $.05 and fiscal 2001 was $1.06. No options were granted in fiscal 2002. Because the fair value provisions have not been applied to options granted prior to June 30, 1995, the resulting pro forma compensation cost

(See Note 1) may not be representative of that to be expected in future years.

YEARS ENDED JUNE 30,

The fair value of each option is estimated on the date of grant using the Black-Scholes option pricing model. The following assumptions were used to estimate the fair value of options:

	2003	2002	2001
Risk-free interest rate	4.00%	5.00%	5.00%
Expected life	10 years	5 years	5 years
Expected volatility	220%	150%	150%
Expected dividend yield	None	None	None

6. COMMITMENTS AND CONTINGENCIES

RTL Shopping S. A.

The Company has been named in a lawsuit filed in France brought by RTL9, a French cable TV station. The action seeks damages in the approximate amount of 20 million French Francs, or approximately $2.8 million. Initially, RTL9 was named as a defendant in a suit brought by a competitor of K-tel Marketing Ltd. alleging that RTL9 ran a commercial for K-tel Marketing which presented a product under brand names alleged to infringe on the competitor s own trademarks and also translated an English language script indicating that the product was just like or as good as others into better than in French, contrary to French law. The suit alleged trademark infringement, unfair competition, illicit comparative advertising and passing off. RTL9 then sued K-tel Marketing on October 4, 2000, pursuant to an indemnification provision the parties had entered into. Subsequently, K-tel Marketing went into liquidation and RTL9 filed a suit in March 2000 against K-tel International, Inc. under its agreement to guarantee payment for the commercial time. On May 28, 2001, RTL9 presented documents in court identifying K-tel International (USA), Inc. as a target of its claim. On September 3, 2001, the Company filed documents disputing the claim and advising the court of K-tel (USA) s Chapter 7 bankruptcy filing.

After the Company advised the Court that RTL9 had no basis for a complaint against the Company, RTL9 proposed to drop its lawsuit. On September 23, 2003, RTL9 and the Company signed an agreement terminating the suit. The final disposition of the lawsuit was confirmed by the Court at a trial hearing involving only the two remaining parties to the lawsuit.

K-tel International, Inc. vs. Tristar Products, Inc.

On March 14, 2000, K-tel and its subsidiary in Germany commenced an action for breach of express and implied warranties against Defendant Tristar Products, Inc. This action arose out of Tristar s sale to K-tel of a defective home exercise product called the BunBlaster for resale in Germany, Austria and Switzerland. By written contract, Tristar has agreed to indemnify K-tel for injuries and damages arising out of the resale of those goods.

On April 30, 2001, Tristar also asserted a patent and trademark/ trade-dress counterclaim against K-tel for allegedly passing off a product called the K-tel Hook and Hang while allegedly a distributor of the original patented Tristar Hook and Hang product. The Company denies the allegation because it never was a distributor of this or any similar product.

On December 30, 2004, a Mutual General Release and Settlement Agreement was signed by K-tel and Tristar, whereby both Companies agreed to mutual releases and Tristar agreed to pay K-tel $350,000. The payment of $350,000 was received February 18, 2005.

Other Litigation and Disputes

K-tel and its subsidiaries are also involved in other legal actions in the ordinary course of their business. With all litigation matters, management considers the likelihood of loss based on the facts and circumstances. If management determines that a loss is probable and the amount of loss can be reasonably estimated, such amount is recorded as a liability. Although the outcome of any such legal actions cannot be predicted, in the opinion of management there is currently no legal proceeding pending or asserted against or involving K-tel for which the outcome is likely to have a material adverse effect upon the consolidated financial position or results of operations of K-tel.

Leases

The Company has entered into several office and warehouse leases which expire through 2005. Commitments under these leases are $210,576 in 2004, and $46,490 in 2005. Rental expense was $253,523 in 2003, $216,327 in 2002, and $654,000 in 2001.

7. SIGNIFICANT CUSTOMERS AND RELATED PARTY TRANSACTIONS

Three customers, Madacy Entertainment Group, Inc., Anderson Merchandisers and Handleman Company accounted for approximately 19.2%, 14.9% and 11.5% respectively, of K-tel s revenue for the year ended June 30, 2003. The loss of, or a substantial reduction in, business from any of these customers would have a material adverse effect on the Company.

See Note 3 for information regarding debt transactions with related parties.

The Company purchased approximately $463,000 in the year ended June 30, 2003, $366,000 in the year ended June 30, 2002 and $574,000 in the year ended June 30, 2001 of music entertainment and consumer convenience products from K-5, the Company s largest shareholder, which is controlled by Philip Kives, Chairman of the Board, President and Chief Executive Officer of K-tel. There were trade payables to K-5 of $371,000 at June 30, 2003, $291,000 at June 30, 2002 and $285,000 at June 30, 2001.

The Company had no sales of consumer convenience products to K-5 during the years ended June 30, 2003 and 2002, and sales of $13,000 during the year ended June 30, 2001. There was a balance receivable from K-5 at June 30, 2003 of $73,000, June 30, 2002 of $129,000, and June 30, 2001 of $109,000. No interest was charged on the related outstanding balances during fiscal years 2003, 2002 and 2001.

8. RETIREMENT PLANS

Pension Plan

The Company has a pension plan for its U.K. employees. Company contributions to the Plan on behalf of eligible employees were terminated effective February 15, 2001 and all benefit accruals under the Plan ceased at that time. Summary plan information is as follows:

	(In Thousands) Pension Benefits 2003	2002
Net periodic cost:		
Interest cost	$ 23	$ 19

Expected return on assets		(63)		(10)
Amortization of transition amount		(15)		(13)
Actuarial loss				
Net periodic benefit cost	$	(55)	$	(4)
Change in benefit obligation:				
Benefit obligation at beginning of year	$	417		
Interest cost		23		
Actuarial loss		324		
Benefit obligation at end of year	$	764		
Change in plan assets:				
Fair value of plan assets at beginning of year	$	601		
Actual return on plan assets	$	111		
Fair value of plan at end of year	$	712		

The Company is not expected to contribute to the plan in fiscal 2004.

The Company s pension plan asset allocations are as follows at June 30:

	Percentage of Plan Assets	
	2004	2003
Asset category:		
Short-tem liquid investments	100%	100%

The Company s investment strategy with respect to pension plan assets is to continue to hold the plan assets in a deposit administration fund, which is similar to a bank account. Interest is added to the fund at a rate declared by Swiss Life.

(In Thousands)		2003
Reconciliation of funded status:		
Funded status	$	(51)
Unrecognized actuarial loss		180
Unrecognized transaction obligation		(183)
Unfunded accrued pension cost	$	(54)

		2003
Statement of financial position:		
Unfunded accrued pension cost	$	(54)
Additional minimum liability		
Accumulated other comprehensive income		
Recognized amount	$	(54)

At June 30, 2003, the projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with a projected benefit obligation in excess of plan assets, and pension plans with an accumulated benefit obligation in excess of plan assets, were are follows:

	(In thousands)			
	Project Benefit Obligation Exceeds the Fair Value of Plan s Assets June 30, 2003		Accumulated Benefit Obligation Exceeds the Fair Value of Plan s Assets June 30, 2003	
Projected benefit obligation	$	764	$	764
Accumulated benefit obligation		764		764
Fair Value of plan assets		712		712

The Company s accumulated benefit obligation of $764,000 at June 30, 2003 exceeded the fair value of the plan s assets at June 30, 2003. This amount has been accrued as of June 30, 2003; there was no additional minimum liability in 2003.

WEIGHTED-AVERAGE ASSUMPTIONS USED TO DETERMINE NET PERIODIC COST FOR THE YEARS ENDED JUNE 30:

	2003	2002
Discount rate	9%	5%
Expected return on plan assets	5%	5%
Rate of compensation increase	0%	0%

WEIGHTED-AVERAGE ASSUMPTION USED TO DETERMINE BENEFIT OBLIGATIONS AS OF JUNE 30:

	2003
Discount rate	5%
Rate of compensation increase	N/A

Money Purchase Plan

The Company s U.K. subsidiaries contribute amounts for their employees to a money purchase defined contribution plan. The Company contributed $51,000 and $26,000 for the years ended June 30, 2003 and 2002.

9. BUSINESS SEGMENT AND GEOGRAPHIC AREA DATA

The Company markets and distributes entertainment products internationally and through its operating subsidiaries. K-tel s businesses are organized, managed and internally reported as three segments: retail music sales, music licensing and other, which consists primarily of e-commerce (which was closed in the fourth quarter of fiscal 2002). These segments are based on differences in products, customer type and sales and distribution methods. The Company s consumer product operations have been discontinued and are presented in the accompanying financial statements as discontinued operations and are therefore not included in the segment information.

The retail music segment consists primarily of the sales of pre-recorded music both from the Company s music master catalog and under licenses obtained from other record companies. The Company sells compact discs and DVD s directly to retailers, wholesalers and rack service distributors which stock and manage inventory within music departments for retail stores.

In the licensing segment, the Company licenses the rights to its master music catalog, consisting of original recordings and re-recordings of music from the 1950 s through today, to third parties world-wide for use in albums, films, television programs, and commercials, for either a flat fee or a royalty based on the number of units sold.

Operating profits or losses of these segments include an allocation of general corporate expenses. Depreciation and amortization and capital additions are not significant and have therefore been excluded from presentation.

Certain financial information on the Company s continuing operating segments is as follows:

BUSINESS SEGMENT INFORMATION

Fiscal Years Ended June 30, (in thousands)		**Music**	**Licensing**	**Other**	**Corporate Eliminations**	**Total Company**
Net Sales	2003	$ 4,454	$ 2,780	$		$ 7,234
	2002	3,773	3,118			6,891
	2001	14,202	3,710	365	(763)	17,514
Operating Income (Loss)	2003	$ (1,010)	$ 1,159	$		$ 149
	2002	(1,439)	1,393			(46)
	2001	(7,749)	425	(2,156)		(9,480)
Assets	2003	$ 2,900	$ 2,128	$ 273		$ 5,301
	2002	2,679	1,668	121	142	4,610
	2001	1,501	1,650	443	238	3,832

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GEOGRAPHIC INFORMATION

Fiscal Years Ended June 30, (in thousands)		United States	Europe	Total
Net Sales	2003	$ 4,949	$ 2,285	$ 7,234
	2002	3,949	2,942	6,891
	2001	13,914	3,600	17,514
Assets	2003	$ 3,889	$ 1,412	$ 5,301
	2002	2,792	1,818	4,610
	2001	2,042	1,790	3,832

10. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2003, the FASB issued Interpretation (FIN 46R), *Consolidation of Variable Interest Entities.* FIN 46R is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and addresses consolidation by business enterprises of variable interest entities. FIN 46R applies to variable interest entities created or obtained after January 31, 2003 and it applies in the first fiscal year or interim period beginning after March 15, 2004, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement will have an effect on the Company s consolidated financial position and results of operations as the Company will consolidate a variable interest entity in the quarter ending March 31, 2004.

In December 2002, the FASB issued Statement 148 (FAS 148), *Accounting for Stock-Based Compensation Transition and Disclosure.* FAS 148 amends the disclosure and certain transition provisions of Statement 123, *Accounting for Stock-Based Compensation.* Its disclosure provisions, which apply to all entities with employee stock-based compensation, are effective for fiscal years ending after December 15, 2002. New interim period disclosures are required in financial statements for interim periods beginning after December 15, 2002. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

In November 2002, the FASB issued FASB Interpretation No. 45 (FIN 45), *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.* FIN 45 addresses the disclosure requirements of a guarantor in its interim and annual financial statements about its obligations under certain guarantees that is has issued. FIN 45 also requires a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. The disclosure requirements of FIN 45 are effective for the Company for its quarter ended December 31, 2002. The liability recognition requirement is applicable prospectively to all guarantees issued or modified after December 31, 2002. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146 (SFAS 146), *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 provides financial accounting and reporting guidance for costs associated with exit or disposal activities, including one-time termination benefits, contract termination costs other than for a capital lease, and costs to consolidate facilities or relocate employees. This statement is effective for exit or disposal activities that are initiated after December 31, 2002. Management does not believe this pronouncement will have a material effect on the Company s consolidated financial position and results of operations.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. Statement 150 changes the classifications in the statement of financial position of certain common financial instruments from either equity or mezzanine presentation to liabilities and requires an issuer of those financial statements to recognize changes in fair value or redemption amount, as applicable, in earnings. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of Statement 150 is not anticipated to have an impact on the Company s consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*, which replaced SFAS No. 123 and superseded APB 25. SFAS No. 123R addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company s equity instruments or that may be settled by the issuance of such equity instruments. Under SFAS No. 123R, companies will no longer be able to account for the share-based compensation transactions using the intrinsic method in accordance with APB 25 but will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of operations. SFAS No. 123R is effective beginning in the Company s first quarter of fiscal year 2006. Under SFAS 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at date of adoption. The transition methods include prospective and retroactive adoption options. The Company has begun, but has not completed, evaluating the impact of the adoption of SFAS 123R on its results of operations. In connection with evaluating the impact of SFAS 123R, the Company is considering the potential implementation of different valuation methods to determine the fair value of share-based compensation. The Company believes the adoption of SFAS 123R will not have a material impact on our results of operations, regardless of the valuation method used.

11. RESTATEMENTS

In September 2004, the Company discovered that the former Chief Financial Officer of its UK subsidiary misappropriated funds from the Company s UK subsidiary and a customer of such subsidiary. The Company terminated the employee, undertook a full-scale investigation of the matter, retained a forensic auditing firm and dismissed the accounting firm in the UK that audited the UK subsidiary s financial books and records. Based upon the estimates of the Company s forensic auditor, it was determined that the former employee misappropriated approximately $914,200 from the Company s UK subsidiary and approximately $343,588 from a customer of such subsidiary beginning approximately in January 2001 and continuing until September 2004. Further, the Company spent approximately $150,862 investigating the misappropriation. Through negotiations with the former employee, the Company s UK subsidiary and its customer have recovered an aggregate of approximately $1,493,076 and interest of approximately $1,919. Approximately $99,640 remains outstanding. The Company s UK subsidiary has received a deed of guarantee in connection with this remaining obligation and it expects to collect the remaining amount owed on or before February 15, 2008.

The effect of the misappropriation was to overstate product costs by $9,000, $21,000, $24,000 and $27,000 and selling and general and administrative expenses by $14,000, $10,000, $32,000 and $13,000 for the quarters ending September 30, 2002, December 31, 2002, March 31, 2003 and June 30, 2003, respectively.

For the fiscal year ending June 30, 2002, the misappropriation understated sales by $16,000 in the quarter ending September 30, 2001. Product costs were overstated by $74,000, $10,000, $35,000 and $13,000 and selling and general and administrative expenses by $102,000, $9,000, $16,000 and $11,000 for the quarters ending September 30, 2001, December 31, 2001, March 31, 2002 and June 30, 2002, respectively.

Statements of operations previously reported for each of the quarters of fiscal year 2003 and 2002 in the Company s Form 10-Qs are restated as follows:

Quarterly Financial Information (Unaudited)

Three Months Ended,

AS FILED	September 30, 2002	December 31, 2002	March 31, 2003	June 30, 2003
Total revenues	$ 1,498	$ 1,874	$ 1,923	$ 1,939
Gross profit	$ 899	$ 977	$ 933	$ 1,244
Total cost and expenses	$ 997	$ 978	$ 1,109	$ 918
Income (loss) from operations	$ (98)	$ (1)	$ (174)	$ 326
Net income (loss)	$ (508)	$ (389)	$ (439)	$ 348
Basic and diluted net income (loss) per common share	$ (.04)	$ (.03)	$ (.03)	$ .03
Shares used in computing basic and dilutednet loss per common share	13,654	13,654	13,654	13,654

AS RESTATED	Three Months Ended, September 30, 2002	December 31, 2002	March 31, 2003	June 30, 2003
Total revenues	$ 1,498	$ 1,874	$ 1,923	$ 1,939
Gross profit	$ 908	$ 998	$ 957	$ 1,271
Total cost and expenses	$ 983	$ 968	$ 1,077	$ 957
Income (loss) from operations	$ (75)	$ 30	$ (118)	$ 312
Net income (loss)	$ (485)	$ (358)	$ (383)	$ 334
Basic and diluted net income (loss) per common share	$ (.04)	$ (.03)	$ (.03)	$ .02
Shares used in computing basic and dilutednet loss per common share	13,654	13,654	13,654	13,654

Quarterly Financial Information (Unaudited)

AS FILED	Three Months Ended, September 30, 2001	December 31, 2001	March 31, 2002	June 30, 2002
Total revenues	$ 1,381	$ 2,104	$ 1,766	$ 1,624
Gross profit	$ 859	$ 1,210	$ 1,047	$ 1,274
Total cost and expenses	$ 1,257	$ 1,062	$ 1,175	$ 1,228
Income (loss) from operations	$ (398)	$ 148	$ (128)	$ 46
Net income (loss)	$ (504)	$ (107)	$ (307)	$ 932
Basic and diluted net income (loss) per common share	$ (.04)	$ (.01)	$ (.02)	$ .07
Shares used in computing basic and dilutednet loss per common share	13,654	13,654	13,654	13,654

AS RESTATED	Three Months Ended, September 30, 2001	December 31, 2001	March 31, 2002	June 30, 2002
Total revenues	$ 1,397	$ 2,104	$ 1,766	$ 1,624
Gross profit	$ 949	$ 1,220	$ 1,082	$ 1,287
Total cost and expenses	$ 1,155	$ 1,053	$ 1,159	$ 1,217
Income (loss) from operations	$ (206)	$ 167	$ (77)	$ 70
Net income (loss)	$ (312)	$ (88)	$ (256)	$ 956
Basic and diluted net income (loss) per common share	$ (.02)	$ (.01)	$ (.02)	$ .07
Shares used in computing basic and dilutednet loss per common share	13,654	13,654	13,654	13,654

SCHEDULE II

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

VALUATION AND QUALIFYING ACCOUNTS

Years ended June 30,

(In thousands)

	Balance at Beginning of Period	Charged to Costs and Expenses or Net Sales	Charged to Other Accounts (1)	Deductions	Balance at End of Period
Allowance for Doubtful Accounts					
2003	$ 68	$ 62	$ 9	$ (114)(2)	$ 25
2002	$ 33	$ 50	$ 5	$ (20)(2)	$ 68
2001	$ 1,416	$ (41)	$ (4)	$ (1,338)(2)	$ 33
Reserve for Returns					
2003	$ 46	$ 447	$	$ (273)	$ 220
2002	$ 50	$ 55	$ 6	$ (65)	$ 46
2001	$ 4,623	$ 45	$ (3)	$ (4,615)	$ 50

(1) Exchange rate change

(2) Uncollectible accounts written off, net of recoveries

EXHIBIT INDEX

Exhibit No.	Description of Exhibit
3.1	Restated Articles of Incorporation, as amended.*
3.2	Restated By-Laws (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1985 (File No. 1-07115)).
4	See Exhibits 3.1 and 3.2.
10.1	1987 Stock Incentive Plan (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1987 (File No. 1-07115)).
10.2	1997 Stock Option Plan (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1997 (File No. 1-07115)).
10.3	Form of Incentive Stock Option Agreement under the Company s 1997 Stock Option Plan (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2000 (File No. 1-07115)).
10.4	Form of Non-Qualified Stock Option Agreement under the Company s 1997 Stock Option Plan (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2000 (File No. 1-07115)).
10.5	Form of Non-Qualified Stock Option Agreement between the registrant and certain non-employee directors of the registrant, authorized effective November 27, 2002 (incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2003 (File No. 1-07115)).
10.6	Loan and Security Agreement between the Company and Foothill Capital Corporation dated November 19, 1997 (incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended December 31, 1997 (File No. 1-07115)).
10.7	Amendment Number One to the Loan and Security Agreement between the Company and Foothill Capital Corporation dated March 30, 1998 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1998 (File No. 1-07115)).
10.8	Amendment Number Two to the Loan and Security Agreement between the Company and Foothill Capital Corporation dated September 23, 1998 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1998 (File No. 1-07115)).
10.9	Restated Amendment Number Two to the Loan and Security Agreement between the Company and Foothill Capital Corporation dated September 30, 1998 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 1998 (File No. 1-07115)).
10.10	Amendment Number Three to the Loan and Security Agreement between the Company and Foothill Capital Corporation dated September 22, 1999 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2000 (File No. 1-07115)).
10.11	Amendment Number Four to the Loan and Security Agreement between the Company and Foothill Capital Corporation dated May 15, 2000(incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2000 (File No. 1-07115)).
10.12	Amendment to Loan Agreement and Security Agreement between the Company and K-5 Leisure Products, Inc., as assignee of Foothill Capital Corporation dated February 12, 2002 (incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended December 31,

	2001 (File No. 1-07115)).
10.13	Credit Agreement between the Company and K-5 Leisure Products, Inc. dated September 27, 1999.*
10.14	$8,000,000 principal amount Note between the Company and K-5 Leisure Products, Inc. dated September 27, 1999.*
10.15	Amendment to Credit Agreement and Note between the Company and K-5 Leisure Products, Inc. dated February 12, 2002 (incorporated by reference to the Company s Quarterly Report on Form 10-Q for the fiscal quarter ended December 31, 2001 (File No. 1-07115)).*
21	Subsidiaries of the Registrant.*
23	Consent of Independent Registered Public Accounting Firm.
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14.
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14.
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Previously filed.