K TEL INTERNATIONAL INC
Form 10-K
September 18, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

x	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the fiscal year ended June 30, 2005
	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.R.S. Employer Identification No.)
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 x

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 x

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

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. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

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

Yes o No x

As of September 12, 2006 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 $331,645.

As of September 12, 2006, the registrant had 13,653,738 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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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 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; 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. See Risk Factors in Item 1A for additional information. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements, except as required by law.

PART I

ITEM 1: BUSINESS

K-tel International, Inc. (the Company , K-tel or the registrant) 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 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.

Description of Businesses

Music Licensing and Sales

K-tel s primary activity is marketing and distributing pre-recorded compact discs utilizing the Company s master recordings in its music catalog. Customers include retailers, wholesalers and rack service distributors. These products are also sold through subsidiaries and licensees in the United States, United Kingdom and elsewhere in Europe. The principal entertainment products that K-tel markets and sells consist primarily of pre-recorded thematic music packages in a compilation format featuring various artists. These thematic music selections, which cover nearly all music genres, are targeted at a variety of age groups. K-tel provides marketing support for its music sales through cooperative advertising with retailers, print media, radio and television advertising, and in-store promotions and displays.

The Company also licenses music to other record companies and to other segments of the entertainment industry. K-tel owns a proprietary master music catalog of approximately 6,000 titles consisting of original recordings and re-recordings of music from the 1950 s through today. The Company licenses the rights to its master recordings to third parties worldwide for use in albums, which typically last three to five years, and is based on the number of units sold. The Company also licenses its master recordings for films, television programs, commercials and electronic downloads to various media formats, for either a flat fee or a royalty based on the number of units sold. Licensing of its proprietary music rights to third parties has historically been an important revenue source for K-tel.

Three customers, Anderson Merchandising, Inc., Handleman Company and D.A.Tapes accounted for approximately 18.4%, 15.3%, and 13.2%, respectively, of K-tel s revenue for the year ended June 30, 2005. The loss of, or a substantial reduction in, business from any of these customers could have a material adverse effect on the Company.

K-tel delivers music products (CDs) through traditional wholesale and retail distribution channels. Prior to April 2001, the Company was distributing its music products in the United States to most major music retailers (Transworld Entertainment, Musicland, Best Buy, Circuit City, Tower Records) and to major distributors (Handleman, Anderson Merchandising, Valley Media). The Company now has a customer base that includes only a few selected retailers and distributors, and offers products that are of more interest to these individual customers. This focused approach is intended to improve product sell-through, minimize returns of unsold inventory and allow the Company to realize more competitive profit margins. This existing method of distributing music could be materially altered by technologies that enable users and customers of pre-recorded music to electronically download pre-recorded music at home to various personal computer media formats. The technology is developing and a number of competing companies are seeking to have the industry and the public embrace their technologies. Participants in this technology competition include Microsoft Corporation, AOL, Apple Computer, Inc., YAHOO and others. Digital music distribution provides both significant risks and opportunities for K-tel. The risks include K-tel s uncertain ability to compete with other music companies from a marketing and technological standpoint. The Company believes there are opportunities to enhance its current distribution methods as well as increase opportunities to license its owned library of master recordings. K-tel s music sales and licensing subsidiaries are pursuing these alternative distribution channels and have entered into licensing agreements with several companies offering electronic downloads.

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., the Company s largest shareholder which is controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel (see Note 3 to the consolidated financial statements), 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 the Company s indebtedness on an ongoing basis.

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Management is focusing its efforts on music distribution and music licensing. However, there can be no assurance that the Company will achieve profitable operations through these efforts or be able to continue operations. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

Competition

The music business is highly competitive and dominated by major companies. K-tel faces competition for discretionary consumer purchases of its products from other record companies and other entertainment sources, such as film and video companies. Several major record companies in the United States, including Sony BMG Corp., Time Warner, Inc. and EMI, dominate the market for pre-recorded music. K-tel does not have the financial resources, nor does it have the depth or breadth of catalog, distribution capabilities or current repertoire of these companies. Its ability to compete in this market depends upon:

- the skill and creativity of its employees to expand and utilize its music catalog to create compilation packages;
- its ability to distribute its products effectively and efficiently; and
- its ability to build upon and maintain its reputation for producing, licensing, marketing and distributing high quality music.

The major pre-recorded music companies, either directly or through subsidiaries, now manufacture and distribute pre-recorded music compilations in direct competition with K-tel s music compilation products. With this competition, the Company relies on its own Dominion master music catalog for the production of music compilations.

Intellectual Property

The Company believes that the K-tel® name and mark are well recognized and are therefore valuable assets of the Company. The Company pursues the registration of its trademarks and service marks in the U.S. and internationally. Effective trademark, service mark and copyright protection may not be available in every country in which its products and services are made available. Federal and state trademark registrations continue indefinitely, so long as the trademarks are in use and periodic renewals and other required filings are made.

The Company regards its copyrights, service marks, trademarks, trade dress, trade secrets and similar intellectual property as critical to its success, and relies on trademark and copyright law, trade secret protection and confidentiality and/or license agreements with its employees, customers, partners and others to protect its proprietary rights. K-tel believes strongly in protecting its intellectual property and will seek protection for new products and marks whenever the Company believes it is advisable. K-tel cannot assure you that any trademarks held by it will be valid, enforceable or otherwise of value to the Company in relation to its competitors or the market in general, or that any trademark for which it has applied or may apply will be granted.

In addition to trademark protection, the Company generally obtains copyrights in music works, compilations and sound recordings.

Employees

On June 30, 2005, K-tel employed 17 full time people worldwide.

Financial and Geographic Information

For financial information about the Company s business segment and geographic area operations for each of the three fiscal years ended June 30, 2005 (see Note 9 to the consolidated financial statements).

ITEM 1A: RISK FACTORS

The following are certain risk factors that could affect our business, financial condition, operation results and cash flows. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report on Form 10-K because these risk factors could cause our actual results to differ materially from those expressed in any forward-looking statement. The risks we have highlighted below are not the only ones we face. If any of theses events actually occur, our business, financial condition, operating results or

cash flows could be negatively affected.

The Company cautions you to keep in mind these risk factors and to refrain from attributing undue certainty to any forward-looking statements, which speak only as of the date of this report.

Continuing losses could affect our ability to obtain additional working capital.

The Company incurred losses in recent fiscal years and expects to continue incurring losses for the foreseeable future. Continuation 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 which may not be available on acceptable terms or at all.

The level of our indebtedness could adversely affect our financial condition.

The Company has primarily funded its recent operations through internally generated capital and secured loans from K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder which is controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Although K-5 continues to advance funds sufficient to meet the Company s needs at this time, 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 or at all when required.

A substantial portion of our total net sales are from a small group of customers. A reduction in sales to any of these customers could have a material adverse effect on our net sales and profitability.

For the fiscal year ended June 30, 2005, net sales to three customers, Handleman Company , Anderson Merchandising and D.A Tapes, accounted for approximately 18%, 15% and 12%, respectively, of our total net sales. The Company believes that sales to a small group of customers will continue to represent a significant percentage of our total net sales. Substantially all of the products the Company distributes to these customers are supplied on a non-exclusive basis under arrangements that may be cancelled without cause and upon short notice, and our retail customers generally are not required to make minimum purchases. If the Company is unable to continue to sell our products to all or any of these customers or are unable to maintain our sales to these customers at current levels and cannot find other customers to replace these sales, there would be an adverse impact on our net sales and profitability. There can be no assurance that the Company will continue to recognize a significant amount of revenue from sales to any specific customer.

The Company may not have the resources necessary to successfully compete in the music industry.

The music business is highly competitive and dominated by several major record companies that 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.

Technology developments, particularly electronic downloading, may adversely affect our net sales, margins and results of operations.

Home entertainment products have traditionally been marketed and delivered on a physical delivery basis. If, in the future, these products are increasingly marketed and delivered through technology transfers, such as electronic downloading through the Internet or similar delivery methods, then our retail and wholesale distribution business could be negatively impacted. As electronic downloading grows through Internet retailers, competition between suppliers to electronic retailers in traditional ways will intensify and likely negatively impact our net sales and margins. If the Company is unable to develop the necessary vendor and customer relationships to facilitate additional electronic downloading or if the terms of these arrangements differ from those related to our physical product sales our business may be materially harmed.

Increased counterfeiting or piracy may negatively affect the demand for our entertainment products.

The recorded music industry has been adversely affected by counterfeiting of CDs and DVDs and also by websites and technologies that allow consumers to illegally download and access music. Increased proliferation of these alternative access methods could impair our ability to generate sales.

The Company may not be able to successfully protect its intellectual property rights.

The Company regards its copyrights, service marks, trademarks, and similar intellectual property critical to its success, and relies on trademark and copyright law to protect the intellectual property the Company license. Infringement on our intellectual property may lead to litigation to protect our intellectual property rights which could result in substantial costs and diversion of resources and could have a material effect on our business.

Product returns or inventory obsolescence could reduce our sales and profitability or negatively impact our liquidity.

The Company maintains a significant investment in product inventory. Like other companies operating in our industry, product returns from our retail customers are significant when expressed as a percentage of revenues. Weakening market conditions could lead to increased product returns, increasing the Company s inventory and obsolescence reserve. Adverse financial conditions could cause a significant decline in the value and marketability of our products, possibly making it difficult for us to recover our initial product acquisition costs. Under such circumstances, our business, financial condition, operating results and cash flows, could be adversely affected. The Company maintains a sales return reserve based on historical product line experience rates. The Company can not assure you that our reserves will be adequate to cover

potential returns.

If the Company is unable to successfully remediate the material weaknesses in its internal controls, the Company s ability to report its financial results on a timely and accurate basis may be adversely affected.

The Company has reported material weaknesses and the actions taken to address them. Such remediation may not prove effective. Further, should any material weaknesses develop, there are no assurances that the Company will be able to remediate them in a manner satisfactory to outside parties. This could result in the Company not being able to report its financial results on a timely basis, harm our operating results, or result in material misstatements in our financial statements. In addition, the Company may be unable to have its internal controls over financial reporting attested to by our independent registered public accounting firm when required.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None

ITEM 2: PROPERTIES

K-tel s corporate offices and U.S. operations are located in leased facilities in Plymouth, a suburb of Minneapolis, Minnesota, consisting of approximately 4,000 square feet of office space and approximately 6,000 square feet of warehouse. K-tel s foreign subsidiaries lease a total of approximately 1,350 square feet of office space. Effective October 2006, the Company s U.S. operations is relocating to a smaller facility in Plymouth, Minnesota, which consists of 3,000 square feet of office space and 4,500 square feet of warehouse space. See Note 6 to the consolidated financial statements for a summary of the lease agreements.

ITEM 3: LEGAL PROCEEDINGS

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

On March 14, 2000, K-tel and its subsidiary in Germany commenced an action in U.S. District Court for the District of Minnesota for breach of express and implied warranties against 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 agreed to indemnify K-tel for injuries and damages arising out of the resale of those goods.

On April 30, 2001, Tristar 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 denied 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 on February 18, 2005.

Other Litigation and Disputes

K-tel and its subsidiaries are also involved in other legal proceedings 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 proceedings 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 on the consolidated financial position or results of operations of K-tel.

Subsidiary s Liquidation

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. As the only secured creditor, the Company received distributions of approximately $138,000 on March 1, 2004 and $76,000 on May 14, 2004.

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In June 2004, the Company received funds for the sale of assets and the collections of accounts receivables related to the March 2001 bankruptcy of K-tel International (USA), Inc., the Company s music distribution subsidiary in the United States. The Company received approximately $220,000 for assets sold by a third party and received approximately $113,000 in account receivable collections.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of K-tel s security holders during the fourth quarter of fiscal 2005.

Executive officers of the registrant

Each of our Company s executive officers is appointed to serve until his or her successor is duly appointed or his or her earlier removal or resignation from office.

The following table sets forth certain information with respect to the executive officers of K-tel at September 18, 2006.

Name of Officer	Age	Positions and Offices Held
Philip Kives	77	Chairman of the Board, Chief Executive Officer, President and Director
Larry Dunmall	56	Chief Financial Officer

Philip Kives, age 77, has held various offices and/or managerial positions with K-tel for more than thirty-five years. Mr. Kives is currently the Company s Chairman of the Board, Chief Executive Officer, President and Director.

Larry Dunmall, age 56, was appointed the Chief Financial Officer of K-tel in April 2005. From 2003 to 2005, Mr. Dunmall was the Chief Financial Officer of Protegra Technology Group, a computer software development company. From 2002 to 2003, he was the Controller of the Agricultural Products Division of Saskatchewan Wheat Pool and from 1995 to 2002 he was the Chief Financial Officer of ConAgra Grain, Canada.

PART II

ITEM 5: MARKET FOR REGISTRANT S COMMON STOCK, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

On August 17, 2006, there were 1,383 record holders of K-tel s common stock and 13,653,738 shares outstanding. The Company s common stock is traded on the Over-the-Counter Bulletin Board under the symbol KTEL .

The following table shows the range of high and low closing prices per share of K-tel s common stock for the fiscal year periods indicated. Such over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	2005 High	Low	2004 High	Low
1st Quarter	$ .15	$ .10	$ .13	$ .06
2nd Quarter	$ .12	$ .10	$ .11	$ .06
3rd Quarter	$ .13	$ .08	$ .29	$ .09
4th Quarter	$ .10	$ .06	$ .24	$ .09

No cash dividends were declared on K-tel s common stock during fiscal year 2005 or 2004 and K-tel does not expect to pay cash dividends in the foreseeable future. The declaration or payment by K-tel of dividends, if any, on its common stock in the future is subject to the discretion of the Board of Directors and will depend on K-tel s earnings, financial condition, capital requirements and other relevant factors. The declaration or payment by K-tel of dividends is also subject to the terms of its credit facility.

Equity Compensation Plan Information

The following table provides information as of June 30, 2005 with respect to compensation plans under which the Company s equity securities are authorized for issuance.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	126,900 (1)	$ 5.86	2,896,878 (2)
Equity compensation plans not approved by security holders	2,437,939 (3)	$ 0.08	
Total	2,564,839	$ 0.36	2,896,878

(1) Consists of 125,900 shares issuable pursuant to options granted under the Company s 1997 Stock Option Plan and 1,000 shares of common stock issuable pursuant to options granted under the Company s 1987 Stock Incentive Plan.

(2) Represents shares of common stock remaining available for future issuance under the Company s 1997 Stock Option Plan, as amended.

(3) Includes non-qualified stock options to purchase 95,000 shares of common stock issued outside the Company s 1997 Stock Option Plan to each of Jay William Smalley, Richard R. Marklund and Wesley C. Hayne in connection with such non-employee directors appointment to the Company s Compensation/ Stock Option Committee and a non-qualified stock option to purchase 15,000 shares of common stock issued outside the Company s 1997

Stock

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Option Plan to Jay William Smalley in consideration of his past and continued service on the Company s board of directors. See Director Compensation in Item 11. Includes an aggregate of 2,137,939 shares of common stock issuable pursuant to a stock option exchange program approved on March 18, 2003 by a committee of the Company s board of directors comprised solely of independent directors. Under the program, four optionees agreed to the cancellation of previously awarded options under the Company s 1997 Stock Option Plan and the Company agreed to issue options to purchase an equal number of shares outside the Company s stock option plan not earlier than six months and one day after the date of cancellation of the previously awarded options, such options to be issued at an exercise price per share equal to the then fair market value of the Company s common stock and to expire ten years after the new date of grant. On November 18, 2003, the replacements options were issued at a price per share of $.08. There was no compensation expense recognized as a result of this exchange.

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, 2005. This summary should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report. 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.

	2005	2004	2003	2002	2001
Net sales	$ 6,041	$ 6,679	$ 7,234	$ 6,891	$ 17,514
Operating income (loss)	$ (90)	$ (33)	$ 149	$ (46)	$ (9,480)
Income (loss) from discontinued operations (1)	$ 151	$ (52)	$ (581)	$ (180)	$ (4,315)
Extraordinary item (2)	$	$ 347	$	$ 894	$ 16,185
Net income (loss)	$ (457)	$ (87)	$ (892)	$ 300	$ 1,369
Net loss per share:					
Continuing operations	$ (.04)	$ (.03)	$ (.02)	$ (.03)	$ (.77)
Total assets	$ 4,695	$ 4,496	$ 5,301	$ 4,610	$ 3,832
Long-term debt	$	$	$	$	$ 4,000

(1) The income (loss) from discontinued operations reflects the operations of the Company s consumer products business, net of any income taxes allocated to it. The Company discontinued its consumer products operations in Germany in June 2000, in the United Kingdom in November 2000, and in the United States in January 2001. The income in fiscal 2005 also includes the $350,000 lawsuit settlement received from Tristar that had originated in the discontinued consumer products business.

(2) The extraordinary items reflect activity related to subsidiary liquidations and are shown net of any income taxes allocated to them. The activity in fiscal 2004 relates to distributions received from the liquidation of K-tel Marketing, Ltd. in the United Kingdom and proceeds from the sale of assets and collections on accounts receivable related K-tel International, (USA), Inc. that had filed for bankruptcy in March 2001. The extraordinary item in fiscal 2002 relates to the net liability that existed on K-tel Marketing, Ltd. when it filed for voluntary liquidation and was subsequently removed when the Company received assurances that it would not be held liable for any of K-tel Marketing, Ltd. s debts. The extraordinary item in fiscal 2001 relates to the net liability that existed on K-tel International (USA), Inc. when it filed for Chapter 7 bankruptcy and was removed as control of the subsidiary was transferred to the bankruptcy trustee.

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.

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 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.

In fiscal 2005, the Company began licensing its master recording music catalog to several companies that sell electronic downloads to various media formats via their internet sites.

A. RESULTS OF OPERATIONS

The following sections discuss the results of operations by business segment. See Note 9 to the consolidated financial statements for additional segment information. General corporate expenses of $656,000 in the year ended June 30, 2005, $869,000 in the year ended June 30, 2004 and $860,000 in the year ended June 30, 2003 have been allocated to the segments.

FISCAL 2005 VERSUS FISCAL 2004

Net sales for the year ended June 30, 2005 were $6,041,000, a decrease of 10.0% from fiscal 2004 sales of $6,679,000. This sales decrease was attributed to reduced licensing activity. The net loss for fiscal 2005 was $457,000, or $.03 per share, compared to a net loss of $87,000, or $.01 per share, in fiscal 2004.

In fiscal 2005, the Company received $350,000 from the settlement of a lawsuit that involved the discontinued subsidiary, K-tel Consumer Products, Inc.

In fiscal 2004 the Company received approximately $214,000 from the liquidation of K-tel Marketing LTD., the Company s consumer products subsidiary in the United Kingdom, which ceased operations in November 2000, and approximately $333,000 from the sale of assets and account receivable collections related to the March 2001 bankruptcy of K-tel International, (USA), Inc., the Company s music distribution subsidiary in the United States (see Note 1 to the consolidated financial statements). The $547,000 of distributions have been reflected as extraordinary items, net of income taxes.

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

BUSINESS SEGMENT RESULTS

Music

Net sales in the music segment were $4,552,000 for the year ended June 30, 2005 compared to $4,763,000 for the year ended June 30, 2004, a decrease of 4.4%. The decrease was primarily related to the discontinued sales of unprofitable budget music DVDs.

Cost of goods sold in the music segment decreased to 52.8% of net sales for the year ended June 30, 2005 compared to 67.6% of net sales for the year ended June 30, 2004, due primarily to the higher cost as a percentage of sales of the budget music DVDs which were discontinued in fiscal 2005. Advertising expenses within the segment, which consist primarily of co-operative advertising payments, trade advertising and promotions, increased to $123,000 for the year ended June 30, 2005 compared to $110,000 for the year ended June 30, 2004 due primarily to increased promotional programs in fiscal 2005 compared to fiscal 2004.

Selling, general and administrative expenses for the segment remained flat at $2,423,000 for the year ended June 30, 2005 compared to $2,424,000 for the year ended June 30, 2004. The music segment incurred an operating loss of $416,000 for the year ended June 30, 2005 compared to an operating loss of $992,000 for the year ended June 30, 2004.

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Licensing

Licensing revenues were $1,489,000 for the year ended June 30, 2005 compared to $1,916,000 for the year ended June 30, 2004, a decrease of 22.3%. Both domestic and European revenue decreased due primarily to the overall decrease in sales of the retail music business. Operating income in the licensing segment was $326,000 for the year ended June 30, 2005 and $959,000 for the year ended June 30, 2004, a decrease of 66.1%.

FISCAL 2004 VERSUS FISCAL 2003

Net sales for the year ended June 30, 2004 were $6,679,000, a decrease of 7.7% from fiscal 2003 sales of $7,234,000. This sales decrease was primarily due to fiscal 2003 including additional licensing revenue that resulted from a one time licensing audit. The net loss for fiscal 2004 was $87,000, or $.01 per share, compared to a net loss of $892,000, or $.06 per share, in fiscal 2003.

In fiscal 2004 the Company received approximately $214,000 from the liquidation of K-tel Marketing LTD. the Company s consumer products subsidiary in the United Kingdom which ceased operations in November 2000 and approximately $333,000 from the sale of assets and account receivable collections related to the March 2001 bankruptcy of K-tel International, (USA), Inc. the Company s music distribution subsidiary in the United States (see Note 1 to the consolidated financial statements). The $547,000 of distributions have been reflected as extraordinary items, net of income taxes.

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

BUSINESS SEGMENT RESULTS

Music

Sales in the music segment were $4,763,000 for the year ended June 30, 2004 compared to $4,454,000 for the year ended June 30, 2003, an increase of 6.9%. The increase was primarily related to an increase in DVD sales as a result of the Company s introduction of new DVD product lines.

Cost of goods sold in the music segment increased to 67.6% of net sales for the year ended June 30, 2004 compared to 61.4% of net sales for the year ended June 30, 2003, primarily relating to increasing the obsolescence reserve for karaoke related products. Advertising expenses within the segment, which consist primarily of co-operative advertising payments, trade advertising and promotions, decreased to $110,000 for the year ended June 30, 2004 compared to $200,000 for the year ended June 30, 2003 due primarily to decreased promotional programs in fiscal 2004 compared to fiscal 2003.

Selling, general and administrative expenses for the segment decreased $161,000, or 6.3%, to 2,424,000 for the year ended June 30, 2004 compared to $2,585,000 for the year ended June 30, 2003. 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. The music segment incurred an operating loss of $992,000 for the year ended June 30, 2004 compared to an operating loss of $1,010,000 for the year ended June 30, 2003.

Licensing

Licensing revenues were $1,916,000 for the year ended June 30, 2004 compared to $2,780,000 for the year ended June 30, 2003, a decrease of 31.1%. While European revenue increased $342,000, domestic revenue from licensing activity decreased $1,206,000. In mid-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 that was subject to this audit made the catch up royalty payments that were required under the license, and the Company s revenue increased accordingly. Operating income in the licensing segment was $959,000 for the year ended June 30, 2004 and $1,159,000 for the year ended June 30, 2003, a decrease of 17.2%. The decreased sales and income in fiscal 2004 were due to fiscal 2003 reflecting the collection of the catch up royalties from the audit.

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

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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 $221,000 at June 30, 2005 and $133,000 at June 30, 2004.

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.

Inventory Obsolescence - The Company estimates and records inventory losses for obsolete inventory based upon estimated market prices to sell identified inventory items that are slow moving. The Company reviews this estimate quarterly and the estimate is adjusted accordingly.

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. The Company began consolidating a variable interest entity during the quarter ending March 31, 2004 (see Note 12 to the financial statements).

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 did not 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 2007. 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.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

CONTRACTUAL OBLIGATIONS

The table below discloses a summary of the Company s specified contractual obligations at June 30, 2005 (in thousands):

	Total	Under 1 Year	1-3 Years
Notes payable to Affiliate and Other	$ 11,518	$ 11,518	$
Operating Leases	134	124	10
Total	$ 11,652	$ 11,642	$ 10

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 (6.0% at June 30, 2005), expires July 20, 2008, 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 $7,518,000 and $7,165,000 as of June 30, 2005 and 2004, respectively, under the K-5 Facility. At June 30, 2005, 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, 2008, 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% (7.0% at June 30, 2005) 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, 2005 and June 30, 2004, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2005, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel had an overdraft privilege borrowing facility of $45,000 with The Royal Bank of Scotland in the United Kingdom. This facility was secured by a standby letter of credit for $55,000 provided by K-tel International Ltd., a Canadian company controlled by Philip Kives and was payable on demand in accordance with normal banking practices. Borrowings bore interest of 2.0% per annum over the base rate (a total of 6.0% at June 30, 2004) but were subject to a minimum of 6.0% per annum. This overdraft privilege borrowing facility was canceled at the end of calendar 2004. K-tel had no outstanding balance as of June 30, 2004.

K-tel has primarily funded its recent operations through internally generated capital and secured loans from K-5. Assuming K-5 continues to advance funds sufficient to meet the Company s needs, management currently believes that K-tel has sufficient cash and borrowing capacity to ensure the Company will continue operations for the foreseeable future. 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 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 the Company s 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.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

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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, 2005, K-tel had variable rate debt of $11,518,000. 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 43.3% of K-tel s revenues during the year ended June 30, 2005 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 have been $2,910 for the year ended June 30, 2005. Additionally, approximately 53% of K-tel s assets at June 30, 2005 were based in its foreign operations and were translated into U.S. dollars at foreign currency exchange rates 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.

ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There were no changes in or disagreements with accountants during the years ended June 30, 2005 and June 30, 2004.

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 weaknesses 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 periods prior to June 30, 2004 and for the years ended June 30, 2005 and 2004.

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 reestablish effective internal control over financial reporting.

In fiscal 2005 and 2004, it was determined that the segregation of duties in the U.S. office was limited due to the small number of employees. This segregation of duties became further limited by vacancies that occurred in the Company s finance department. In particular, customer orders were recorded by the same person who initiated shipments, checks were

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deposited by the accounts receivable clerk, and employee payroll and changes were entered by the Operations Manager, who also distributed the payroll checks.

In response to the material weakness in the U.S. office, the former Controller was recently rehired and duties and responsibilities were revised to allow for improved segregation of duties and to increase the level of approvals and reviews.

Other than as set forth above, during the fiscal year ended June 30, 2006, there was 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.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10: DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The following describes the business, the business experience and background of each current director and executive officer of K-tel at August 15, 2006. No family relationships exist between K-tel s directors and executive officers, except that Mr. Smalley is the brother-in-law of Mr. Kives.

Each of our company s executive officers is appointed to serve until his or her successor is duly appointed or his or her earlier removal or resignation from office.

Larry Dunmall, age 56, was appointed the Chief Financial Officer of K-tel in April 2005. From 2003 to 2005, Mr. Dunmall was the Chief Financial Officer of Protegra Technology Group, a computer software development company. From 2002 to 2003, he was the Controller of the Agricultural Products Division of Saskatchewan Wheat Pool and from 1995 to 2002 he was the Chief Financial Officer of ConAgra Grain, Canada.

Wesley C. Hayne, age 58, was elected a director in November 2002. Since 2000, Mr. Hayne has been Chief Executive Officer of Biorefining, Inc., a company that develops, commercializes and licenses patented technologies capable of converting residual plant material into high-end, value-added products. From 1999 to 2000, Mr. Hayne was President of Cybrix Corporation, Inc., a company that provides solutions and leases staffing for computer security and disaster planning. From 1997 to 2000, Mr. Hayne was Chief Executive Officer of International Concept Development, Inc., a company that develops fast food restaurants in Europe. Mr. Hayne, one of our independent 401 directors, serves as the audit committee financial expert as defined by Item 401(h) of Regulation S-K.

Philip Kives, age 77, founded K-tel in 1968 and has served as its Chairman of the Board since K-tel s inception. In addition, Mr. Kives has been the Chief Executive Officer and President for more than five years.

Richard Marklund, age 61, was elected a director in November 2002. Since 2002, Mr. Marklund has been Chairman and Chief Executive Officer of Phoenix Newcastle Holdings, Inc., a management consulting company. From 2000 until 2002, Mr. Marklund served as Executive Vice President of WAM!NET, Inc., a telecommunication company. From 1998 until 2000, Mr. Marklund served as Chief Executive Officer of Hyperport International, Inc., a real estate development company.

Jay William Smalley, age 72, was elected a director in January 1999. From 1970 until 1998, Mr. Smalley served as Chief Executive Officer of JWS, Inc., a privately owned real estate development and sales company specializing in hotel, motel, industrial and residential properties. Since 1998, Mr. Smalley has been a broker and private contractor for Prudential California Realty.

Audit Committee

K-tel has a separate designated audit committee made up of Wesley C. Hayne, Richard Marklund and Jay William Smalley.

Code of Ethics

K-tel has adopted a code of ethics that applies to its principal executive officer, principal financial officer and principal accounting officer. This code of ethics is available on K-tel s website at K-tel.com and in print upon written request to: Code of Ethics, K-tel International, Inc., 2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota 55447. Any amendment to, or waiver from, a provision of the code of ethics will be posted to the above referenced website.

Section 16(a) Beneficial Ownership Reporting Compliance

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires K-tel s officers, directors and persons who own more than 10% of a registered class of K-tel s equity securities to file reports of ownership on Form 3 and changes in ownership on Form 4 or 5 with the Securities and Exchange Commission. Such officers, directors and 10% shareholders also are required by Securities and Exchange Commission s rules to furnish K-tel with copies of all Section 16(a) reports they file. Based solely on its review of the copies of such forms received by it, or written representations from certain reporting persons, the Company believes that during fiscal year 2005, its officers, directors and 10% shareholders filed all reports on a timely basis.

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

ITEM 11: EXECUTIVE COMPENSATION

The following table sets forth the aggregate cash compensation paid to or accrued for each of K-tel s executive officers for services rendered to K-tel during the fiscal years ended June 30, 2005, 2004 and 2003. K-tel has no written employment agreements with its executive officers.

Summary Compensation Table

Name and Principal Position	Annual Compensation Fiscal Year	Salary	Bonus	Long-Term Compensation Awards Securities Underlying Options	All Other Compensation
Philip Kives	2005	$	$		$
Chief Executive Officer	2004	$	$		$
	2003	$	$		$

During the fiscal years ended June 30, 2005, 2004 and 2003, the Company paid approximately $68,000 in annual management fees to K-5 for services provided to the K-tel International, Inc. Companies. These management fees included payments for services provided by Mr. Kives to the Company.

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 provided 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. Mr. Kives exchanged 1,702,939 options with a weighted average price per share of $5.95 under this Stock Option Exchange Program. Replacement options were proposed to be issued six months and one day after the date of cancellation of the existing options and were to 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 replacement options were issued at a price per share of $.08. There was no compensation expense recognized as a result of this exchange.

Option Grants in Last Fiscal Year

No options were granted to directors or executive officers in fiscal year 2005.

Aggregated Option Exercises in Last Fiscal Year

and FY-end Option Values

Name	Shares Acquired On Exercise	Value Realized	Number of Securities Underlying Options at FY-End Exercisable	Unexercisable	Value of In-the Money Options at FY-End(1) Exercisable	Unexercisable
Philip Kives	0	N/A	1,702,939		$	N/A

(1) Market value of underlying securities at fiscal year end minus the exercise price.

Director Compensation

Directors who are employees of the Company receive no compensation for their services as director. Non-employee directors receive cash compensation of $10,000 per year (paid quarterly) and are entitled to receive non-qualified stock options for the purchase of 5,000 shares of the Company s common stock at an exercise price equal to the fair market value of the common stock on the date of initial election and upon each re-election by the shareholders at an annual or special meeting. In

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

connection with their appointment to the Company s Compensation/Stock Option Committee during the fiscal year ended June 30, 2003, Jay William Smalley, Richard R. Marklund and Wesley C. Hayne each also received a non-qualified stock option to purchase 95,000 shares of common stock issued outside the Company s 1997 Stock Option Plan. During the fiscal year ended June 30, 2003, Mr. Smalley also received a non-qualified stock option to purchase 15,000 shares of common stock outside the Company s 1997 Stock Option Plan in consideration of his past and continued service on the Company s board of directors. All stock options issued to non-employee directors during the fiscal year ended June 30, 2003 are exercisable for a period of ten years from the date of grant and bear an exercise price of $.05 per share. No options were granted to directors during fiscal year 2004 or 2005.

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table contains certain information as of August 15, 2006, regarding the beneficial ownership of our common stock by (i) each person known to K-tel to own beneficially five percent or more of our common stock, (ii) each director of K-tel, (iii) each named executive officer, and (iv) the directors and executive officers as a group. The percentage of beneficial ownership is based on 13,653,738 shares of common stock outstanding as of August 15, 2006. Any shares which are subject to an option or a warrant exercisable within 60 days are reflected in the following table and are deemed to be outstanding for the purpose of computing the percentage of common stock owned by the option or warrant holder but are not deemed to be outstanding for the purpose of computing the percentage of common stock owned by any other person. Unless otherwise indicated, each person in the table has sole voting and investment power as to the shares shown. Unless otherwise indicated, the address for each listed shareholder is c/o K-tel International, Inc., 2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota 55447.

	Amount and Nature of Beneficial Ownership(1)		Percent of Outstanding Stock	
Philip Kives 220 Saulteaux Crescent Winnipeg, Manitoba R3J 3W3 Canada	10,076,953	(2)	65.6	%
Jay William Smalley	120,000	(3)	*	
Wesley C. Hayne	100,000	(3)	*	
Richard Marklund	100,000	(3)	*	
All current directors and officers as a group (4 persons)	10,396,953	(4)	66.3	%

* Indicates ownership of less than 1% of the outstanding shares of Common Stock.

(1) The securities beneficially owned by a person are determined in accordance with the definition of beneficial ownership set forth in the regulations of the Securities and Exchange Commission and accordingly, may include securities owned by or for, among others, the spouse, children or certain other relatives of such person as well as other securities as to which the person has or shares voting or investment power or has the right to acquire within 60 days. More than one person may beneficially own the same shares.

(2) Consists of 8,048,678 shares held directly by K-5 Leisure Products Inc. (an affiliate of the Company controlled by Mr. Kives), 325,336 shares held by a wholly-owned subsidiary of K-5 and 1,702,939 shares purchasable upon the exercise of options.

(3) Represents shares purchasable upon the exercise of options.

(4) Includes 2,022,939 shares purchasable upon the exercise of options.

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder which is controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

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 (6.0% at June 30, 2005), expires July 20, 2008, 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 $7,518,000 and $7,165,000 as of June 30, 2005 and 2004, respectively, under the K-5 Facility. At June 30, 2005, 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, 2008, 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% (7.0% at June 30, 2005) 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, 2005 and June 30, 2004, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2005, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel had an overdraft privilege borrowing facility of $45,000 with The Royal Bank of Scotland in the United Kingdom. This facility was secured by a standby letter of credit for $55,000 provided by K-tel International Ltd., a Canadian company which is controlled by Philip Kives, and was payable on demand in accordance with normal banking practices. Borrowings bore interest of 2.0% per annum over the base rate (a total of 6.0% at June 30, 2004) but were subject to a minimum of 6.0% per annum. This overdraft privilege borrowing facility was canceled at the end of calendar 2004. K-tel had no outstanding balance as of June 30, 2004.

The Company purchased approximately $400,000 in the year ended June 30, 2005, $502,000 in the year ended June 30, 2004 and $463,000 in the year ended June 30, 2003 of music entertainment and consumer convenience products from K-5, which represented 16.0%, 17.1% and 14.6% of cost of goods sold, respectively. There were trade payables to K-5 of $398,000 at June 30, 2005, $390,000 at June 30, 2004, and $371,000 at June 30, 2003, or 23.1%, 27.2% and 31.9% of total trade payables, respectively.

During the fiscal years ended June 30, 2005, 2004 and 2003, the Company paid approximately $68,000 in annual management fees to K-5 for services provided to the K-tel International, Inc. Companies. These management fees included payment for services provided by Mr. Kives to the Company.

The Company had no sales of products to K-5 during fiscal years 2005, 2004, and 2003. There was a balance receivable from K-5 at June 30, 2005 of $129,000, June 30, 2004 of $113,000, and June 30, 2003 of $73,000. No interest was charged on the related outstanding balances during fiscal years 2005, 2004 and 2003.

All future transactions between the Company, its officers, directors and principal shareholders and its affiliates will be approved by the audit committee of the Company s board of directors.

Other than as set forth above, during the fiscal year ended June 30, 2006, there was no change in the Company s

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Fees and Services

The following table shows the aggregate fees billed to the Company by Grant Thornton for services rendered during fiscal years ended June 30, 2005 and June 30, 2004:

Description of Fees	Fiscal 2005 Amount		Fiscal 2004 Amount	
Audit Fees	$ 95,000	(1)	$ 180,000	(1)
Tax Fees	37,000	(2)	60,000	(2)
Other Fees		(3)	3,000	(3)
Total	$ 132,000		$ 243,000	

(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 2005 and 2004 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 and other financial consulting assistance.

Pre-Approval Policy and Procedures

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 Fees and Services table pursuant to engagements that occurred in fiscal 2005 and 2004.

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 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 September 18, 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	September 18, 2006
/s/ Larry Dunmall Larry Dunmall	Chief Financial Officer (Principal Financial and Accounting Officer)	September 18, 2006
/s/ Jay William Smalley Jay William Smalley	Director	September 18, 2006
/s/ Wesley C. Hayne Wesley C. Hayne	Director	September 18, 2006
/s/ Richard Marklund Richard Marklund	Director	September 18, 2006

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets as of June 30, 2005 and 2004

Consolidated Statements of Operations for each of the three years ended June 30, 2005

Consolidated Statements of Shareholders Equity (Deficit) for each of the three years ended June 30, 2005

Consolidated Statements of Cash Flows for each of the three years ended June 30, 2005

Notes to Consolidated Financial Statements

Supplemental Schedule to Consolidated Financial Statements:

Schedule II - Valuation and Qualifying Accounts for each of the three years ended June 30, 2005

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, 2005 and 2004 and the related consolidated statements of operations, shareholders deficit, and cash flows for each of the three years in the period ended June 30, 2005. 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 the standards of the Public Company Accounting Oversight Board (United States). 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of K-tel International, Inc. and Subsidiaries as of June 30, 2005 and 2004 and the consolidated results of their operations and their consolidated cash flows for the each of the three years in the period ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 12 to the consolidated financial statements, the Company adopted FASB Interpretation 46 (Revised December 2003), *Consolidation of Variable Interest Entities*, during the quarter ended March 31, 2004.

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statement taken as a whole. The accompanying Schedule II of K-tel International, Inc. and Subsidiaries is presented for the purposes of additional analysis and is not a required part of the basic consolidated financial statements. This schedule has been subjected to the auditing procedures applied in the audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole

/S/ GRANT THORNTON LLP

Minneapolis, Minnesota,
August 15, 2006

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

JUNE 30,

(in thousands - except share and per share data)

	2005	2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 1,272	$ 147
Accounts receivable, net of allowance for doubtful accounts of $4 in 2005 and 2004	2,045	2,691
Inventories	563	561
Royalty advances	6	50
Prepaid expenses and other	227	308
Total Current Assets	4,113	3,757
Property and equipment, net of accumulated depreciation and amortization of $1,138 in 2005 and $1,506 in 2004	84	83
Owned catalog masters, net of accumulated amortization of $3,115 in 2005 and $2,942 in 2004	498	656
	$ 4,695	$ 4,496
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current Liabilities:		
Notes payable to affiliate and other	$ 11,518	$ 11,165
Accounts payable	1,727	1,432
Accrued royalties	1,760	1,907
Reserve for returns	221	133
Net liabilities of discontinued operations	30	30
Total Current Liabilities	15,256	14,667
Shareholders Deficit:		
Common Stock 50,000,000 shares authorized, par value $.01; 13,653,738 issued and outstanding in 2005 and 2004	136	136
Additional paid-in capital	21,292	21,292
Accumulated deficit	(31,923)	(31,466)
Accumulated other comprehensive loss	(66)	(133)
Total Shareholders Deficit	(10,561)	(10,171)
	$ 4,695	$ 4,496

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

YEARS ENDED JUNE 30,

(in thousands - except per share data)

	2005	2004	2003
Net Sales	$ 6,041	$ 6,679	$ 7,234
Costs and Expenses:			
Cost of goods sold	2,439	2,934	3,100
Advertising	123	110	200
Selling, general and administrative	3,569	3,668	3,785
Total Costs and Expenses	6,131	6,712	7,085
Operating Income (Loss)	(90)	(33)	149
Other Income (Expense):			
Interest expense	(630)	(497)	(534)
Other income (expense), net	24	(20)	74
Total Other Expense	(606)	(517)	(460)
Loss from Continuing Operations Before Income Taxes	(696)	(550)	(311)
Benefit for Income Taxes	88	168	
Loss from Continuing Operations	(608)	(382)	(311)
Discontinued Operations:			
Gain (loss) from discontinued operations, net of taxes	151	(52)	(581)
Loss before Extraordinary Item	(457)	(434)	(892)
Extraordinary Item:			
Gain on Subsidiary Liquidations, net of taxes		347	
Net Loss	$ (457)	$ (87)	$ (892)
Income (Loss) per Share Basic and Diluted:			
Continuing Operations	$ (.04)	$ (.03)	$ (.02)
Discontinued Operations	.01	(.01)	(.04)
Extraordinary Item		.03	
Net Loss	$ (.03)	$ (.01)	$ (.06)
Shares used in the calculation of loss per share Basic and Diluted:	13,654	13,654	13,654
Comprehensive Loss			
Net loss	$ (457)	$ (87)	$ (892)
Unrealized pension cost		(74)	
Translation adjustment	67	96	131
Comprehensive loss	$ (390)	$ (65)	$ (761)

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, 2005, 2004 AND 2003

(in thousands)

	Common Stock Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total
Balance at June 30, 2002	13,654	$ 136	$ 21,292	$ (30,485)	$ (286)	$ (9,343)
Net loss				(892)		(892)
Translation adjustment					131	131
Balance at June 30, 2003	13,654	136	21,292	(31,377)	(155)	(10,104)
Net loss				(87)		(87)
Other				(2)		(2)
Unrealized pension cost					(74)	(74)
Translation adjustment					96	96
Balance at June 30, 2004	13,654	136	21,292	(31,466)	(133)	(10,171)
Net loss				(457)		(457)
Translation adjustment					67	67
Balance at June 30, 2005	13,654	$ 136	$ 21,292	$ (31,923)	$ (66)	$ (10,561)

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)

	2005	2004	2003
Operating Activities:			
Net loss	$ (457)	$ (87)	$ (892)
Adjustment to reconcile net loss to cash Provided by (used in) operating activities:			
Depreciation and amortization	224	253	315
(Gain) loss on disposal of property and equipment	(11)	7	3
Discontinued operations		(93)	7
Changes in operating assets and liabilities:			
Accounts receivable, net	657	(118)	(147)
Inventories	(4)	(21)	135
Royalty advances	(6)	193	68
Prepaid expenses	130	11	89
Accounts payable	358	(190)	(10)
Accrued royalties	(98)	(485)	87
Reserve for returns	89	(88)	173
Cash provided by (used in) operating activities	882	(618)	(172)
Investing Activities:			
Purchases of property and equipment	(42)	(66)	(18)
Music catalog additions	(15)	(26)	
Other		2	15
Cash used in investing activities	(57)	(90)	(3)
Financing Activities:			
Borrowings on notes payable	4,773	2,569	2,278
Payments on notes payable	(4,421)	(2,944)	(1,033)
Cash provided by (used in) financing activities	352	(375)	1,245
Effect of exchange rates on cash	(52)	11	74
Net increase (decrease) in cash equivalents	1,125	(1,072)	1,144
Cash and cash equivalents at beginning of period	147	1,219	75
Cash and cash equivalents at end of period	$ 1,272	$ 147	$ 1,219
Supplemental Cash Flow Information			
Cash paid for interest	$ 714	$ 539	$ 396

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2005, 2004 AND 2003

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 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.

Subsidiary Liquidation

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. In fiscal 2002, the assets and liabilities of the subsidiary were removed from the books of the Company and the remaining net liability was shown as a gain on liquidation. As the only secured creditor, the Company subsequently received distributions of approximately $138,000 on March 1, 2004 and $76,000 on May 14, 2004 and reflected these as additional gain on liquidation, net of taxes. K-tel Marketing Ltd. had no operations during the fiscal years ended June 30, 2005, 2004 and 2003.

In June 2004, the Company received funds for the sale of assets and the collections of accounts receivables related to the March 2001 bankruptcy of K-tel International, (USA), Inc., the Company s music distribution subsidiary in the United States. The Company received approximately $220,000 for assets sold by a third party and received approximately $113,000 in account receivable collections. These receipts were reflected as a gain on liquidation, net of taxes.

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. 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 June 30, 2005 and 2004 and losses from discontinued operations relate primarily to legal matters and completion of statutory reporting requirements for the former operations in Germany (See Note 6).

In fiscal 2005 the Company received $350,000 from the settlement of a lawsuit that involved the discontinued subsidiary, K-tel Consumer Products, Inc. Legal expenses relating to the lawsuit offset this amount.

Liquidity

During the years ended June 30, 2005, 2004 and 2003, the Company incurred net losses from continuing operations of $608,000, $382,000 and $311,000, respectively, and provided $882,000 and used $618,000 and $172,000 of cash in operating activities. Additionally, the Company had a working capital deficit of $11,143,000 at June 30, 2005.

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

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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.

During the quarter ended March 31, 2004, the Company began to consolidate the financial statements of Lancaster Trading Limited (Lancaster), a variable interest entity of which the Company determined it was the primary beneficiary (see Note 12).

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 $221,000 at June 30, 2005 and $133,000 at June 30, 2004.

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. At June 30, 2005 and 2004, $1,172,000 and $94,000, respectively, was held at various financial institutions in Europe.

Accounts Receivable - Accounts receivable balances are presented net of allowances. The Company determines its allowances by considering a number of factors, including the length of time trade receivables are past due, the Company s previous history, and the customer s current ability to pay obligations to the Company. The Company writes off accounts receivables when they become uncollectible.

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. Amortization expense for the years ended June 30, 2005, 2004 and 2003 was $173,000, $190,000, and $238,000, respectively.

Estimated amortization expense for the owned catalog masters is as follows for the years ended June 30:

2006	$ 159,000
2007	144,000

2008	118,000
2009	64,000
2010	13,000
	$ 498,000

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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, 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 $123,000, $110,000, and $200,000 for the years ended June 30, 2005, 2004 and 2003, 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, whereby the options are granted at market price, and therefore no compensation costs are recognized. If compensation expense for the Company s various stock option plans had been determined based on the projected fair values at the grant dates for awards under those plans, the Company s pro-forma net loss, basic and diluted loss per common share would have been as follows:

	Fiscal Year Ended June 30, 2005	2004	2003
Net loss (in thousands):			
As reported	$ (457)	$ (87)	$ (892)
Pro forma	$ (457)	$ (258)	$ (907)
Basic and Diluted EPS:			
As reported	$ (.03)	$ (.01)	$ (.06)
Pro forma	$ (.03)	$ (.02)	$ (.06)

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, 2005, 2004,and 2003, weighted average options to purchase 2,564,839, 2,574,839, and 442,900 shares of common stock, with weighted average exercise prices of $.36, $.39, and $1.95, respectively, 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. NOTES PAYABLE TO AFFILIATE AND OTHER

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 (6.0% at June 30, 2005), expires July 20, 2008, 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 $7,518,000 and $7,165,000 as of June 30, 2005 and 2004, respectively, under the K-5 Facility. At June 30, 2005, 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, 2008, 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% (7.0% at June 30, 2005) 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, 2005 and 2004, $4,000,000 was outstanding under the term loan and there were no borrowings under the revolving facility. At June 30, 2005, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel had an overdraft privilege borrowing facility of $45,000 with The Royal Bank of Scotland in the United Kingdom. This facility was secured by a standby letter of credit for $55,000 provided by K-tel International Ltd., a Canadian company controlled by Philip Kives and was payable on demand in accordance with normal banking practices. Borrowings bore interest of 2.0% per annum over the base rate (a total of 6.0% at June 30, 2004) but were subject to a minimum of 6.0% per annum. This overdraft privilege borrowing facility was canceled at the end of calendar 2004. K-tel had no outstanding balance as of June 30, 2004.

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

	2005	2004	2003
Income (loss) before provision for income taxes:			
United States	$ (163)	$ 277	$ 196
Foreign	(289)	(364)	(1,088)
Total	$ (452)	$ (87)	$ (892)
Provision for income taxes:			
Current			
United States	$ 5	$	$
Foreign			
Total provision for income taxes	$ 5	$	$

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

	2005	2004	2003
Federal statutory rate	(34)%	(34)%	(34)%
State Taxes, net of Federal benefit	(2)	(2)	(2)
Valuation allowance	36	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, 2005	June 30, 2004
Net operating loss carryfowards	$ 15,836	$ 15,637
Alternative minimum tax credits	439	439
Foreign tax credit	325	325
Reserve for returns	221	221
Depreciation and amortization	(89)	(64)
Royalty reserves	65	96
Inventory reserves	21	40
Nondeductible accruals	96	83
Valuation allowance	(16,914)	(16,777)
	$	$

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

For U.S. tax reporting purposes, the Company has net operating loss (NOL) carryforwards of approximately $43,990,000. 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 if and 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 $439,000 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 1,000 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 for 2,037,605 net shares granted under this plan as of June 30, 2005, of which 1,011,111 have been exercised. Any options cancelled become 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 provided 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. Mr. Kives exchanged 1,702,939 options with a weighted average price per share of $5.95 under this Stock Option Exchange Program. Replacement options were proposed to be issued six months and one day after the date of cancellation of the existing options and were to 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 replacement options were issued at a price per share of $.08. There was no compensation expense 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 for 2,482,939 net shares granted outside the Stock Option Plan as of June 30, 2005. No options were granted outside the Stock Option Plan during fiscal 2005.

The share information for all plans is summarized below:

	Incentive Stock Options	Non-Qualified Stock Options	Weighted Average Exercise Price
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
Granted		2,137,939	.08
Cancelled	(6,000)		5.30
Outstanding June 30, 2004	81,900	2,492,939	$ .39
Cancelled		(10,000)	5.86
Outstanding June 30, 2005	81,900	2,482,939	$ .36

(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, 2005:

Options Outstanding and Exercisable

Exercise Prices Range	Weighted Average	Number of Shares	Weighted Average Remaining Contractual Life
$ 0.05 - 0.08	$ 0.08	2,447,939	8.3 years
$ 1.75	$ 1.75	1,000	1.3 years
$ 3.06	$ 3.06	400	2.3 years
$ 5.51 - 5.66	$ 5.66	87,500	4.6 years
$ 8.73	$ 8.73	28,000	3.7 years
		2,564,839	

The weighted average fair value of options granted in fiscal 2004 was $.08 and fiscal 2003 was $.05. No options were granted in fiscal 2005. 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.

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:

	2005	2004	2003
Risk-free interest rate	4.00 %	4.00 %	4.00 %
Expected life	10 years	10 years	10 years
Expected volatility	220 %	220 %	220 %
Expected dividend yield	None	None	None

6. COMMITMENTS AND CONTINGENCIES

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 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 agreed to indemnify K-tel for injuries and damages arising out of the resale of those goods.

On April 30, 2001, Tristar 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 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 2006. Commitments under these leases are $120,000 in 2006. Rental expense was $222,000 in 2005, $228,000 in 2004, and $254,000 in 2003. Effective October 2006, the Company is planning to relocate its U.S. operations to a smaller facility in Plymouth, Minnesota, which consists of 3,000 square feet of office space and 4,500 square feet of warehouse space.

7. SIGNIFICANT CUSTOMERS AND RELATED PARTY TRANSACTIONS

Three customers accounted for approximately 18.4%, 15.3% and 13.2% of K-tel s revenue for the year ended June 30, 2005 and had accounts receivable balances of $503,000, $403,000, and $22,000 respectively, at June 30, 2005. The loss of, or a substantial reduction in, business from any of these customers could have a material adverse effect on the Company.

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

The Company purchased approximately $400,000 in the year ended June 30, 2005, $502,000 in the year ended June 30, 2004, and $463,000 in the year ended June 30, 2003 of music entertainment and consumer convenience products from K-5, the Company s largest shareholder controlled by Philip Kives, Chairman of the Board, President and Chief Executive Officer of K-tel. There were trade payables to K-5 of $398,000 at June 30, 2005, and $390,000 at June 30, 2004.

The Company had no sales of products to K-5 during the years ended June 30, 2005, 2004 and 2003. There was a balance receivable from K-5 at June 30, 2005 of $129,000 and June 30, 2004 of $113,000. No interest was charged on the related outstanding balances during fiscal years 2005, 2004 and 2003.

All future transactions between the Company, its officers, directors and principal shareholders and its affiliates will be approved by the audit committee of the Company s board of directors.

8. RETIREMENT PLANS

Pension Plan

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

	Pension Benefits	
	2005	2004
	(In Thousands)	
Net periodic cost:		
Interest cost	$ 58	$ 44
Expected return on assets	(37)	(42)
Amortization of transition amount	(17)	(16)
Actuarial loss	15	9
Net periodic benefit cost	$ 19	$ (5)
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 957	$ 764
Interest cost	58	44
Actuarial loss	197	77
Exchange rate adjustment	(12)	72
Benefit obligation at end of year	$ 1,200	$ 957
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 823	$ 712
Actual return on plan assets	43	42
Exchange rate adjustment	(5)	69
Fair value of plan at end of year	$ 861	$ 823

The employer is not expected to contribute to the plan in fiscal 2006.

The Company s pension plan asset target allocation for 2005 and actual asset allocations are as follows at June 30:

	Target	Percentage of Plan Assets	
	2005	2005	2004
Asset category:			
Short-tem liquid investments	100 %	100 %	100 %

The Company s investment strategy with respect to pension plan assets is to continue to hold the plan asset 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)	2005	2004
Reconciliation of funded status:		
Funded status	$ (339)	$ (134)
Unrecognized actuarial loss	435	265
Unrecognized transition amount	(168)	(185)
Unfunded accrued pension cost	$ (72)	$ (54)

	2005	2004
Statement of financial position:		
Unfunded accrued pension cost	$ (72)	$ (54)
Additional minimum liability		(74)
Accumulated other comprehensive income		74
Recognized amount	$ (72)	$ (54)

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

	2005	2004
Discount rate	5.75 %	5 %
Expected return on plan assets	4.5 %	4.25 %
Rate of compensation increase	0 %	0 %

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

	2005	2004
Discount rate	5.00 %	5.75 %
Rate of compensation increase	N/A	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 has contributed $53,000, $77,000, and $51,000 for the years ended June 30, 2005, 2004 and 2003, respectively.

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 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 from the Company s master music catalog. 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, commercials and electronic downloads to various media formats, 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

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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)*

Fiscal Years Ended June 30,		Music	Licensing	Other	Total Company
Net Sales	2005	$ 4,552	$ 1,489	$	$ 6,041
	2004	4,763	1,916		6,679
	2003	4,454	2,780		7,234
Operating Income (Loss)	2005	$ (416)	$ 326	$	$ (90)
	2004	(992)	959		(33)
	2003	(1,010)	1,159		149
Assets	2005	$ 3,893	$ 548	$ 254	$ 4,695
	2004	3,519	664	313	4,496
	2003	2,900	2,128	273	5,301

GEOGRAPHIC INFORMATION *(in thousands)*

Fiscal Years Ended June 30,		United States	Europe	Total
Net Sales	2005	$ 3,428	$ 2,613	$ 6,041
	2004	3,836	2,843	6,679
	2003	4,949	2,285	7,234
Assets	2005	$ 2,240	$ 2,455	$ 4,695
	2004	2,148	2,348	4,496
	2003	3,889	1,412	5,301

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. The Company began consolidating a variable interest entity during the quarter ending March 31, 2004 (see Note 12).

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

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

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 did not 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

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In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

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 2007. 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. INTERIM FINANCIAL DATA (UNAUDITED)

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 $924,000 from the Company s UK subsidiary and approximately $344,000 from a customer of such subsidiary beginning approximately in January 2001 and continuing until September 2004. Further, the Company spent approximately $150,000 investigating the misappropriation. Through negotiations with the former employee, the Company s UK subsidiary and its customer have received an aggregate of approximately $1,495,000 including interest and an additional $100,000 is expected to be recovered. 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.

For the fiscal year ending June 30, 2004, the misappropriation understated sales by $4,000 in the quarter ending September 30, 2003. Product costs were overstated by $13,000, $2,000, $63,000 and $72,000 and selling and general and administrative expenses by $28,000, $43,000, $53,000 and $62,000 for the quarters ending September 30, 2003, December 31, 2003, March 31, 2004 and June 30, 2004, respectively.

The Company recorded account receivable amounts relating to the misappropriated funds of approximately $857,000 and $545,000 at June 30, 2004 and June 30, 2003, respectively, to the consolidated balance sheet. At June 30, 2004 the consolidated balance sheet accounts receivable amount also includes approximately $324,000 from a Lancaster receivable relating to the misappropriated funds (see Note 12).

Fiscal 2005 Interim Financial Data

Quarterly Financial Information (Unaudited)

	Three Months Ended, September 30, 2004	December 31, 2004	March 31, 2005	June 30, 2005
Net sales	$ 1,836	$ 1,695	$ 1,316	$ 1,194
Gross profit	$ 915	$ 923	$ 911	$ 853
Advertising, selling, general & administrative	$ 944	$ 913	$ 953	$ 882
Operating Income (loss)	$ (29)	$ 10	$ (42)	$ (29)
Net income (loss)	$ (153)	$ 190	$ (240)	$ (254)
Basic and diluted net loss per common share	$ (.01)	$ .01	$ (.02)	$ (.02)
Shares used in computing basic and diluted net loss per common share	13,654	13,654	13,654	13,654

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

Fiscal 2004 Interim Financial Data

Quarterly Financial Information (Unaudited)

	Three Months Ended, September 30, 2003	December 31, 2003	March 31, 2004	June 30, 2004
Net sales	$ 1,622	$ 1,759	$ 1,647	$ 1,651
Gross profit	$ 966	$ 902	$ 912	$ 965
Advertising, selling, general & administrative	$ 881	$ 943	$ 987	$ 967
Operating Income (loss)	$ 85	$ (40)	$ (71)	$ (7)
Net income (loss)	$ (84)	$ (180)	$ (76)	$ 253
Basic and diluted net loss per common share	$ (.01)	$ (.01)	$ (.01)	$ .02
Shares used in computing basic and diluted net loss per common share	13,654	13,654	13,654	13,654

12. CONSOLIDATION OF VARIABLE INTEREST ENITITY

The Company sells certain products to and buys from Lancaster, a company established in the U.K. In accordance with FASB Interpretation 46 (Revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46 (R)), the Company determined that Lancaster is a variable interest entity and that the Company is the primary beneficiary of this entity. The Company was required to apply the guidance of FIN 46 (R) for periods ending after March 15, 2004, and accordingly, during the quarter ended March 31, 2004, the financial statements of Lancaster were consolidated with those of the Company.

As of June 30, 2005, the consolidated financial statements included approximately $399,000 of current assets and $243,000 of current liabilities related to Lancaster. Lancaster s current assets include approximately $322,000 of amounts receivable related to the misappropriation of assets as described in Note 11. Sales and purchases between Lancaster and the Company have been eliminated in consolidation, and the additional effects of Lancaster on the Company s operations were not material.

13. SUBSEQUENT EVENT

K-tel International, Inc., through a wholly owned subsidiary, entered into a trademark license agreement with BCI Eclipse Company, LLC (BCI), a subsidiary of Navarre Corporation, effective October 10, 2005. K-tel, through a wholly owned subsidiary, also entered into a phonograph record license agreement with BCI effective October 16, 2005.

Pursuant to the trademark license agreement, K-tel has granted to BCI a license to use its trademarks, K-TEL® and K-tel s circular design logo. The agreement, which runs for an initial term of fourteen months, grants BCI the exclusive license to use the marks in the United States in a field of use limited to the sale and distribution of compact discs and DVDs. The marks may be used in connection with distribution of K-tel s music titles as well as products owned by third parties and released by BCI. The products which may be distributed using the marks exclude digital downloads, but include tangible products which may be marketed digitally. The marks may not be used in connection with TV and/or radio-advertised and mail order packages. The agreement provides for royalties of $0.30 per compact disc on a minimum of 80% of the compact discs using the K-tel mark and between $0.27 and $0.29 on the balance, with the payments due after BCI receives payment from its customers. BCI paid K-tel a $100,000 advance against royalties upon execution of the agreement. The advance is recoupable by BCI out of 50% of the royalties otherwise payable to K-tel. After the initial term, BCI has the right to extend the term for one year if K-tel has earned royalties based on products shipped including the advance totaling $350,000 or BCI has made make-up payments in such amount, and for a second year extension if BCI has earned royalties based on products shipped of $450,000 in the first extension term.

Pursuant to the phonograph record license agreement, K-tel, through a wholly owned subsidiary, licensed master recordings from K-tel s master recording catalog for a period of two years commencing on the initial release date of each titled album from the catalog. The initial term of the agreement expires on December 31, 2006 and BCI has the right to extend the term for one year if it has earned royalties based on products shipped, including the advance, totaling $350,000, or has made make-up payments in such amount, and for a second year extension if BCI has earned royalties

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

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based on products shipped of $450,000 during the first extension period. The nonexclusive license allows BCI to make reproductions of K-tel s master recordings in audio compact disc and DVD formats. The agreement provides for non-returnable advances of $150 per licensed master recoupable against royalties payable when BCI receives payment from their customers at the rate of $0.03 per pre-recorded licensed master and $0.04 per original licensed master embodied in any album. The territory of the license is the U.S. and Canada. The license allows BCI to compile master recordings and manufacture, distribute and sell albums in compact disc format through retail stores, online retail stores and record and video club sales channels under K-tel s licensed marks.

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					
2005	$ 4	$	$	$	$ 4
2004	$ 25	$ 24	$ 2	$ (47)(2)	$ 4
2003	$ 68	$ 62	$ 9	$ (114)(2)	$ 25
Reserve for Returns					
2005	$ 133	$ 646	$	$ (558)	$ 221
2004	$ 220	$ 375	$ 1	$ (463)	$ 133
2003	$ 46	$ 447	$	$ (273)	$ 220

(1) Exchange rate change

(2) Uncollectible accounts written off, net of recoveries

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

EXHIBIT INDEX

Exhibit No.	**Description of Exhibit**
3.1	Restated Articles of Incorporation, as amended (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2003 (File No. 1-07115)).
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)).

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of

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10.13	Credit Agreement between the Company and K-5 Leisure Products, Inc. dated September 27, 1999 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2003 (File No. 1-07115)).
10.14	$8,000,000 principal amount Note between the Company and K-5 Leisure Products, Inc. dated September 27, 1999 (incorporated by reference to the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2003 (File No. 1-07115)).
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)).
10.16	Trademark license agreement dated effective October 10, 2005, between Dominion Entertainment, Inc. and BCI Eclipse Company, LLC (incorporated by reference to the Company s Report on Form 8-K filed on August 29, 2006 (File No. 1-07115)).
10.17	Phonograph record license agreement between Dominion Entertainment, Inc. and BCI Eclipse Company, LLC, effective October 16, 2005 (incorporated by reference to the Company s Report on Form 8-K filed on August 29, 2006 (File No. 1-07115)).
10.18	Digital music download sales agreement dated October 10, 2003, between Dominion Entertainment, Inc. and Apple Computer, Inc. (incorporated by reference to the Company s Report on Form 8-K filed on August 29, 2006 (File No. 1-07115)).
10.19	Amendment Number Two to Loan Agreement and Security Agreement between the Company and K-5 Leisure Products, Inc., as assignee of Foothill Capital Corporation dated July 20, 2005 (incorporated by reference to the Company s Annual Report on Form 10-K/A for the fiscal year ended June 30, 2004 (File No. 1-07115)).
10.20	Amendment Number Two to Credit Agreement and Note between the Company and K-5 Leisure Products, Inc. dated July 20, 2005 (incorporated by reference to the Company s Annual Report on Form 10-K/A for the fiscal year ended June 30, 2004 (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(a).
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a).
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.

In May 2003, the FASB issued Statement 150, Accounting for Certain Financial Instruments with Characteristics of