K TEL INTERNATIONAL INC
Form 10-Q
February 17, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended December 31, 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 incorporation or organization)	(I.RS. Employer Identification No.)
2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota	**55447**
(Address of principal executive offices)	(Zip Code)

(763) 559-5566

(Registrant s telephone number, including area code)

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 ý No o

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

Yes o No ý

As of February 13, 2004, there were 13,653,738 shares of the registrant s common stock, par value $0.01 per share, outstanding.

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

FORM 10-Q

FOR THE THREE AND SIX MONTH PERIODS

ENDED DECEMBER 31, 2003

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Important Factors Relating to Forward Looking Statements

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-Q 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 terminology. 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.

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS - UNAUDITED

(in thousands)

	December 31, 2003	June 30, 2003
ASSETS		
Current Assets:		
Cash and equivalents	$ 49	$ 1,219
Accounts receivable, net of allowance for doubtful accounts of $27 and $25	1,833	1,559
Inventories	588	520
Royalty advances	243	235
Prepaid expenses and other	511	304
Total Current Assets	3,224	3,837
Property and equipment, net of accumulated depreciation and amortization of $1,466 and $1,506	103	101
Owned catalog masters, net of accumulated amortization of $2,852 and $2,755	733	819
	$ 4,060	$ 4,757
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current Liabilities:		
Notes payable to affiliate and other	$ 11,198	$ 11,515
Accounts payable	974	1,162
Accrued royalties	2,467	2,333
Reserve for returns	204	213
Net liabilities of discontinued operations	118	116
Total Current Liabilities	14,961	15,339
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	(32,115)	(31,759)
Accumulated other comprehensive loss	(214)	(251)
Total Shareholders Deficit	(10,901)	(10,582)
	$ 4,060	$ 4,757

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

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K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS - UNAUDITED

(in thousands - except per share data)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	**2002**	**2003**	**2002**
Net Sales	$ 1,759	$ 1,874	$ 3,377	$ 3,372
Costs and Expenses:				
Cost of goods sold	860	897	1,529	1,496
Advertising	32	19	75	65
Selling, general and administrative	954	959	1,820	1,910
Total Costs and Expenses	1,846	1,876	3,424	3,472
Operating Loss	(87)	(2)	(47)	(100)
Other Expense:				
Interest expense	(120)	(133)	(237)	(269)
Other		(51)	(11)	(115)
Total Other Expense	(120)	(184)	(248)	(384)
Loss from Continuing Operations	(207)	(186)	(295)	(484)
Loss from Discontinued Operations	(20)	(204)	(61)	(414)
Net Loss	$ (227)	$ (390)	$ (356)	$ (898)
Loss per Share Basic and Diluted:				
Continuing Operations	$ (.02)	$ (.01)	$ (.02)	$ (.04)
Discontinued Operations		(.02)	(.01)	(.03)
Net Loss	$ (.02)	$ (.03)	$ (.03)	$ (.07)
Shares used in the calculation of loss per share - Basic and Diluted	13,654	13,654	13,654	13,654
Comprehensive Loss:				
Net loss	$ (227)	$ (390)	$ (356)	$ (898)
Translation adjustment		15	37	(46)
Comprehensive Loss	$ (227)	$ (375)	$ (319)	$ (944)

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS - UNAUDITED

(in thousands)

	Six Months Ended December 31, 2003	Six Months Ended December 31, 2002
Cash flows from Operating Activities:		
Net loss	$ (356)	$ (898)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	132	172
Other	(5)	(9)
Changes in operating assets and liabilities:		
Accounts receivable, net	68	(378)
Inventories	(54)	60
Royalty advances	8	32
Prepaid expenses	(197)	(167)
Accounts payable	(558)	271
Accrued royalties	138	12
Reserve for returns	(8)	122
Income taxes, net	24	
Cash used in operating activities	(808)	(783)
Cash flows from Investing Activities:		
Purchases of property and equipment	(41)	(13)
Other	(6)	
Cash used in investing activities	(47)	(13)
Cash flows from Financing Activities:		
Borrowings on notes payable	1,483	1,665
Payments on notes payable	(1,819)	(713)
Cash provided by (used in) financing activities	(336)	952
Effect of exchange rates on cash	21	(96)
Net increase (decrease) in cash and equivalents	(1,170)	60
Cash and equivalents at beginning of period	1,219	75
Cash and equivalents at end of period	$ 49	$ 135

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

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K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 selected 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 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.

<u>Discontinued Operations</u>

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. The accompanying condensed consolidated financial statements have been prepared to reflect the consumer products division as a discontinued operation. The net liabilities of discontinued operations at December 31, 2003 and 2002 consist of assets of $0 and $326,000 and liabilities of $118,000 and $404,000. The ongoing current expenses relate to legal matters and completion of statutory reporting requirements for the former operations in Germany.

<u>Going Concern</u>

During the six months ended December 31, 2003 and 2002, the Company incurred net losses from continuing operations of $295,000 and $484,000 respectively. Operating activities used $808,000 and $783,000 of cash during the six months ended December 31, 2003 and 2002 respectively. Additionally, the Company had a working capital deficit of $11,737,000 at December 31, 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. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - The accompanying condensed consolidated unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended December 31, 2003 are not necessarily indicative of the results that may be expected for the year as a whole. The unaudited condensed consolidated balance sheet for June 30, 2003 has been derived from audited consolidated financial statements as of that date. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended June 30, 2003.

Principles of Consolidation - The accompanying condensed 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 $204,000 at December 31, 2003 and $213,000 at June 30, 2003.

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 Cash Equivalents Cash and cash 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.

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. Advertising expenses were $75,000 and $65,000 for the six month periods ended December 31, 2003 and 2002 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:

	Three Months Ended December 31,		Six Months Ended December 31,	
	2003	**2002**	**2003**	**2002**
Net Loss (in thousands)				
As reported	$ (227)	$ (390)	$ (356)	$ (898)
Pro forma	$ (334)	$ (405)	$ (463)	$ (913)
Basic and Diluted EPS				
As reported	$ (.02)	$ (.03)	$ (.03)	$ (.07)
Pro forma	$ (.04)	$ (.03)	$ (.03)	$ (.07)

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 voluntarily for options to purchase an equal number of shares outside the Company s Stock Option Plan. Options to purchase an aggregate of 2,137,939 shares of common stock, with a weighted average price per share of $5.95, were submitted for cancellation. Replacement options were proposed to be issued six months and one day after the date of cancellation of the existing options and would be 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 and expire ten years after the date of grant. On November 18, 2003, the replacements options were issued at a price per share of $.08. There will be no compensation expense recognized as a result of this exchange.

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 six month periods ended December 31, 2003 and 2002, weighted average options to purchase 953,630 and 2,332,395 shares of common stock, with weighted average exercise prices of $0.95 and $5.74 were excluded from the computation of common share equivalents for the respective periods as they were antidilutive. For the three month periods ended December 31, 2003 and 2002, weighted average options to purchase 1,464,360 and 2,390,950 shares of common stock, with weighted average exercise prices of $0.64 and $5.60 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 December 31, 2003), expires July 20, 2005, and is subordinated to the Foothill loan (see below). 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 $6,947,000 and $7,282,000 as of December 31, 2003 and June 30, 2003 respectively under the K-5 Facility. At December 31, 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 has been extended through July 20, 2005, 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 December 31, 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 December 31, 2003 and June 30, 2003, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At December 31, 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 December 31, 2003) but are subject to a minimum of 6.0% per annum. K-tel had outstanding balances of $234,000 and $233,000 as of December 31, 2003 and June 30, 2003 respectively.

4. 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 December 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 their lawsuit. On September 23, 2003, RTL9 and the Company signed an agreement terminating the suit. The final disposition of the lawsuit will be confirmed by the Court at a trial hearing. A date has not been set by the Court.

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 is venued in the United States District Court for the District of Minnesota. This action arises 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. K-tel is seeking approximately $2 million in consequential damages. Tristar is vigorously defending this claim. Discovery has been completed. Tristar filed a Motion for Summary Judgment, to which the Company filed a Memorandum in Opposition. This motion was heard in U.S. District Court in Minneapolis on August 25, 2003. The Court issued its order denying the motion on January 29, 2004. The parties are now waiting for a trial date to be set by the Court.

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 and intends to defend this action vigorously. Tristar has not identified the amount of damages it seeks with respect to this counterclaim. The United States District Court for the District of Minnesota issued an order on August 14, 2001 severing this action from the Company s action. This action is at an early stage and no discovery or other actions have occurred.

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.

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 United States Bankruptcy Code. Pursuant to an agreement between the bankruptcy trustee and K-5 Leisure Products, Inc. (K-tel s secured creditor and controlling shareholder) entered into on March 3, 2003, the trustee released K-5 Leisure Products, Inc., K-tel and its subsidiaries and affiliates from any claims and actions with respect to the bankruptcy filing. The trustee filed a Limited Notice of Abandonment relative to K-5 s security interest in K-tel s assets. The Bankruptcy Court approved the abandonment as of June 13, 2003.

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.

5. 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 two segments: retail music sales and music licensing. These segments are based on differences in products, customer type and sales and distribution methods. The Company s consumer product and e-commerce operations have been discontinued, 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 master music 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 the presentation.

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

BUSINESS SEGMENT INFORMATION

(in thousands)		**Music**	**Licensing**	**Other**	**Corporate Elimination**	**Total Company**
Six Months Ended December 31,						
Net Sales	2003	$ 2,497	$ 880	$	$	$ 3,377
	2002	2,184	1,188			3,372
Operating Income (Loss)	2003	$ (146)	$ 99	$		$ (47)
	2002	(400)	300			(100)
Assets	2003	$ 3,080	$ 783	$ 197	$	$ 4,060
	2002	2,944	1,229	510		4,683
Three Months Ended December 31,						
Net Sales	2003	$ 1,398	$ 361	$	$	$ 1,759
	2002	1,241	633			1,874
Operating Income (Loss)	2003	$ (39)	$ (48)	$	$	$ (87)
	2002	(233)	231			(2)

GEOGRAPHIC INFORMATION

(in thousands)		United States	Europe	Total
Six Months Ended December 31,				
Net Sales	2003	$ 2,022	$ 1,355	$ 3,377
	2002	2,080	1,292	3,372
Assets	2003	$ 2,660	$ 1,400	$ 4,060
	2002	3,177	1,506	4,683
Three Months Ended December 31,				
Net Sales	2003	$ 1,058	$ 701	$ 1,759
	2002	1,100	774	1,874

6. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN 46), *Consolidation of Variable Interest Entities.* FIN 46 is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and addresses consolidation by business enterprises of variable interest entities. FIN 46 applies in the first fiscal year or interim period beginning after December 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

ITEM 2: 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 selected individual retailers and supplies products suited to each retailer s specific needs. These new products are primarily 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.

THREE MONTHS ENDED DECEMBER 31, 2003 VERSUS DECEMBER 31, 2002

Net sales for the three month period ended December 31, 2003 were $1,759,000 a decrease of 6.1% from net sales of $1,874,000 for the three month period ended December 31, 2002. This decrease was attributed to decreased licensing revenue partially offset by an increase in music sales. The net loss for the three month period ended December 31, 2003 was $227,000, or $.02 per share, compared to a net loss of $390,000, or $.03 per share, for the three month period ended December 31, 2002.

General corporate expenses of $237,000 and $338,000 for the three month periods ended December 31, 2003 and 2002 respectively have been allocated to the segments.

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

BUSINESS SEGMENT RESULTS

Music

Sales in the music segment were $1,398,000 for the three month period ended December 31, 2003 compared to $1,241,000 for the three month period ended December 31, 2002, an increase of $157,000, or 12.7%. The overall increase was primarily due to an increase in music DVD sales.

Cost of goods sold in the music segment decreased to 55.7% of sales for the three month period ended December 31, 2003 compared to 64.7% of sales for the three month period ended December 31, 2002 reflecting cost containment on new product offerings. Advertising expenses within the segment, which consists primarily of co-operative advertising payments, trade advertising and promotions, decreased to $37,000 for the three month period ended December 31, 2003 compared to $39,000 for the three month period ended December 31, 2002.

Selling, general and administrative expenses were $627,000, or 44.8% of sales for the three month period ended December 31, 2003 compared to $700,000, or 56.4% of sales for the three month period ended December 31, 2002. The primary reason for the decrease was the discontinuation of unprofitable product lines in England along with the continued staff and cost reductions in the U.S. and English operations. As a result, the music segment incurred an operating loss of $39,000 for the three month period ended December 31, 2003 compared to an operating loss of $233,000 for the three month period ended December 31, 2002.

Licensing

Licensing revenue was $361,000 for the three month period ended December 31, 2003 compared to $633,000 for the three month period ended December 31, 2002, a decrease of 43.0% reflecting reduced licensing activity. As a result, the licensing segment incurred an operating loss of $48,000 for the three month period ended December 31, 2003 compared to operating income of $231,000 for the three month period ended December 31, 2002, a decrease of 120.8%.

SIX MONTHS ENDED DECEMBER 31, 2003 VERSUS DECEMBER 31, 2002

Net sales for the six month period ended December 31, 2003 were $3,377,000 a marginal increase from net sales of $3,372,000 for the six month period ended December 31, 2002. This increase was attributed to increased music sales offset by a decrease in licensing revenue. The net loss for the six month period ended December 31, 2003 was $356,000, or $.03 per share, compared to a net loss of $898,000, or $.07 per share, for the six month period ended December 31, 2002.

General corporate expenses of $449,000 and $452,000 for the six month periods ended December 31, 2003 and 2002 respectively have been allocated to the segments.

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

BUSINESS SEGMENT RESULTS

Music

Sales in the music segment were $2,497,000 for the six month period ended December 31, 2003 compared to $2,184,000 for the six month period ended December 31, 2002, an increase of $313,000, or 14.3%. Domestic sales of CD and DVD music products accounted for this increase. K-tel anticipates continuing increased sales of music-related DVD products by exploiting its owned and licensed master recordings.

Cost of goods sold in the music segment decreased to 54.8% of sales for the six month period ended December 31, 2003 compared to 57.8% of sales for the six month period ended December 31, 2002 reflecting cost containment efforts in the English operations. Advertising expenses within the segment, which consists primarily of co-operative advertising payments, trade advertising and promotions, decreased to $60,000 for the six month period ended December 31, 2003 compared to $85,000 for the six month period ended December 31, 2002.

Selling, general and administrative expenses were $1,199,000, or 48.0% of sales for the six month period ended December 31, 2003 compared to $1,302,000, or 59.9% of sales for the six month period ended December 31, 2002. The primary reason for the decrease was the discontinuation of unprofitable product lines in England along with continued staff and cost reductions in the U.S. and England.

As a result, the music segment incurred an operating loss of $146,000 for the six month period ended December 31, 2003 compared to an operating loss of $400,000 for the six month period ended December 31, 2002.

Licensing

Licensing revenue was $880,000 for the six month period ended December 31, 2003 compared to $1,188,000 for the six month period ended December 31, 2002, a decrease of 25.9% reflecting reduced domestic licensing activity that was partially offset by increased licensing in England. The Company is concentrating its efforts on building licensing arrangements in several other segments of the entertainment industry.

Royalty costs within the segment decreased to $160,000 for the six month period ended December 31, 2003 compared to $237,000 for the six month period ended December 31, 2002 primarily because of the decrease in licensing revenue.

Selling, general and administrative expenses decreased to $432,000 for the six month period ended December 31, 2003 compared to $541,000 for the six month period ended December 31, 2002, a decrease of 20.1% reflecting audit costs incurred in the previous period and reduced amortization expense of owned master recordings as the masters became fully amortized.

Operating income in the licensing segment was $99,000 for the six month period ended December 31, 2003 compared to $300,000 for the six month period ended December 31, 2002, a decrease of 67.0%.

New Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN 46), *Consolidation of Variable Interest Entities.* FIN 46 is an interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements,* and addresses consolidation by business enterprises of variable interest entities. FIN 46 applies in the first fiscal year or interim period beginning after December 15, 2003, to variable interest entities in which an enterprise holds a variable interest that is acquired before February 1, 2003. This pronouncement is not anticipated to have a material effect on the Company s consolidated financial position or results of operations.

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 December 31, 2003), expires July 20, 2005, and is subordinated to the Foothill loan (see below). 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 $6,947,000 and $7,282,000 as of December 31, 2003 and June 30, 2003 respectively under the K-5 Facility. At December 31, 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 has been extended through July 20, 2005, 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 December 31, 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 December 31, 2003 and June 30, 2003, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At December 31, 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 December 31, 2003) but are subject to a minimum of 6.0% per annum. K-tel had outstanding balances of $234,000 and $233,000 as of December 31, 2003 and June 30, 2003 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. In part, this is a result of improvement in operating results in fiscal 2003 as well as the two existing lines of credit with K-5. 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, 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the Company s market risk during the six month period ended December 31, 2003. For additional information, refer to page 15 of the Company s annual report on Form 10-K for the fiscal year ended June 30, 2003.

ITEM 4. 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 upon 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 are adequately designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in applicable rules and forms.

During the Company s most recent fiscal quarter, there has been no change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-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.

PART II

ITEM 1. LEGAL PROCEEDINGS

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 December 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 their lawsuit. On September 23, 2003, RTL9 and the Company signed an agreement terminating the suit. The final disposition of the lawsuit will be confirmed by the Court at a trial hearing. A date has not been set by the Court.

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 is venued in the United States District Court for the District of Minnesota. This action arises 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. K-tel is seeking approximately $2 million in consequential damages. Tristar is vigorously defending this claim. Discovery has been completed. Tristar filed a Motion for Summary Judgment, to which the Company filed a Memorandum in Opposition. This motion was heard in U.S. District Court in Minneapolis on August 25, 2003. The Court issued its order denying the motion on January 29, 2004. The parties are now waiting for a trial date to be set by the Court.

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 and intends to defend this action vigorously. Tristar has not identified the amount of damages it seeks with respect to this counterclaim. The United States District Court for the District of Minnesota issued an order on August 14, 2001 severing this action from the Company s action. This action is at an early stage and no discovery or other actions have occurred.

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.

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 United States Bankruptcy Code. Pursuant to an agreement between the bankruptcy trustee and K-5 Leisure Products, Inc. (K-tel s secured creditor and controlling shareholder) entered into on March 3, 2003, the trustee released K-5 Leisure Products, Inc., K-tel and its subsidiaries and affiliates from any claims and actions with respect to the bankruptcy filing. The trustee filed a Limited Notice of Abandonment relative to K-5 s security interest in K-tel s assets. The Bankruptcy Court approved the abandonment as of June 13, 2003.

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.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

See Index to Exhibits.

(b) REPORTS ON FORM 8-K

There were no reports filed under Form 8-K by the Company during the three month period ended December 31, 2003.

SIGNATURES

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

K-TEL INTERNATIONAL, INC.
REGISTRANT

Dated: February 13, 2004

/S/ PHILIP KIVES
PHILIP KIVES
CHAIRMAN AND CHIEF EXECUTIVE OFFICER

Dated: February 13, 2004

/S/ DENNIS WARD
DENNIS WARD
CHIEF FINANCIAL OFFICER
(principal accounting officer)

INDEX TO EXHIBITS

Exhibit No.	Description of Exhibit
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 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 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.