

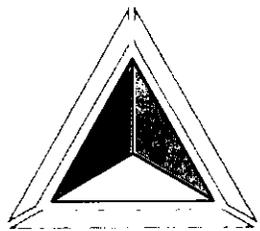
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2006 ANNUAL REPORT

## **Board of Directors as of February 23, 2007**

**Michael R. Duckworth**  
*Chairman of the Board*  
*Source Interlink Companies, Inc.*

**James R. Gillis**  
*Co-Chief Executive Officer*  
*Source Interlink Companies, Inc.*

**George A. Schnug**  
*Chief Executive Officer*  
*Americold Logistics LLC*

**Gray Davis**  
*Of Counsel*  
*Loeb & Loeb LLP*

**Ariel Z. Emanuel**  
*Member*  
*The Endeavor Agency LLC*

**David R. Jessick**  
*Retired Retail Executive*

**Terrence J. Wallock**  
*Consultant*

**Allan R. Lyons**  
*Managing Partner*  
*21st Century Strategic Investment Planning LLC*

**Gregory Mays**  
*Consultant & Private Investor*

## **Corporate Officers as of February 23, 2007**

**Michael R. Duckworth**  
*Chairman of the Board*

**James R. Gillis**  
*Co-Chief Executive Officer*

**Alan E. Tuchman**  
*Co-Chief Executive Officer*

**Jason S. Flegel**  
*Executive Vice President*

**Marc Fierman**  
*Chief Financial Officer*

**CAUTIONARY STATEMENT FOR PURPOSES OF THE "SAFE HARBOR" PROVISIONS OF THE  
PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

Some of the information contained in this Annual Report including, but not limited to, those contained under the headings "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are not historical facts are considered to be "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The words "believe," "expect," "anticipate," "estimate," "project," and similar expressions often characterize forward-looking statements. These statements may include, but are not limited to, projections of collections, revenues, income or loss, cash flow, estimates of capital expenditures, plans for future operations, products or services, and financing needs or plans, as well as assumptions relating to these matters. These statements are only predictions and you should not unduly rely on them. Our actual results will differ, perhaps materially, from those anticipated in these forward-looking statements as a result of a number of factors, including the risks and uncertainties faced by us described below and those set forth in our Annual Report on Form 10-K filed with the SEC on April 17, 2006:

- market acceptance of and continuing demand for magazines, DVDs, CDs and other home entertainment products;
- the impact of competitive products and technologies;
- the pricing and payment policies of magazine publishers, film studios, record labels and other key vendors;
- changing market conditions and opportunities;
- our ability to realize operating efficiencies, cost savings and other benefits from recent acquisitions; and
- retention of key management and employees.

We believe it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. The factors listed above provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. Before you make an investment decision relating to our common stock, you should be aware that the occurrence of the events described in these risk factors and those set forth in our Annual Report on Form 10-K under Item 1A. "Risk Factors" could have a material adverse effect on our business, operating results and financial condition. You should read and interpret any forward-looking statement in conjunction with our consolidated financial statements, the notes to our consolidated financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operation." Any forward-looking statement speaks only as of the date on which that statement is made. Unless required by U.S. federal securities laws, we will not update any forward-looking statement to reflect events or circumstances that occur after the date on which the statement is made.

**BUSINESS**

**OVERVIEW**

We are a premier marketing, merchandising and fulfillment company of entertainment products including DVDs, music CDs, magazines, books and related items serving about 110,000 retail store locations throughout North America. Our fully integrated businesses include:

- Distribution and fulfillment of entertainment products to major retail chains throughout North America and direct-to-consumers via the Internet;
- Import and export of periodicals sold in more than 100 markets worldwide;
- Coordination of product selection and placement for impulse items sold at checkout counters;
- Processing and collection of rebate claims as well as management of sales data obtained at the point-of-purchase;
- Design, manufacture and installation of wire fixtures and custom wood displays in major retail chains.

Our clients include:

- Mainstream retailers, such as Wal-Mart Stores, Inc., The Kroger Company, Target Corporation, Walgreen Company, Ahold USA, Inc., Sears Holdings Corporation., and Meijers;

- Specialty retailers, such as Barnes & Noble, Inc., Borders Group, Inc., Hastings Entertainment, Inc., Fry's Electronics, Inc. and Circuit City Stores, Inc.; and

- e-commerce retailers, such as amazon.com, barnesandnoble.com, circuitcity.com and bestbuy.com.

Our suppliers include:

- Record labels, such as Vivendi Universal S.A., Sony BMG Music Entertainment Company, WEA Distribution and Thorn-EMI;

- Film studios, such as The Walt Disney Company, Time-Warner Inc., Sony Corp., The News Corporation, Viacom Inc. and General Electric Company; and

- Magazine Distributors, such as COMAG Marketing Group, LLC., Time Warner Retail Sales & Marketing, Inc., Curtis Circulation Company and Kable Distribution Services, Inc.

On February 28, 2005, we completed our merger with Alliance Entertainment Corp, a logistics and supply chain management services company for the home entertainment product market, principally selling CDs and DVDs. Following the merger, we organized the combined company into three operating business units:

- Magazine Fulfillment - The magazine fulfillment segment sells and distributes magazines to major retailers and wholesalers, imports foreign titles for domestic retailers and wholesalers, exports domestic titles to foreign wholesalers, provides return processing services, serves as an outsource fulfillment agent and provides customer-direct fulfillment.

- CD and DVD Fulfillment - The CD and DVD fulfillment segment sells and distributes pre-recorded music, videos, video games and related products to retailers, provides product and commerce solutions to retailers and provides customer-direct fulfillment and vendor managed inventory.

- In-Store Services - The in-store services segment designs, manufactures and invoices participants in front-end fixture programs, provides claim filing services for rebates owed retailers from publishers and their agents, designs, manufactures, ships, installs and removes front-end fixtures and provides information and management services relating to retail magazine sales to U.S. and Canadian retailers and magazine publishers.

## **INDUSTRY OVERVIEW**

### **HOME ENTERTAINMENT CONTENT**

According to industry sources, including the Motion Picture Association, the Recording Industry Association of America, Harrington Associates, LLC, and the American Booksellers Association, the total retail market in calendar year 2005 for DVDs, prerecorded music, single-copy magazines and books was approximately \$56.8 billion

The structure of the distribution channel for single-copy magazines has changed little over the past several decades. Publishers each generally engage a single national distributor, which acts as its representative to regional and local wholesalers and furnishes billing, collecting and marketing services throughout the United States or other territories. These national distributors then secure distribution to retailers typically through a number of regional and local wholesalers. The wholesalers maintain direct vendor relationships with the retailers. Retailers in the mainstream retail market require these wholesalers to provide extensive in-store services including receiving, verifying, stocking new issues and removing out-of-date issues. However, this traditional structure is not economically viable in the specialty retail market. Thus, wholesalers servicing the specialty retail market typically do not provide these in-store services.

In contrast, the distribution channel for prerecorded video and music products is dominated by the major film studios and record labels, which through their respective distribution units periodically compete with intermediaries by seeking to establish direct trading relationships with high volume retailers. This disintermediation strategy has limited appeal to retailers that demand a variety of value-added services, including e-commerce support, inventory management, return logistics, advertising and marketing assistance, information services, and in store merchandising services to manage these increasingly volatile categories. Some retailers have sought to maintain a dual supply chain by establishing a direct trading relationship with the major studios and labels for high volume product, primarily newly released titles, and a more expansive procurement and service relationship with intermediaries to secure lower volume, higher margin product and value-added services.

## **IN-STORE SERVICES**

### **Front-End Management**

The retail sale of single-copy magazines is largely an impulse purchase decision by the consumer, and the retail sale of other home entertainment content is becoming increasingly so. As a result, film studios, record labels, publishers and manufacturers of other impulse merchandise such as confections and general merchandise (i.e., razor blades, film, batteries, etc.) consider it important for their products to be on prominent display in those areas of a store where they will be seen by the largest number of shoppers in order to increase the likelihood that their products will be sold. Retailers typically display DVDs, CDs, magazines, confections and general merchandise in specific aisles, or the "mainline," and the checkout area, or the "front-end." Product visibility is highest in the front-end because every shopper making a purchase must pass through this area.

Due to the higher visibility and resulting perception of increased sales potential, vendors compete vigorously for favorable display space in the front-end. To secure the desired display space, vendors offer rebate and other incentive payments to retailers, such as:

- initial fees to rearrange front-end display fixtures to ensure the desired placement of their products;
- periodic placement fees based on the location and size of their products' display; and
- cash rebates based on the total sales volume of their products.

Due to the high volume of sales transactions and great variety of incentive programs offered, there is a significant administrative burden associated with front-end management. As a result, most retailers have historically outsourced the information gathering and administration of rebate claims collection to third parties such as our Company. This relieves retailers of the administrative burdens, such as monitoring thousands of titles each with a distinct incentive arrangement.

### **Information Services**

Prompt delivery of information regarding sales activity, including timing of the redesign of front-end space, changes in display positions or the discontinuance of a vendor's product, is important to vendors of front-end products. This information allows vendors to make important strategic decisions in advance of re-configurations and other changes implemented by retailers to the front-end. Conversely, timely delivery of information about price changes, special promotions, new product introductions and other plans is important to retailers because it enables them to enhance the revenue potential of the front-end. Historically, information available to vendors regarding retail activity at the front-end and information available to retailers about vendors has been fragmented and out-of-date. We believe that there is an increasing demand on the part of vendors of front-end products for more frequent and detailed information regarding front-end retail activity. Through our operating units we have access to a significant amount of information regarding retail front-end and mainline sales activity.

## **OUR BUSINESS**

Our business consists of three operating segments, as discussed above. Due to the similar operating characteristics of the Magazine Fulfillment and CD and DVD Fulfillment, they are discussed in aggregate, as the Fulfillment business unit below.

### **FULFILLMENT**

In the spring of 2001, we acquired a group of affiliated specialty magazine distributors to establish a platform from which to offer an expanding list of merchandise and services to retailers. From 2002 through 2004, we continued to expand our magazine product offerings by licensing and then purchasing international distribution rights to a series of domestic magazine titles. In February 2005, we further expanded our product offering beyond magazine fulfillment to include DVDs, CDs and other home entertainment content products through our merger with Alliance. In May 2005, we acquired Chas. Levy Circulating Co., one of the principal magazine wholesalers in the United States, for the purpose of strengthening our position in the mainstream market. In March 2006, we acquired Anderson Mid-Atlantic News, LLC and Anderson-SCN Services, LLC, major distributors of magazines in the mid-Atlantic and Southern California regions, respectively. For a more complete discussion of the Alliance merger, the acquisition of Chas. Levy Circulating Co., and the acquisitions of Anderson Mid-Atlantic News, LLC and Anderson-SCN Services, LLC, see "Recent Acquisitions."

Currently, our Fulfillment unit offers a broad array of products and services including the following:

## **Product Procurement**

Through our extensive relationships with record labels, film studios, magazine publishers and other producers of home entertainment content, we can offer our retail clients the ability to display virtually every domestic DVD, CD and magazine title and a significant selection of foreign titled magazines. To maintain the high order fill rate demanded by our clients, we have established an in stock catalogue of approximately 300,000 CD titles and approximately 100,000 DVD titles. We purchase home entertainment content from every major record label, film studio and magazine publisher, typically on a fully returnable basis.

Product is received at strategically located distribution centers. The principal distribution centers are located in Harrisburg, Pennsylvania, Coral Springs, Florida, Shepherdsville, Kentucky, Dallas, Texas, Lancaster, Pennsylvania, Ontario, California, Chicago, Illinois, and Brainerd, Minnesota. At each of these distribution points, we process merchandise orders using sophisticated warehouse management systems. Once filled, orders are shipped to our retailers by a combination of third party *freight carriers* and, in certain high volume locations, in-house truck delivery. Given our broad distribution infrastructure, we are capable of delivering home entertainment content overnight to virtually any location within the continental United States.

## **Fulfillment Services**

Our sophisticated warehouse management systems, just-in-time replenishment and order regulation techniques enable us to offer value-added fulfillment services including next day order delivery, ready for shelf inventory preparation (such as price labeling and security device placement) and a wide variety of electronic data interchange tools.

Most customers utilizing our fulfillment services are brick and mortar retailers seeking support for their e-commerce initiatives in the DVD and CD markets. For these clients, which include *barnesandnoble.com*, *amazon.com* and *bestbuy.com*, we offer a comprehensive e-commerce platform, which includes direct customer product delivery, real-time inventory querying and commitment capabilities, credit card processing and settlement services, *custom packaging*, *promotional inserts* and customer care services. Other fulfillment services clients furnish magazines to us, rather than purchasing the product from us, which we then package into individual orders and ship directly to individual retail outlets.

## **Category Management Services**

For retailers seeking a total merchandising solution, we offer category management services that include product selection and preparation, fixturing, in-store stocking and replenishment, marketing and promotional program development, and inventory control.

## **IN-STORE SERVICES**

The In-Store Services group provides rebate and other incentive payment collection, information services and display fixture design and manufacture.

## **Claim Submission Services**

Claim submission services related to the display and sale of magazines have been the historical core of our business. U.S. and Canadian retailers engage our In-Store Services group to accurately monitor, document, claim and collect publisher rebate and other incentive payments. Our services are designed to relieve our clients of the substantial administrative burden associated with documenting, verifying and collecting their payment claims, and to collect a larger percentage of the potential incentive payments available to the retailers.

We established our Advance Pay Program as an enhancement to our claim submission services. Typically, retailers are required to wait a significant period of time to receive payments on their claims for incentive rebates. We improve the retailer's cash flow by advancing the claims for rebates and other incentive payments filed by us on their behalf, less our commission, within a contractually agreed upon period after the end of each quarter.

## **Information Services**

In connection with our claim submission services, we gather extensive information on magazine sales, pricing, new titles, discontinued titles and display configurations on a chain-by-chain and store-by-store basis. As a result, we are able to furnish our clients with reports of total sales, sales by class of trade and sales by retailer, as well as reports of unsold magazines and total sales ranking. One of our products, the Cover Analyzer, permits subscribers to determine the effectiveness of particular magazine covers on sales for 300 top selling titles in the United States. Our website gives subscribers the capability to react more quickly to market changes, including the ability to reorder copies of specific issues, track pricing information, introduce new titles, and act on promotions offered by publishers. Publishers also use the website to promote special incentives and advertise and display special

editions, new publications and upcoming covers. We have supplemented our own data with data obtained under agreements with Barnes & Noble, Inc., Walgreen Company and The Kroger Company.

### **Front-End and Point-of-Purchase Display Fixtures**

To enhance retailers' marketing efficiency, we developed the capacity to design, manufacture, deliver and dispose of custom front-end and point-of-purchase displays for both retail store chains and product manufacturers. Retailers perceive our experience in developing and implementing product display strategies supported by our information services as helpful in improving the revenue they generated from the sale of home entertainment content merchandise. In addition, we believe that our influence on the design and manufacture of display fixtures enhances our ability to incorporate features that facilitate the gathering of information. Our services in this regard frequently include designing front-end display fixtures, supervising fixture installation, selecting products and negotiating, billing and collecting incentive payments from vendors. We frequently assist our retailer clients in the development of specialized marketing and promotional programs, which include special mainline or front-end displays and cross-promotions of magazines and products of interest to the readers of these magazines. Raw materials used in manufacturing our fixtures include wire, wood, powder coating, paints and stains, metal tubing and paneling, wood veneer and laminates, all of which are readily available from multiple sources.

### **Custom Wood Manufacturing**

We manufacture custom wood store fixtures and displays to customer specifications using wood veneers and laminates. Delivery of fixtures is highly concentrated in our third fiscal quarter as a result of the demands of retailers to be ready for the critical holiday selling season. To assure that their seasonal demands for the delivery are met, retailers typically provide commitments well in advance of anticipated product delivery. Accordingly, our inventory levels increase during seasonal periods when retailers are not opening or remodeling stores, typically November through April.

## **CUSTOMERS**

Our customers in the specialty retail market consist of bookstore chains, music stores and other specialty retailers. Our customers in the mainstream retail market consist primarily of grocery stores, drug stores and mass merchandise retailers. Two customers account for a large percentage of our total revenues. Barnes & Noble, Inc. accounted for 27.5%, 28.7%, and 28.3% in the fiscal years ended January 31, 2006, 2005 and 2004 respectively. Borders Group, Inc. accounted for 6.3%, 24.5%, and 25.1% of total revenues in the fiscal years ended January 31, 2006, 2005 and 2004, respectively. Revenues provided by Barnes & Noble, Inc. and Borders Group for the fiscal year ended January 31, 2006 include revenues generated by Alliance and Levy from the date of their respective acquisitions.

## **MARKETING AND SALES**

Our target market includes magazine publishers, film studios, record labels, magazine distributors and retailers. We specialize in providing nationwide home entertainment product distribution to retailers with a national or regional scope. We believe that our distribution centers differentiate us from our national competitors and are a key element in our marketing program. Our distribution centers focus on our just-in-time replenishment and our ability to deliver product, particularly magazines published on a weekly basis, overnight to virtually any location within the continental United States.

While we frequently attend trade shows and advertise in trade publications, we emphasize personal interaction between our sales force and customers so that our customers are encouraged to rely on our dependability and responsiveness. To enhance the frequency of contact between our sales force and our customers, we have organized our direct sales force into a unified marketing group responsible for soliciting sales of all products and services available from each of our operating groups. We believe this combined marketing approach will enhance cross-selling opportunities and lower the cost of customer acquisition.

## **SEASONALITY AND INFLATION**

Our CD and DVD Fulfillment segment is highly seasonal. The fiscal fourth quarter is typically the largest revenue producing quarter due to increased distribution of pre-recorded music, videos, and video games during the holiday shopping season.

Our Magazine Fulfillment segment is generally not impacted by a significant amount of seasonality. The fiscal third quarter is typically the largest revenue quarter due to increased distribution of certain monthly titles, such as fashion titles and sports titles, and various quarterly, semi-annual and annual titles that are only produced and distributed in the third quarter to be in retail stores during the holiday shopping season.

Our In-Store Services segment is also highly seasonal. Historically, the largest revenue producing fiscal quarters for this segment are the second and third. This is primarily due to the fact that most retailers we design, manufacture and deliver product to want their goods in their retail stores prior to the holiday shopping season, which is our fourth quarter.

The moderate rate of inflation over the past three years has not had a significant effect on our revenues or profitability.

## COMPETITION

Each of our business units faces significant competition. Our Fulfillment group distributes home entertainment product in competition with a number of national and regional companies, including Anderson News LLC, Anderson Merchandisers, L.P., Hudson News Company, News Group, Ingram Book Group, Inc., Ingram Entertainment, Inc., Handleman Company, and Baker & Taylor, Inc. Major record labels and film studios compete with us by establishing direct trading relationships with the larger retail chains.

Our In-Store Services group has a very limited number of direct competitors for its claims submission program, and it competes in a highly fragmented industry with other manufacturers for wood and wire display fixture business. In addition, some of this group's information and management services may be performed directly by publishers and other vendors, retailers or distributors. Other information service providers, including A.C. Nielsen Company, Information Resources and Audit Bureau of Circulations, also collect sales data from retail stores. If these service providers were to compete with us, given their expertise in collecting information and their industry reputations, they could be formidable competitors.

The principal competitive factors faced by each of our business units are price, financial stability, breadth of products and services, and reputation.

## MANAGEMENT INFORMATION SYSTEMS

The efficiency of our business units are supported by our information systems that combine traditional outbound product counts with real-time register activity. Our ability to access real-time register data enables us to quickly adjust individual store merchandise allocations in response to variation in consumer demand. This increases the probability that any particular merchandise allotment will be sold rather than returned for credit. In addition, we have developed sophisticated database management systems designed to track various on-sale and off-sale dates for the numerous issues and regional versions of the magazine titles that we distribute.

Our primary operating systems are built on an open architecture platform and provide the high level of scalability and performance required to manage our large and complex business operations. We acquired certain of these systems in connection with our acquisition of Alliance, including proprietary, real-time, fully integrated enterprise planning, warehouse management and retail inventory management systems.

We also deploy a variety of additional hardware and software to manage our business, including a complete suite of electronic data interchange tools that enable us to take client orders, transmit advanced shipping notifications, and place orders with our manufacturing trading partners. We also use an automated e-mail response system and automated call distribution system to manage our call center and conduct customer care services.

Software used in connection with our claims submission program and in connection with our subscriber information website was developed specifically for our use by a combination of in-house software engineers and outside consultants. We believe that certain elements of these software systems are proprietary to us. Other portions of these systems are licensed from a third party that assisted in the design of the system. We also receive systems service and upgrades under the license. We believe that we have obtained all necessary licenses to support our information systems.

We employ various security measures and backup systems designed to protect against unauthorized use or failure of our information systems. Access to our information systems is controlled through firewalls and passwords, and we utilize additional security measures to safeguard sensitive information. Additionally, we have backup power sources for blackouts and other emergency situations. Although we have never experienced any material failures or downtime with respect to any systems operations, any systems failure or material downtime could prevent us from taking orders and/or shipping product.

We have made strategic investments in material handling automation. Such investments include computer-controlled order selection systems that provide labor efficiencies and increase productivity and handling efficiencies. We have also invested in specialized equipment for our rapidly growing e-commerce accounts. We believe that in order to remain competitive, it will be necessary to invest and upgrade from time to time all of our information systems.

## **EMPLOYEES**

As of April 3, 2006, we had approximately seven thousand employees, of whom approximately four thousand were full-time employees. Approximately eight hundred of our employees are covered by collective bargaining agreements that expire at various times through October 31, 2008. We are currently in negotiations with several unions whose collective bargaining agreements have expired. We believe our relations with our employees are good.

## **RECENT ACQUISITIONS**

### **ACQUISITION OF ANDERSON MID-ATLANTIC NEWS, LLC**

On March 30, 2006, we completed the acquisition of Anderson Mid-Atlantic News, LLC ("Mid-Atlantic") a major distributor of magazines in the mid-Atlantic region. The results of operations for Mid-Atlantic will be included in our fiscal 2007 consolidated results of operations from the date of acquisition forward.

### **ACQUISITION OF ANDERSON-SCN SERVICES, LLC**

On March 30, 2006, we completed the acquisition of Anderson-SCN Services, LLC ("SCN"), major distributors of magazines in the southern California region. The results of operations for SCN will be included in our fiscal 2007 consolidated results of operations from the date of acquisition forward.

### **ACQUISITION OF CHAS. LEVY CIRCULATING CO.**

On May 10, 2005, we signed a Unit Purchase Agreement to acquire all of the outstanding equity interests of Chas. Levy Circulating Co., LLC ("Levy") from its sole member, Chas. Levy Company, LLC, for a purchase price of approximately \$30 million, subject to certain adjustments. Chas. Levy Circulating Co. is one of the principal magazine wholesalers in the United States and distributes magazines from all leading publishers to more than 9,000 store fronts operated by leading retail chains throughout the Midwest, East and West coasts. The results of Levy's operations have been included in our Consolidated Statements of Income since May 10, 2005.

Concurrent with the acquisition, we entered into a separate 10-year marketing and service agreement with Levy Home Entertainment, LLC., a Chas Levy company not included in the transaction. Levy Home Entertainment is a full line book distributor.

### **ACQUISITION OF ALLIANCE**

On February 28, 2005, we completed the acquisition of Alliance Entertainment Corp, a logistics and supply chain management services company for the home entertainment product market. In connection with the acquisition we issued approximately 26.9 million shares of our common stock to the former Alliance stockholders and assumed options, warrants and other obligations to issue approximately 0.9 million shares of our common stock.

Alliance historically operated two business segments: the Distribution and Fulfillment Services Group and the Digital Media Infrastructure Services Group. Prior to the merger, on December 31, 2004, Alliance disposed of all of the operations conducted by the Digital Media segment. Consequently, in completing the merger, we acquired only the Distribution and Fulfillment business, but retained access to the Digital Media technology through a 5-year licensing agreement.

We consummated the acquisition of Alliance to further our objective of creating the premier provider of information, supply chain management and logistics services to retailers and producers of home entertainment content products. We expect to benefit from substantial cost savings in the areas of procurement, marketing, information technology and administration and from other operational efficiencies, particularly in the distribution and fulfillment functions, where we plan to consolidate some distribution operations, reorganize others and leverage our best practices across all of our distribution operations.

### **REINCORPORATION FROM MISSOURI INTO DELAWARE**

Also, on February 28, 2005, we reincorporated our Company from Missouri into Delaware (the "Reincorporation"). The Reincorporation was adopted and approved at a special meeting of our shareholders. Each stock certificate representing our issued and outstanding shares prior to the Reincorporation will continue to represent the same number of our shares after the Reincorporation. The Reincorporation did not result in any change in our name, headquarters, business, jobs, management, location of offices or facilities, number of employees, assets, liabilities or net worth. Our common stock continues to be traded on the NASDAQ National Market under the symbol "SORC."

As a result of the Reincorporation, the rights of our stockholders became subject to and are now governed by Delaware law, a new certificate of incorporation and new bylaws. Certain differences in the rights of stockholders arise from distinctions between Missouri law and Delaware law, as well as from differences between the charter instruments of our Company. These differences are described in the section entitled "Comparison of Stockholder Rights and Corporate Governance Matters" on pages 149-165 of the Registrant's Registration Statement on Form S-4/A filed on January 18, 2005, which section is incorporated herein by reference.

## MARKET INFORMATION

Our common stock is quoted on the NASDAQ National Market under the symbol SORC.

The following table sets forth, for the periods indicated, the range of high and low bid prices for our common stock as reported by the NASDAQ National Market during the fiscal year shown. All such quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	High	Low
	-----	-----
Year ended January 31, 2005		
First quarter	\$ 13.58	\$ 10.31
Second quarter	\$ 11.39	\$ 8.89
Third quarter	\$ 10.73	\$ 8.39
Fourth quarter	\$ 13.32	\$ 10.20
Year ended January 31, 2006		
First quarter	\$ 12.51	\$ 10.36
Second quarter	\$ 13.20	\$ 9.20
Third quarter	\$ 12.70	\$ 9.36
Fourth quarter	\$ 11.65	\$ 9.66

## HOLDERS

As of April 10, 2006, there were approximately 147 holders of record of our common stock.

## DIVIDENDS

We have never declared or paid dividends on our common stock. Our Board of Directors presently intends to retain all of our earnings, if any, for the development of our business for the foreseeable future. The declaration and payment of cash dividends in the future will be at the discretion of our Board of Directors and will depend upon a number of factors, including, among others, any restrictions contained in our credit facilities and our future earnings, operations, capital requirements and general financial condition and such other factors that our Board of Directors may deem relevant. Currently, our credit facilities prohibit the payment of cash dividends or other distributions on our capital stock or payments in connection with the purchase, redemption, retirement or acquisition of our capital stock.

## SELECTED FINANCIAL DATA.

The following selected consolidated financial data are only a summary and should be read in conjunction with our financial statements and related notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this Annual Report. The consolidated statement of operations data for the years ended January 31, 2004, 2005 and 2006 and the balance sheet data as of January 31, 2005 and 2006, which have been prepared in accordance with accounting principles generally accepted in the U.S., are derived from our financial statements audited by BDO Seidman, LLP, an independent registered public accounting firm, which are included elsewhere in this Annual Report. The consolidated statements of income data for the years ended January 31, 2002 and 2003 and the balance sheet data as of January 31, 2002, 2003 and 2004, which have been prepared in accordance with accounting principles generally accepted in the U.S., are derived from our audited financial statements which are not included in this Annual Report. On February 28, 2005, we consummated our merger with Alliance Entertainment Corp. The results of operations of Alliance are included in the selected financial data presented below for the period beginning March 1, 2005 and ending January 31, 2006 only. Also on May 10, 2005, we consummated our acquisition of Chas. Levy Circulating Co, LLC. The results of operations of Levy are included in the selected financial data presented below for the period beginning May 10, 2005 and ending January 31, 2006. For a description of the merger of Source Interlink and Alliance and the acquisition of Levy, please see the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations." Historical operating results are not necessarily indicative of the results that may be expected for any future period.

(IN THOUSANDS, EXCEPT PER SHARE DATA)	Year ended January 31,				
	2006	2005	2004(c)	2003(c)	2002(c)
Consolidated statement of operations data:					
Revenues	\$ 1,527,451	\$ 356,644	\$ 315,791	\$ 269,191	\$ 218,697
Cost of revenues	1,219,997	258,851	229,748	197,431	159,660
Gross profit	307,454	97,793	86,043	71,760	59,037
Selling, general and administrative expenses	196,080	55,130	50,538	43,710	36,464
Fulfillment freight	72,806	21,067	16,381	14,721	7,931
Relocation expenses(a)	--	2,450	1,730	1,926	--
Amortization of goodwill	--	--	--	--	5,424
Goodwill impairment charge(b)	--	--	--	--	48,993
Loss on sale of land and building	--	(1,122)	--	--	--
Merger and acquisition charges	3,319	--	--	--	--
Operating income	35,249	18,024	17,394	11,403	(39,775)
Other income (expense):					
Interest expense	(6,794)	(1,575)	(3,427)	(3,473)	(2,650)
Interest income	220	175	358	277	--
Deferred loan costs	--	(1,495)	(865)	--	--
Other	203	161	393	445	(2,390)
Total other expense	(6,371)	(2,734)	(3,541)	(2,751)	(5,040)
Income from continuing operations before income taxes	28,878	15,290	13,853	8,652	(44,815)
Income tax expense (benefit)	14,553	2,228	3,690	893	(969)
Income from continuing operations	14,325	13,062	10,163	7,759	(43,846)
Loss from discontinued operation, net of tax	(1,446)	(980)	(115)	(421)	(29,019)
Net income	\$ 12,879	\$ 12,082	\$ 10,048	\$ 7,338	\$ (72,865)
Earnings (loss) per share - basic					
Continuing operations	\$ 0.29	\$ 0.57	\$ 0.55	\$ 0.42	\$ (2.45)
Discontinued operations	(0.03)	(0.04)	(0.01)	(0.02)	(1.62)
Total	\$ 0.26	\$ 0.53	\$ 0.54	\$ 0.40	\$ (4.07)
Earnings (loss) per share - diluted					
Continuing operations	\$ 0.28	\$ 0.53	\$ 0.52	\$ 0.42	\$ (2.45)
Discontinued operations	(0.03)	(0.04)	(0.01)	(0.02)	(1.62)
Total	\$ 0.25	\$ 0.49	\$ 0.51	\$ 0.40	\$ (4.07)
Weighted average of shares outstanding in computing					
Basic net income per share	49,097	22,963	18,476	18,229	17,915
Diluted net income per share	50,894	24,833	19,866	18,478	17,915

(IN THOUSANDS)	At January 31.				
	2006	2005	2004	2003	2002
Consolidated balance sheet data:					
Cash	\$ 23,239	\$ 1,387	\$ 4,963	\$ 5,570	\$ 2,943
Working capital	\$ 54,783	\$ 41,186	\$ 19,418	\$ (3,519)	\$ (9,424)
Total assets	\$ 884,472	\$ 197,753	\$ 164,101	\$ 157,239	\$ 164,430
Current maturities of debt	\$ 6,984	\$ 5,630	\$ 4,059	\$ 29,215	\$ 42,097
Debt, less current maturities	\$ 81,845	\$ 34,139	\$ 31,541	\$ 17,026	\$ 15,578
Total liabilities	\$ 424,879	\$ 70,070	\$ 97,027	\$ 106,320	\$ 120,887
Total equity	\$ 459,593	\$ 127,683	\$ 67,074	\$ 50,919	\$ 43,543

(a) In 2003 and 2004, relocation costs relate to the consolidation of our prior offices from St. Louis, MO, High Point, NC and San Diego, CA to our new offices in Bonita Springs, FL. In addition, during fiscal 2005, we relocated distribution centers from Milan, OH, San Diego, CA and Kent, WA to Harrisburg, PA and Carson City, NV.

(b) Charge related to the impairment of the goodwill attributed to our Magazine Distribution and Wood Manufacturing businesses.

(c) 2003 and 2004 are restated for the discontinued operations as discussed in Note 8.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

Throughout this section we discuss and refer to the following reportable segments:

- Magazine Fulfillment - Our Magazine Fulfillment group provides domestic and foreign titled magazines to specialty retailers, such as bookstores and music stores, and to mainstream retailers, such as supermarkets, discount stores, drug stores, convenience stores and newsstands. This group also exports domestic titled magazines from more than 100 publishers to foreign markets worldwide. We provide fulfillment services to more than 36,000 retail stores, 21,000 of which also benefit from our selection and logistical procurement services.
- CD and DVD Fulfillment - Our CD and DVD Fulfillment group sells and distributes pre-recorded music, videos, video games and related products to retailers, provides product and commerce solutions to retailers and provides customer-direct fulfillment and vendor managed inventory.
- In-Store Services - Our In-Store Services group designs, manufactures and invoices participants in front-end fixture programs, provides claim filing services for rebates owed retailers from publishers and their agents, designs, manufactures, ships, installs and removes front-end fixtures and provides information and management services relating to retail magazine sales to U.S. and Canadian retailers and magazine publishers.
- Shared Services - Our Shared Services group consists of overhead functions not allocated to the other groups. These functions include corporate finance, human resource, management information systems and executive management that are not allocated to the three operating groups. Upon completion of the consolidation of our administrative operations, we restructured our accounts to separately identify corporate expenses that are not attributable to any of our three main operating groups. Prior to fiscal year 2004, these expenses were included within our In-Store Services group.

This segment structure represents a change in organizational structure from that reported in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our 2005 Annual Report. The segment organization presented herein corresponds to the financial and other reporting received by our chief operating decision maker. For additional financial and geographic information regarding our segments and a discussion of the change in organizational structure, see Note 17 "Segment Information" to our Consolidated Financial Statements.

### OVERVIEW

On February 28, 2005, we completed the acquisition of Alliance Entertainment Corp, a logistics and supply chain management services company for the home entertainment product market pursuant to the terms and conditions of the Agreement and Plan of Merger Agreement dated as of November 18, 2004 (the "Merger Agreement").

Alliance historically operated two business segments: the Distribution and Fulfillment Services Group ("DFSG") and the Digital Medial Infrastructure Services Group (the "DMISG"). Prior to the merger, on December 31, 2004, Alliance disposed of all of the operations conducted by the DMISG business lines through a spin-off to its existing stockholders. Consequently, in connection with the merger, we acquired only the DFSG business and not the DMISG business. The DMISG business represented approximately 1.8% and 1.4% of Alliance's consolidated sales for the years ended December 31, 2004 and 2003, respectively.

We consummated the merger with Alliance to further our objective of creating the premier provider of information, supply chain management and logistics services to retailers and producers of home entertainment content products. We believe that the merger has provided significant market opportunities to take advantage of our strong retailer relationships and experience in marketing our products by expanding product offerings beyond our existing magazine fulfillment business to DVDs, CDs, video games and related home entertainment products and accessories. In addition, we believe that our in-store merchandising capabilities have been strengthened. We also believe this transaction has positioned us as the distribution channel of choice for film studios, record labels, publishers and other producers of home entertainment content products. We have benefited from substantial cost savings in the areas of procurement, marketing, information technology and administration and from other operational efficiencies, particularly in the distribution and fulfillment functions, where we have consolidated some distribution operations, reorganized others and leveraged our best practices across all of our distribution operations. As a result, we believe the merger has enhanced our financial strength, increased our visibility in the investor community and strengthened our ability to pursue further strategic acquisitions.

The total purchase price of approximately \$315.5 million consisted of \$304.7 million in Source Interlink common stock, representing approximately 26.9 million shares, \$6.5 million related to the exchange of approximately 0.9 million shares of common stock on exercise of outstanding stock options, warrants and other rights to acquire Alliance common stock and direct transaction costs of \$4.3 million. The value of the common stock was determined based on the average market price of Source Interlink common stock over the

5-day period prior to and after the announcement of the merger in November 2004. The value of the stock options was determined using the Black-Scholes option valuation model.

On May 10, 2005, we entered into a Unit Purchase Agreement with Chas. Levy Company, LLC. Under the terms of the agreement, we purchased all of the issued and outstanding membership interests in Chas. Levy Circulating Co. LLC ("Levy") from Seller for a purchase price of approximately \$30 million, subject to adjustment based on Levy's net worth as of the closing date of the transaction. In addition, approximately \$19.3 million was also provided on the date of acquisition to repay all outstanding intercompany debt of Levy. The purchase price and the intercompany debt repayment were funded from the revolving line of credit.

On March 30, 2006, we entered into a Unit Purchase Agreement, under which we purchased all of the issued and outstanding membership interests of Anderson Mid-Atlantic News, LLC ("Mid-Atlantic") from Anderson News, LLC for a purchase price of approximately \$4.0 million, subject to adjustment based on the negative net worth as of the closing date of the transaction. In addition, approximately \$9.6 million was also provided on the date of acquisition to Mid-Atlantic to repay a portion of their outstanding intercompany debt. The remaining outstanding intercompany debt of Mid-Atlantic was satisfied by issuance of a promissory note totaling \$4.1 million. The promissory note will be repaid by the Company over a six month period beginning April 2006 and bears interest at LIBOR minus one. The purchase price and the intercompany debt repayment were funded by borrowings against our revolving line of credit.

On March 30, 2006, we entered into a Unit Purchase Agreement, under which we purchased all of the issued and outstanding membership interests of Anderson-SCN Services, LLC ("SCN") from Anderson News, LLC for a purchase price of approximately \$9.0 million, subject to adjustment based on the negative net worth as of the closing date of the transaction. In addition, approximately \$17.0 million was also provided on the date of acquisition to SCN to repay a portion of their outstanding intercompany debt. The remaining outstanding intercompany debt of SCN was satisfied by issuance of a promissory note totaling \$10.2 million. The promissory note will be repaid by the Company over a six month period beginning April 2006 and bear interest at LIBOR minus one. The purchase price and the intercompany debt repayment were funded by borrowings against our revolving line of credit.

## DISCONTINUED OPERATION

In November 2004, we sold and disposed of our secondary wholesale distribution operation for \$1.4 million, in order to focus more fully on its domestic and export distribution. All rights owned under the secondary wholesale distribution contracts were assigned, delivered, conveyed and transferred to the buyer, an unrelated third party. All assets and liabilities relating to our secondary wholesale distribution operation were not assumed by the buyer. We recognized a gain on sale of this business of \$1.4 million (\$0.8 net of tax) in the fourth quarter of fiscal year 2005.

The following amounts related to our Magazine Fulfillment segment's discontinued operation (secondary wholesale distribution business) have been segregated from continuing operations and reflected as discontinued operations in each period's consolidated statement of income:

(IN THOUSANDS)	Year ended January 31,		
	2006	2005	2004
Revenue	\$ --	\$ 13,380	\$ 17,343
Loss before income taxes	\$ (2,410)	\$ (3,033)	\$ (191)
Income tax benefit	964	1,213	76
Loss from discontinued operation, net of tax	(1,446)	(1,820)	(115)
Pre-tax gain on sale of discontinued business	--	1,400	--
Income tax expense	--	(560)	--
Gain on sale of business, net of tax	--	840	--
Discontinued operation, net of tax	\$ (1,446)	\$ (980)	\$ (115)

## **EXPLANATION OF FINANCIAL STATEMENT LINE ITEMS**

### **REVENUES**

The Magazine Fulfillment group derives revenues from:

- selling and distributing magazines, including domestic and foreign titles, to specialty and mainstream retailers throughout the United States and Canada;
- exporting domestic titles internationally to foreign wholesalers or through domestic brokers;
- providing return processing services for major specialty retail book chains; and
- serving as an outsourced fulfillment agent and backroom operator for publishers.

The CD and DVD Fulfillment group derives revenues from:

- selling and distributing pre-recorded music, movies, video games and related products primarily to specialty and mainstream retailers throughout the United States;
- providing return processing services for major specialty and mainstream retailers; and
- serving as an outsourced fulfillment agent and backroom operator for movie studios and record labels.

The In-Store Services group derives revenues from:

- designing, manufacturing and invoicing participants in front-end merchandising programs;
- providing claim filing services related to rebates owed to retailers from publishers or their designated agents;
- storing, shipping, installing, and removing front-end fixtures;
- designing, manufacturing and installing custom wood fixtures primarily for retailers; and
- providing information and management services relating to magazine sales to retailers and publishers throughout the United States and Canada.

### **COST OF REVENUES**

The cost of revenues for the Magazine Fulfillment group consists of the costs of magazines purchased for resale less all applicable publisher discounts and rebates.

The cost of revenues for the CD and DVD Fulfillment group consists of the costs of CDs and DVDs purchased for resale less all applicable discounts and rebates.

The cost of revenues for the In-Store Services group includes:

- raw materials consumed in the production of display fixtures, primarily steel, wood and plastic components;
- production labor; and
- manufacturing overhead.

### **SELLING, GENERAL, AND ADMINISTRATIVE EXPENSES**

Selling, general and administrative expenses for each of the operating groups include:

- non-production labor;
- rent and office overhead;

- insurance;
- professional fees; and
- management information systems.

Expenses associated with corporate finance, human resources, certain management information systems and executive offices are included within the Shared Services group and are not allocated to the other groups.

#### **FULFILLMENT FREIGHT**

Fulfillment freight consists of our direct costs of distributing magazines, CDs and DVDs by third-party freight carriers, primarily UPS ground service, and the cost of delivery by company-owned trucks. Third party freight rates are driven primarily by the weight of the copies being shipped and the distance between origination and destination.

Fulfillment freight is not disclosed as a component of cost of revenues, and, as a result, gross profit and gross profit margins are not comparable to other companies that include shipping and handling costs in cost of revenues.

Fulfillment freight has increased proportionately as the amount of product we distribute has increased. We anticipate the continued growth in our Magazine Fulfillment and CD and DVD Fulfillment groups will result in an increase in fulfillment freight. Generally, as pounds shipped increase, the cost per pound charged by third party carriers decreases. As a result, fulfillment freight as a percent of the Magazine Fulfillment and CD and DVD Fulfillment groups' gross revenues should decline slightly in the future.

#### **RELOCATION EXPENSE**

During fiscal 2005, the Company incurred \$2.5 million of expenses related to distribution center relocations and a plant conversion. The Company began expansion into the mainstream retail market which resulted in distribution fulfillment centers in Milan, OH, San Diego, CA and Kent, WA being moved to Harrisburg, PA and Carson City, NV.

During fiscal 2004, the Company incurred \$1.7 million of expenses related to relocating its claims submission and fixture billing center, its Corporate Headquarters, and its Magazine Fulfillment administrative offices to its facility in Bonita Springs, FL.

## RESULTS OF OPERATIONS

The following table sets forth, for the periods presented, information relating to our continuing operations (in thousands):

	Year ended January 31,					
	2006		2005 (a)		2004 (a)	
	Amount	Margin%	Amount	Margin%	Amount	Margin%
<b>CD AND DVD FULFILLMENT</b>						
Revenues	\$ 889,380		\$ --		\$ --	
Cost of revenues	733,173		--		--	
Gross profit	156,207	17.6%	--	--	--	--
Operating expenses (b)	121,704		--		--	
Operating income	34,503	3.9%	--	--	--	--
<b>MAGAZINE FULFILLMENT</b>						
Revenues	\$ 566,438		\$ 280,171		\$ 238,471	
Cost of revenues	437,869		210,639		179,460	
Gross profit	128,569	22.7%	69,532	24.8%	59,011	24.7%
Operating expenses (b)	114,747		53,030		44,585	
Operating income	13,822	2.4%	16,502	5.9%	14,426	6.0%
<b>IN-STORE SERVICES</b>						
Revenues	\$ 71,633		\$ 76,473		\$ 77,320	
Cost of revenues	48,955		48,212		50,288	
Gross profit	22,678	31.7%	28,261	37.0%	27,032	35.0%
Operating expenses (b)	9,460		10,018		9,618	
Operating income	13,218	18.5%	18,243	23.9%	17,414	22.5%
<b>SHARED SERVICES</b>						
Revenues	\$ --		\$ --		\$ --	
Cost of revenues	--		--		--	
Gross profit	--	--	--	--	--	--
Operating expenses (b)	26,294		16,721		14,446	
Operating income	(26,294)	--	(16,721)	--	(14,446)	--
<b>TOTAL</b>						
Revenues	\$1,527,451		\$ 356,644		\$ 315,791	
Cost of revenues	1,219,997		258,851		229,748	
Gross profit	307,454	20.1%	97,793	27.4%	86,043	27.2%
Operating expenses (b)	272,205		79,769		68,649	
Operating income	35,249	2.3%	18,024	5.4%	17,394	5.5%

(a) Restated to include the results of the former Wood Manufacturing segment in the results of the In-Store Services segment.

(b) Operating expenses include selling, general and administrative expenses, fulfillment freight, relocation expenses, depreciation and amortization, merger and acquisition costs and loss on sale of land and building.

## RESULTS FOR THE FISCAL YEAR ENDED JANUARY 31, 2006 COMPARED TO THE FISCAL YEAR ENDED JANUARY 31, 2005

### REVENUES

Overall revenues for the fiscal year ended January 31, 2006 increased \$1.2 billion, or 328.3% from the prior year due primarily to the acquisitions of Alliance by our CD and DVD Fulfillment group and Levy by our Magazine Fulfillment group.

The acquisition of Alliance on February 28, 2005 created our CD and DVD Fulfillment group. The results of operations of our CD and DVD Fulfillment group have been included in our consolidated results of operations since the acquisition date. The revenues from that group were \$889.4 million for the fiscal year ended January 31, 2006. There were no revenues from the CD and DVD Fulfillment group during the prior fiscal year.

Our Magazine Fulfillment group's revenues were \$566.4 million, an increase of \$286.2 million or 102.2% as compared to the fiscal year ended January 31, 2005. The group's revenues for the fiscal year ended January 31, 2006 are comprised of the following components:

(IN MILLIONS)	Year ended January 31,		
	2006	2005	Change
Domestic mainstream	\$ 319.6	\$ 18.4	\$ 301.2
Domestic specialty	215.1	223.3	(8.2)
Export distribution	31.7	38.5	(6.8)
<b>Total</b>	<b>\$ 566.4</b>	<b>\$ 280.2</b>	<b>\$ 286.2</b>

Revenue consists of the gross amount of magazines (both domestic and imported titles) distributed to domestic retailers and wholesalers, less actual returns received, less an estimate of future returns and customer discounts. Revenues also consists of fees earned for the picking of third party product, return processing and wastepaper revenue.

Domestic mainstream revenues originate from sales to "mainstream" retailers, which consist of Grocery, Discount, Transportation Terminals, Convenience Stores and Drug Stores. The mainstream distribution channel's revenues include book and magazine distribution. In May 2005, the group significantly increased its presence in the mainstream market with the acquisition of Chas. Levy Circulating Company, a leading magazine wholesaler based in Chicago, IL with distribution centers in Chicago, Lancaster, PA, Brainerd, MN, and City of Industry, CA. In March 2006, the group acquired additional distribution territories from Anderson News, LLC as described above in Southern California and Washington D.C./ Baltimore markets. Estimated annualized revenue in these two markets is approximately \$250 million.

Domestic specialty revenues originate from magazine sales to "specialty" retailers, which consist of Bookstores, Music outlets, Office Supply stores and Computer stores. The decrease in revenues is due to an overall decrease in efficiencies in our two major bookstore chains.

Export revenues originate from the sale of US based titles to foreign magazine wholesalers and brokers for distribution overseas. The decrease in the export revenues relates primarily to lower overall efficiencies.

Sales efficiency expressed as a percentage of net distribution to gross distribution was 35.0%, 42.3% and 34.7% for the mainstream, specialty and export groups, respectively. The prior year comparable period efficiencies were 43.3%, 46.1% and 42.1%.

Our In-Store Services group's revenues for the fiscal year ended January 31, 2006 were \$71.6 million, a decrease of \$4.8 million or 6.3% as compared to the prior fiscal year.

The group's revenues for 2006 and 2005 are comprised of the following components:

(IN MILLIONS)	Year ended January 31		
	2006	2005	Change
Claim filing and information	\$ 16.9	\$ 17.3	\$ (0.4)
Wire manufacturing	26.0	36.8	(10.8)
Wood manufacturing	28.7	22.3	6.4
Total	\$ 71.6	\$ 76.4	\$ (4.8)

Our claim filing revenues are recognized at the time the claim is paid. The decrease in revenues in the fiscal year ended January 31, 2006 relate to the timing of the cash payments received on the claims. Information services revenue increased by approximately \$1.0 million over the prior year relating to additional information product contracts being entered into in the current year.

Our front end wire manufacturing revenues declined due to the cyclical nature of the industry and use of fixtures beyond the historical life cycle. Major chains have historically purchased new front-end fixtures every three years; however, the use of the front end fixtures has been extending beyond this life cycle.

Our wood manufacturing services revenues increased due to an increase in the number of store openings and remodelings performed by our significant customers.

## GROSS PROFIT

Gross profit for the fiscal year ended January 31, 2006 increased \$209.7 million, or 214.4%, over the prior fiscal year primarily due to the acquisitions of Alliance and Levy.

Our Magazine Fulfillment gross profits were \$128.6 million, an increase of \$59.0 million or 84.9%, compared to the prior fiscal year. Gross profit margin decreased from 24.8% to 22.7%.

The decrease in gross profit margins is attributable to the change in sales mix due to the increase in revenues in the mainstream distribution channel. The mainstream distribution channel generally has lower gross margins than the specialty distribution channel due to certain publisher rebates that are available to the specialty distribution channel that are not available in the domestic distribution channel.

Gross profit in our In-Store Services group for the fiscal year period ended January 31, 2006 decreased \$5.6 million, or 19.8%, versus the prior year. The decrease in gross profit is primarily due to decreased revenues from the wire manufacturing business, coupled with an increase in lower profit margin projects completed within the wire manufacturing business versus the prior year.

#### **SELLING, GENERAL AND ADMINISTRATIVE EXPENSES**

Selling, general and administrative expenses for the fiscal year ended January 31, 2006 were \$177.9 million, an increase of \$128.2 million, or 258.0%, over the prior fiscal year primarily due to the acquisitions of Alliance and Levy.

The CD and DVD Fulfillment group's selling, general and administrative expenses were \$79.6, as compared to \$0 in previous fiscal year.

The Magazine Fulfillment group's selling, general and administrative expenses include the costs of operating the group's distribution centers, the in-store merchandising field force and the backroom operations. Selling, general and administrative expenses increased \$40.0 million, or 140.5%, from \$28.5 million to \$68.5 million. The increase relates primarily to the expansion of the group's mainstream distribution infrastructure. Expenses as a percentage of revenues increased from 10.2% to 12.1%. The increase relates primarily to a high concentration of total sales being derived from mainstream accounts. As part of our mainstream distribution channel we provide in-store merchandising services to the majority of retailer accounts.

The selling, general, and administrative expenses of our In-Store Services group in the fiscal year ended January 31, 2006 increased \$0.6 million, or 7.4%, compared to the fiscal year ended January 31, 2005. The increase relates to an increase in general operating expenses.

The selling, general, and administrative expenses of our Shared Services group in the fiscal year ended January 31, 2006 increased \$8.0 million, or 60.5%, compared to the fiscal year ended January 31, 2005. This increase relates primarily to increases in corporate overhead and compensation as a result of the merger with Alliance and the acquisition of Levy.

#### **FULFILLMENT FREIGHT**

Fulfillment freight represents the outbound freight costs of distribution. It consists primarily of the costs, including payroll, of operating the fleet of trucks that deliver the majority of the books and magazines in the mainstream distribution channel, as well as payments to third party carriers to provide delivery service directly from our distribution centers to our customers' retail stores, which is the primary mode of delivery to our specialty retail accounts. Fulfillment freight expense increased \$51.7 million, or 245.6% over the previous fiscal year. This increase related primarily to the acquisitions of Alliance and Levy.

Our CD and DVD Fulfillment group's fulfillment freight expense of \$31.0 million, compared to \$0 million in the previous fiscal year, accounted for most of the increase.

The Magazine Fulfillment group's freight expense increased \$20.7 million, or 98.5%, from \$21.1 million to \$41.8 million. Freight expense as a percent of gross domestic distribution decreased from 4.0% to 3.0%. The decrease is attributable to the expansion of our distribution into the mainstream distribution channel, which overall has lower freight costs as a percent of distribution than the specialty market due to concentration of retail accounts in a single marketing territory and the utilization of our own fleet vs. servicing national accounts via third party delivery.

#### **DEPRECIATION AND AMORTIZATION**

Depreciation and amortization increased \$14.5 million, or 385.6%, over the preceding fiscal year. This increase is primarily due to the amortization of fixed and intangible assets acquired in connection with our acquisition of Alliance and Levy. The addition of our CD and DVD Fulfillment group accounted for \$11.1 million of the increase.

## MERGER AND ACQUISITION COSTS

Merger costs related to the acquisition of Alliance recorded as expenses by us through January 31, 2006 totaled \$3.3 million. These expenses represented severance and personnel-related charges, charges to exit certain merchandiser contracts and a success fee paid to certain Company executives. These expenses were not capitalized as they did not represent costs that provide future economic benefits to the Company.

## OPERATING INCOME

Operating income for the fiscal year ended January 31, 2006 increased \$17.2 million or 95.6%, compared to the fiscal year ended January 31, 2005 and operating profit margins decrease from 5.4% to 2.3 %, compared to the fiscal year ended January 31, 2005, due to the factors described above.

## INTEREST EXPENSE

Interest expense includes the interest and fees on our significant debt instruments and outstanding letters of credit.

Interest expense increased \$5.2 million, or 331.4%, for the fiscal year ended January 31, 2006 compared to the fiscal year ended January 31, 2005. This increase was due to significantly higher borrowings in the fiscal year ended January 31, 2006, related to the Alliance and Levy acquisitions and higher average interest rates.

## OTHER INCOME (EXPENSE)

Other income (expense) consists of items outside of the normal course of operations. Due to its nature, comparability between periods is not generally meaningful.

## INCOME TAX EXPENSE

The effective tax rates on income from continuing operations for the years ended January 31, 2006 and January 31, 2005 were 50.4% and 14.6%, respectively. The increase in effective tax rates and differences from statutory rates relate primarily to certain non-deductible charges, including amortization of Alliance intangibles, and gains associated with the Alliance merger and a reduction in a valuation allowance in the fiscal year ended January 31, 2005.

## RESULTS FOR THE FISCAL YEAR ENDED JANUARY 31, 2005 COMPARED TO THE FISCAL YEAR ENDED JANUARY 31, 2004

### REVENUES

Overall revenues for the fiscal year ended January 31, 2005 increased \$40.9 million, or 12.3% from the prior year due primarily to an increase in revenue in our Magazine Fulfillment group as described below.

Our Magazine Fulfillment group's revenues were \$280.2 million, an increase of \$41.7 million or 17.5% as compared to the prior fiscal year.

The group's revenues for fiscal year 2005 and 2004 are comprised of the following components:

(IN MILLIONS)	Year ended January 31.		Change
	2005	2004	
Domestic distribution	\$ 238.9	\$ 204.6	\$ 34.3
Export distribution	38.5	32.0	6.5
Other	3.8	3.4	0.4
Intra-segment sales	(1.0)	(1.5)	0.5
Total	\$ 280.2	\$ 238.5	\$ 41.7

Domestic distribution consists of the gross amount of magazines (both domestic and imported titles) distributed to domestic retailers and wholesalers, less actual returns received, less an estimate of future returns and customer discounts. The \$34.3 million increase in domestic distribution relates primarily to an \$80.0 million increase in gross distribution partially offset by higher returns and estimated return reserve at year-end. The increase in gross distribution related both to an increase in copies distributed as well as an increase in the amount billed per copy to specialty retailers as well as the expansion of our distribution network to traditional retailers via internal

marketing efforts as well as the acquisition of Empire News, a traditional wholesaler servicing the western New York and northern Pennsylvania markets. Gross domestic distribution to our two largest customers increased \$36.6 million. Gross distribution to traditional retailers increased from \$10.9 million to \$43.1 million, an increase of \$32.2 million. Estimated sell-through for the period was lowered from 46.7% to 45.9%. The decreased estimated sell-through relates primarily to the increase in the percent of our distribution related to traditional retailers who generally have lower sell-through percentages than specialty retailers.

Our export distribution began operations in March 2003. Export distribution increased \$6.5 million compared to the prior fiscal year due primarily to an additional month of distribution in the current fiscal year.

Our In-Store Services group's revenues for fiscal year ended January 31, 2005 were \$76.4 million, a decrease of \$0.9 million or 1.2% over the prior year.

The group's revenues for the fiscal year ended January 31, 2005 and 2004 are comprised of the following components:

(IN MILLIONS)	Year ended January 31,		
	2005	2004	Change
Claim filing and information	\$ 17.3	\$ 14.0	\$ 3.3
Wire manufacturing	36.8	44.6	(7.8)
Wood manufacturing	22.3	18.7	3.6
Total	\$ 76.4	\$ 77.3	\$ (0.9)

Our claim filing revenues are recognized at the time the claim is paid. The increase in revenues in the fiscal year ended January 31, 2005 relate to the timing of the cash payments received on the claims. In addition, we acquired Promag Retail Services, LLC in August 2004 which also contributed to the increased revenues for the fiscal year ended January 31, 2005. Information services revenue increased by approximately \$0.5 million over the prior year relating to additional information product contracts being entered into in the current year.

Our front end wire and services revenues declined due to the cyclical nature of the industry. Major chains typically purchase new front-end fixtures every three years; however, the use of the front end fixtures has been extending beyond this life cycle.

Our wood manufacturing services revenues increased due to an increase in the number of store openings and remodelings performed by our customers.

## GROSS PROFIT

Gross profit for the fiscal year ended January 31, 2005 increased \$11.8 million, or 13.7 %, over the prior fiscal year primarily due to an increase in sales volume in our Magazine Fulfillment group and our Wood Manufacturing group.

Our Magazine Fulfillment gross profits were \$69.5 million, an increase of \$10.5 million or 17.8%, compared to the prior fiscal year. The increase related primarily to the increased distribution revenue as described above and the improvement in gross profit margins from 24.7% to 24.8%. The gross profit margins in our domestic distribution businesses are generally higher than our export distribution and, as a result, overall gross profit margins improve as the portion of total revenues is weighted more toward our domestic operations. In addition, we receive certain supplier rebates on gross distribution and as estimated sell-through decreases those rebates become a greater portion of the overall gross profit contribution yielding higher gross profit margins.

Gross profit in our In-Store Services group for the fiscal year period ended January 31, 2005 increased \$1.2 million, or 4.5%, over the prior year. The increase in gross profit is primarily due operational efficiencies at our wood manufacturing facilities and a larger percentage of our sales occurring in claim filing and information which is a significantly higher margin business than our front end wire and services.

## SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, INCLUDING DEPRECIATION AND AMORTIZATION

Selling, general and administrative expenses for the fiscal year ended January 31, 2005 increased \$4.6 million, or 9.1%, over the prior year. Selling, general, and administrative expenses as a percent of revenues declined from 16.0% to 15.5% in those same periods.

The Magazine Fulfillment group's selling, general, and administrative expenses were \$29.9 million, an increase of \$3.3 million, or 12.5% over the prior fiscal year. As a percentage of sales, selling, general and administrative expenses have decreased from 11.1% to 10.7% compared to the prior year same period due to our ability to leverage existing infrastructure over a larger base of distribution

and the consolidation of our distribution centers in Harrisburg, Pennsylvania and Carson City, Nevada. Overall expenses have increased due to the increase in our traditional distribution business and the related merchandising and distribution labor in our distribution centers and the expansion of our marketing efforts in the United Kingdom.

The selling, general, and administrative expenses of In-Store Services in the fiscal year ended January 31, 2005 increased \$0.4 million, or 4.2%, compared to the fiscal year ended January 31, 2004. The increase relates to an increase in general operating expenses offset by a reduction in executive salary expense and a head count reduction at our wood manufacturing facilities in the fiscal year ended January 31, 2005 compared to the fiscal year ended January 31, 2004.

The selling, general, and administrative expenses of Shared Services for the fiscal year ended January 31, 2005 increased \$1.2 million, or 8.6%, compared to the fiscal year ended January 31, 2004. The overall increase is primarily due to Sarbanes-Oxley compliance charges and increased depreciation expense due to increased capital expenditures.

#### **FULFILLMENT FREIGHT**

Fulfillment freight represents the outbound freight costs of domestic distribution. It consists primarily of payments to third party carriers to provide delivery service from our distribution centers to our customer's retail stores.

Our Magazine Fulfillment group's freight expense was \$21.1 million, an increase of \$4.7 million or 28.6% compared to the prior fiscal year. Freight expense as a percentage of gross domestic distribution increased from 3.7% to 4.0%. The increase was primarily attributable to expansion of our fulfillment business where we receive a per pound fee to ship other distributors product.

#### **RELOCATION EXPENSES**

During fiscal 2005, the Company incurred \$2.5 million of expenses related to distribution center relocations and a plant conversion. The Company began expansion into the mainstream retail market which resulted in distribution fulfillment centers in Milan, OH, San Diego, CA and Kent, WA being moved to Harrisburg, PA and Carson City, NV.

During fiscal 2004, the Company incurred \$1.7 million of expenses related to relocating its claims submission and fixture billing center, its Corporate Headquarters, and its Magazine Fulfillment administrative offices to its new facility in Bonita Springs, FL.

#### **LOSS ON SALE OF LAND AND BUILDING**

For the fiscal year ended January 31, 2005, the Company recognized a loss on the sale of land and building of approximately \$1.1 million for a vacant property located in Highpoint, NC.

#### **OPERATING INCOME**

Operating income for the fiscal year ended January 31, 2005 increased \$0.6 million or 3.6%, compared to the fiscal year ended January 31, 2004 due to the factors described above.

Operating profit margins for the fiscal year ended January 31, 2005 decreased from 5.5% to 5.0% as compared to the prior year due to the relocation costs and loss on sale of land and building discussed above.

#### **INTEREST EXPENSE**

Interest expense includes the interest and fees on our significant debt instruments and outstanding letters of credit.

Interest expense decreased \$1.9 million, or 54%, for the fiscal year ended January 31, 2005 compared to the fiscal year ended January 31, 2004. This decrease was due to significantly lower borrowings in the fiscal year ended January 31, 2005. The lower borrowing levels were due to the raising of proceeds from the sale of 3.8 million shares of our common stock.

#### **OTHER INCOME (EXPENSE)**

Other income (expense) consists of items outside of the normal course of operations. Due to its nature, comparability between periods is not generally meaningful.

For the fiscal years ended January 31, 2005 and 2004, we recorded charges of approximately \$1.5 million and \$0.9 million, respectively, related to the write off of deferred financing charges as a result of paying off certain debt instruments, as described below in "Liquidity and Capital Resources."

## INCOME TAX EXPENSE

The effective income tax rates on income from continuing operations were 14.6% and 26.6% for the fiscal years ended January 31, 2005 and 2004, respectively. The difference between the statutory rate and effective tax rates relates primarily to the realization of a net operating loss carry-forward acquired with our acquisition of Interlink through the reduction of the deferred tax valuation allowance in fiscal year 2005 and 2004. Additionally, at January 31, 2005, the Company reassessed the future utilization of such NOLs and determined that it is more likely than not that the benefit of such NOL will be realized and a valuation allowance is no longer necessary, accounting for the difference in the effective tax rate from 2005 to 2004.

## LIQUIDITY AND CAPITAL RESOURCES

### OVERVIEW

Our primary sources of cash include receipts from our customers, borrowings under our credit facilities and from time to time the proceeds from the sale of common stock.

Our primary cash requirements for the CD and DVD Fulfillment and Magazine Fulfillment group consist of the cost of CDs and DVDs, magazines and the cost of freight, labor and facility expense associated with our distribution centers.

Our primary cash requirements for the In-Store Services group consist of the cost of raw materials, labor, and factory overhead incurred in the production of front-end and custom wood displays, the cost of labor incurred in providing our claiming, design and information services and cash advances funding our Advance Pay program. Our Advance Pay program allows retailers to accelerate collections of their rebate claims through payments from us in exchange for the transfer to us of the right to collect the claim. We then collect the claims when paid by publishers for our own account.

Our primary cash requirements for the Shared Services group consist of salaries, professional fees and insurance not allocated to the operating groups.

The following table presents a summary of our significant obligations and commitments to make future payments under debt obligations and lease agreements due by fiscal year as of January 31, 2006 (in thousands).

	Payments due during the year ending January 31.					Total
	2007	2008	2009	2010	2011 and thereafter	
Debt obligations	\$ 6,508	\$ 6,970	\$ 4,239	\$ 2,509	\$ 67,009	\$ 87,235
Interest payments(a)	5,343	4,945	4,518	4,258	9,079	28,143
Capital leases	476	452	452	199	15	1,594
Operating leases	11,367	9,561	8,609	7,499	21,215	58,251
Total contractual cash obligations	\$ 23,694	\$ 21,928	\$ 17,818	\$ 14,465	\$ 97,318	\$ 175,223

(a) Interest is calculated using the prevailing weighted average rate on our outstanding debt at January 31, 2006, using the required payment schedule.

The following table presents a summary of our commercial commitments and the notional amount expiration by period:

(IN THOUSANDS)	Notional amounts expiring during the year ending January 31.					Total
	2007	2008	2009	2010	2011 and thereafter	
Financial standby letters of credit	\$ 9,489	\$ --	\$ --	\$ --	\$ --	\$ 9,489

## OPERATING CASH FLOW

Net cash provided by (used in) operating activities was \$58.8 million, (\$11.5) million and \$12.3 million for the fiscal years ended January 31, 2006, 2005 and 2004, respectively.

Operating cash flows for the fiscal year ended January 31, 2006 were primarily from net income of \$12.9 million, plus non-cash charges including depreciation and amortization of \$20.1 million and provisions for losses on accounts receivable of \$6.1 million and deferred income taxes of \$7.4 million. Additional cash providing activities include an increase in accounts payable of \$81.5 million and a decrease in other non-current assets of \$2.2 million. These cash providing activities were offset by an increase in accounts receivable of \$33.3 million and an increase in inventory of \$41.5 million.

The overall increase in accounts payable of \$81.5 million for the fiscal year ended January 31, 2006 was primarily due to the seasonality of CD and DVD Fulfillment and Magazine Fulfillment groups. An increase in accounts payable in our CD and DVD Fulfillment group of \$56.3 million was due to holiday season purchasing on extended terms provided by the major record labels and studios.

The Magazine Fulfillment Group had an increase in accounts payable of approximately \$36.5 million due primarily to the cyclical nature of the Mainstream Magazine distribution business.

The increase in accounts receivable for the fiscal year ended January 31, 2006 of \$33.3 million and the increase in inventories of \$41.5 million relates primarily to increased distribution and sales levels in our CD and DVD Fulfillment and Magazine Fulfillment, for the holiday season.

Operating cash flows for the fiscal year ended January 31, 2005 were primarily from net income of \$12.1 million, plus non-cash charges including depreciation and amortization of \$5.4 million and provisions for losses on accounts receivable of \$3.0 million, a write off of deferred financing costs and original issue discount of \$1.5 million, a loss of the sale of land and building of \$1.1 million, a decrease in inventories of \$0.6 million and a decrease in other current and non-current assets of \$0.7 million. These cash providing activities were offset by an increase in accounts receivable of \$10.3 million and a decrease in accounts payable and accrued expenses of \$24.8 million.

The increase in accounts receivable for the fiscal year ended January 31, 2005 was primarily due to an increase in accounts receivable in our Magazine Fulfillment group of \$6.6 million. The increase was due to an overall increase in distribution levels, especially in the last month of the quarter, more lenient payment terms offered to a significant customer in exchange for more favorable pricing, and partially offset by \$13.8 million increase in the sales return reserve from the end of fiscal 2004.

The In-Store Services Group had an increase in accounts receivable of approximately \$2.2 million due primarily due to the seasonal nature of the wire manufacturing business, which generally has the highest receivable balance in the third quarter, and increased revenues from the wood manufacturing business.

The decrease in accounts payable and accrued expenses for the fiscal year ended January 31, 2005 of \$24.8 million relates primarily to a \$12.5 million increase of purchase return reserves in our Magazine Fulfillment group.

Operating cash flows for the fiscal year ended January 31, 2004 were primarily from net income of (\$10.1 million), plus non-cash charges including depreciation and amortization of (\$4.1 million) and provisions for losses on accounts receivable of (\$1.8 million), a decrease in accounts receivable of (\$0.5 million) and a decrease in other current and non-current assets of (\$2.0 million). These cash providing activities were offset by an increase in inventory of (\$1.3 million), and a decrease in accounts payable and accrued expenses other current and non-current liabilities of (\$5.7 million).

Accounts receivable and accounts payable balances were impacted by the inception of the magazine export business, which had trade receivable of \$14.2 million and trade payables of \$10.0 million at January 31, 2004. The magazine export agreement allowed us to become a leading exporter of domestic titles to foreign wholesalers and domestic brokers who transport the product overseas. The fiscal year includes eleven months of operations from this business and only eight months of cash collections due to standard payment terms of at least 90 days, which is typical in the industry.

Accounts receivable related to our domestic magazine distribution businesses decreased \$2.6 million primarily due to the increase in the sales return reserve partially offset by the growth in trade receivables as a result of higher distribution levels. Inventories for this business increased \$1.7 million primarily to support higher distribution levels.

Accounts receivable in our front-end fixture manufacturing and claim filing services decreased \$6.7 million due to both better collection procedures as well as the lower revenue base.

## **INVESTING CASH FLOW**

Net cash used in investing activities was \$49.8 million, \$19.8 million and \$9.5 million in the fiscal years ended January 31, 2006, 2005 and 2004, respectively.

Net cash used in investing activities for the fiscal year ended consisted primarily of cash paid to acquire Levy of \$45.0 million, net of cash acquired and capital expenditures of \$13.1 million. Capital expenditures related primarily to our CD and DVD Fulfillment group and its ongoing effort to streamline its distribution process. Net cash used by investing activities also included the net acquisition of claims by our In-Store Services group of \$7.9 million. These cash consuming activities were partially offset by net cash acquired of \$16.8 million upon completion of our merger with Alliance.

For the fiscal year ended January 31, 2005, cash used in investing activities included capital expenditures of \$7.1 million, which in part related to our expansion of our distribution facilities in Harrisburg, Pennsylvania and Carson City, Nevada. Our advance pay program generated net cash flow of \$4.0 million in the fiscal year ended January 31, 2005. In addition, we collected \$6.8 million from the prior operator of our export distribution business during 2005. The initial advances were made as part of the agreement to collect the prior operator's receivables and pay outstanding payables so as to create a seamless transition for both the customers and suppliers. In addition, we incurred approximately \$2.6 million in acquisition costs related to the acquisition of Alliance Entertainment Corp.

In August 2004, we acquired all customer-based intangibles (i.e., all market composition, market share and other value) respecting claiming and information services of PROMAG Retail Services, LLC ("Promag") for approximately \$13.2 million. Of the \$13.2 million purchase price, \$10.0 million was funded from a term loan discussed below and \$0.75 million in a promissory note payable over a three year period to Promag. Promag provides claim filing services related to rebates owed retailers from publishers or their designated agent throughout the United States and Canada.

In September 2004, we acquired substantially all of the assets and liabilities of Empire State News Corp. ("Empire"), a magazine wholesaler in northwest New York state, for approximately \$5.0 million. The purchase price consisted of \$3.4 million of cash paid and \$1.6 million of deferred consideration in the form of two notes payable (\$1.2 million) and deferred compensation, subject to finalization of working capital adjustments in accordance with the purchase agreement.

In November 2004, the Company entered into an agreement to terminate the leases under the magazine import and the magazine export agreements and acquire all import and export assets, naming rights and other intangibles including a non-compete by the seller. The purchase price of the import and export businesses was approximately \$14.1 million (after an allowed reduction of the purchase price for the payments made by the Company under the prior lease agreements). The purchase price was comprised of \$4.2 million paid in cash on the last business day of November 2004 and additional notes payable in the principal amount of \$7.7 million.

In the fiscal year ended January 31, 2004, cash used in investing activities related to capital expenditures of \$2.1 million, which primarily related to our relocation to Florida and expansion of our distribution facility in Harrisburg, Pennsylvania, and \$2.4 million of payments related to acquisition of the customer lists under the import and export agreement. Our advance pay program generated net cash flow of \$1.8 million in the fiscal year ended January 31, 2004. We also advanced to the prior operator of our export distribution business \$6.8 million. The advances were made as part of the agreement to collect the prior operator's receivables and pay outstanding payables so as to create a seamless transition for both the customers and suppliers.

Our borrowing agreements limit the amount of our capital expenditures in any fiscal year.

## **FINANCING CASH FLOW**

Outstanding balances on our credit facility fluctuate partially due to the timing of the retailer rebate claiming process and our Advance Pay program, the seasonality of our CD and DVD Fulfillment and wire manufacturing business, and the payment cycle of the magazine distribution business. Because the magazine distribution business and Advance Pay program cash requirement peak at our fiscal quarter ends, the reported bank debt levels usually are the maximum level outstanding during the quarter.

Payments under our Advance Pay program generally occur just prior to our fiscal quarter end. The related claims are not generally collected by us until 90 days after the advance is made. As a result, our funding requirements peak at the time of the initial advances and decrease over the next 90 days as the cash is collected on the related claims.

Sales of CDs and DVDs are traditionally highest during our fourth quarter (the holiday season), while returns are highest during our first quarter. Consequently, working capital needs for the home entertainment products marketplace are typically highest in our third quarter due to increases in inventories purchased for the holiday selling season and extension of credit terms to certain customers. Historically, the CD and DVD Fulfillment segment has financed their working capital needs through cash generated from operations, extended terms from suppliers and bank borrowings.

Within our magazine distribution business, our significant customers pay weekly, and we pay our suppliers monthly. As a result, funding requirements peak at the end of the month when supplier payments are made and decrease over the course of the next month as our receivables are collected.

The wire manufacturing business is seasonal because most retailers prefer initiating new programs before the holiday shopping season begins, which concentrates revenues in the second and third quarter. Receivables from these fixture programs are generally collected from all participants within 180 days. We are usually required to tender payment on the costs of these programs (raw material and labor) within a shorter period. As a result, our funding requirements peak in the second and third fiscal quarters when we manufacture the wire fixtures and decrease significantly in the fourth and first fiscal quarters as the related receivable are collected and significantly less manufacturing activity is occurring.

Net cash provided by (used in) financing activities was \$12.9 million, \$27.6 million and (\$3.4) million in the fiscal years ended January 31, 2006, 2005 and 2004, respectively.

Financing activities in the fiscal year ended January 31, 2006 consisted primarily of borrowings on our revolving credit facility of \$25.7 million and borrowings under notes payable of \$20.6 million, including a mortgage of \$20.0 million. These cash providing activities were partially offset by the reduction in checks issued against future borrowings on credit facilities of \$13.5 million and payments on notes payable of \$23.4 million, primarily related to the modification of the Wells Fargo Foothill credit facility and the repayment of a mortgage loan. Finally, the exercise of employee stock options for the fiscal year generated approximately \$5.0 million.

Financing activities in the fiscal year ended January 31, 2005 consisted of proceeds from the sale of 3.8 million shares of common stock. The proceeds generated from the issuance of common stock were approximately \$40.5 million (net of underwriting and related expenses). We utilized a portion of these proceeds to repay the Wells Fargo Foothill original term loan, the Hilco Capital note payable and the notes payable to former owners. Total payments on notes payable in the current year was \$24.0 million. For the fiscal year ended January 31, 2005, borrowings on the credit facilities totaled \$7.6 million and a term loan in the amount of \$10.0 million was issued related to the Promag transaction. In addition, the cash provided by the activities noted above was offset by a \$12.2 million decrease in checks issued and outstanding at January 31, 2005. Finally, the exercise of employee stock options for the fiscal year generated approximately \$5.9 million.

In the fiscal year ended January 31, 2004, cash used in financing activities related to our various credit facilities included net repayments under revolving credit facilities of \$27.7 million, payments of notes payable of \$6.0 million and proceeds from the issuance of notes payable of \$20.0 million. The exercise of employee stock options generated \$2.8 million in proceeds. Outstanding checks increased \$7.5 million as our new consolidated financing facility allowed for more efficient cash management.

## **DEBT**

At January 31, 2006, our total debt obligations were \$87.2 million, excluding outstanding letters of credit. Debt consists primarily of our amounts owed under a revolving credit facility, a mortgage loan with Wachovia Bank and the notes payable related to the acquisitions of the magazine import and export businesses, Empire News, and Levy.

On February 28, 2005, in conjunction with our merger with Alliance, we entered into an amended and restated secured financing arrangement with Wells Fargo Foothill, Inc., as arranger and administrative agent (the "Working Capital Loan Agent") for each of the lenders that may become a participant in such arrangement, and their successors and assigns (the "Working Capital Lenders") pursuant to which the Working Capital Lenders will make revolving loans ("Working Capital Loans") to us and our subsidiaries of up to \$250 million ("Advances") and provide for the issuance of letters of credit. The terms and conditions of the arrangement are governed primarily by the Amended and Restated Loan Agreement dated February 28, 2005 by and among us, our subsidiaries, and Wells Fargo (the "Amended and Restated Loan Agreement").

The proceeds of the Working Capital Loans were used to (i) finance transaction expenses incurred in connection with the merger of Source Interlink and Alliance and the reincorporation of Source Interlink into Delaware, (ii) repay certain existing indebtedness of Alliance and its subsidiaries, (iii) repay certain existing indebtedness of Source Interlink to Wells Fargo under our previous credit facility (including, without limitation, a \$10 million term loan) and (iv) for working capital and general corporate purposes, including the financing of acquisitions.

Outstanding Advances bear interest at a variable annual rate equal to the prime rate announced by Wells Fargo Bank, National Association's San Francisco office, plus a margin of between 0% and 1.00% based upon a ratio of the Registrant's EBITDA to interest expense ("Interest Coverage Ratio"). We also have the option of selecting up to five tranches of at least \$1 million each to bear interest at LIBOR plus a margin of between 2.00% and 3.00% based upon our Interest Coverage Ratio. To secure repayment of the Working Capital Loans and other obligations of ours to the Working Capital Lenders, we and our subsidiaries granted a security interest in all of our personal property assets to the Working Capital Loan Agent, for the benefit of the Working Capital Lenders. The Working Capital Loans mature on October 31, 2010.

The commitment of the Working Capital Lenders to make Advances is subject to the existence of sufficient eligible assets to support such Advances under a specified borrowing base formula and compliance with, among other things, certain financial covenants. Under the Amended and Restated Loan Agreement, we are required to maintain a specified minimum level of EBITDA and compliance with specified fixed charge coverage and debt to EBITDA ratios. In addition, we are prohibited, without consent from the Working Capital Lenders, from:

- (i) incurring additional indebtedness or liens on our personal property assets;
- (ii) engaging in any merger, consolidation, acquisition or disposition of assets or other fundamental corporate change;
- (iii) permitting a change of control of us;
- (iv) paying any dividends or making any other distribution on capital stock or other payments in connection with the purchase, redemption, retirement or acquisition of capital stock;
- (v) changing our fiscal year or methods of accounting; and
- (vi) making capital expenditures in excess of \$19.3 million during any fiscal year.

Additional events of default under the Amended and Restated Loan Agreement include, among others:

- (i) failure to pay our obligations to the Working Capital Lenders or to otherwise observe its covenants under the Amended and Restated Loan Agreement and other loan documents,
- (ii) any of our subsidiaries becomes insolvent or bankrupt or has any material portion of its assets seized or encumbered, and
- (iii) a material breach or default under any of the Registrant's material contracts, including contracts for indebtedness.

The balance on the credit facility at January 31, 2006 was \$45.0 million. At January 31, 2006, the Company had availability of \$195.5 million. We believe that availability under this credit facility will be sufficient to finance our operation during the coming year.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

We do not engage in transactions or arrangements with unconsolidated or other special purpose entities.

#### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent liabilities. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of the Board. Actual results may differ from these estimates under different assumptions and conditions.

Management believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements.

#### **REVENUE RECOGNITION**

We record a reduction in revenue for estimated CD, DVD, and magazine sales returns and a reduction in cost of sales for estimated purchase returns. Estimated sales returns are based on historical sales returns and daily point-of-sale data from significant customers. The purchase return estimate is calculated from the sales return reserve based on historical gross profit. If the historical data we use to calculate these estimates does not properly reflect future results, revenue and/or cost of sales may be misstated.

#### **ALLOWANCE FOR DOUBTFUL ACCOUNTS**

We provide for potential uncollectible accounts receivable based on customer-specific information and historical collection experience. If market conditions decline, actual collection experience may not meet expectations and may result in increased bad debt expenses.

## **TAXES ON EARNINGS**

The carrying value of our net deferred tax assets assumes that we will be able to generate sufficient future taxable income in certain tax jurisdictions, based on estimates and assumptions. If these estimates and assumptions change in the future, we may be required to increase or decrease valuation allowances against our deferred tax assets resulting in additional income tax expenses or benefits.

## **GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill represents the excess of cost over the fair value of net assets acquired in connection with business acquisitions. In accordance with SFAS 142, goodwill and other intangible assets are tested for impairment at the reporting unit level, which is defined as an operating segment or a component of an operating segment that constitutes a business for which financial information is available and is regularly reviewed by management. The Company assesses goodwill for impairment at least annually in the absence of an indicator of possible impairment and immediately upon an indicator of possible impairment. The annual impairment review was completed in the first fiscal quarter of 2006, 2005 and 2004 and no impairment charge was necessary. Fair value of the operating unit is determined based on a combination of discounted cash flows and publicly traded company multiples and acquisition multiples of comparable businesses. For goodwill valuation purposes only, the fair value of the operating segment is allocated to the assets and liabilities of the operating segment to arrive at an implied fair value of goodwill, based upon known facts and circumstances as if the acquisition occurred currently. The difference between the carrying value and the estimated fair value of the goodwill would be recognized as an impairment loss.

## **IMPAIRMENT OF LONG-LIVED ASSETS**

The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. Our estimates of fair value represent our best estimate based on industry trends and reference to market rates and transactions.

## **RECENT ACCOUNTING PRONOUNCEMENTS**

In November 2004, the FASB issued SFAS 151 - "Inventory Costs" (SFAS 151). SFAS 151 is effective for the first fiscal year beginning after June 15, 2005. SFAS 151 clarifies current guidance regarding the classification of costs associated with inventory, such as idle facility costs, freight, handling, and waste. The Company does not believe that the adoption of SFAS 151 will have a material affect on the Company's results of operations or financial position.

In December 2004, the FASB issued SFAS 123(R) - "Share-Based Payment" ("SFAS 123(R)"). SFAS 123(R) is effective for the first fiscal year beginning after June 15, 2005. SFAS 123(R) changes the way entities account for the issuance of stock-based compensation. In particular, SFAS 123(R) requires that entities begin expensing the fair value of stock options. The Company has not yet completed its evaluation of the impact of adopting SFAS 123(R). However, it believes that initial adoption of SFAS 123(R) will result in expense being recognized for outstanding and unvested stock options and that additional compensation expense will be recognized in subsequent fiscal years.

In May 2005, the FASB issued SFAS 154 - "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and Statement No. 3" ("SFAS 154"). SFAS 154 is effective for the first fiscal year beginning after December 15, 2005. SFAS 154 changes the way entities account for accounting changes for which there is no stated transition method and for the correction of accounting errors. The adoption of SFAS 154 will only impact the Company's results of operations and financial position to the extent that it adopts accounting methods for which there is no stated transition method or corrects accounting errors in future periods. Therefore, the Company does not believe that the adoption of SFAS 154 will have a material affect on its results of operations or financial position.

In March 2006, the FASB issued SFAS 156 - "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" ("SFAS 156"). SFAS 156 is effective for the first fiscal year beginning after September 15, 2006. SFAS 156 changes the way entities account for servicing assets and obligations associated with financial assets acquired or disposed of. The Company has not yet completed its evaluation of the impact of adopting SFAS 156 on its results of operations or financial position, but does not expect that the adoption of SFAS 156 will have a material impact.

## QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Our primary market risks include fluctuations in interest rates and exchange rate variability.

Our debt primarily relates to credit facilities with Wells Fargo Foothill. See "Debt" in Management's Discussion and Analysis.

The revolving credit facility with Wells Fargo Foothill had an outstanding principal balance of approximately \$45.0 million at January 31, 2006. Interest on the outstanding balance is charged based on a variable interest rate related to the prime rate (7.5% at January 31, 2006) plus a margin specified in the credit agreement based on an availability calculation (0.0% at January 31, 2006).

As a result of the above, our primary market risks relate to fluctuations in interest rates. A 1% increase in the prevailing weighted average interest rate on our debt at January 31, 2006, is estimated to cause an increase of \$0.8 million in interest expense for the year ending January 31, 2007.

We do not perform any interest rate hedging activities related to these two facilities.

We have exposure to foreign currency fluctuation through our exporting of foreign magazines and the purchase of foreign magazines for domestic distribution.

Revenues derived from the export of domestic titles (or sales to domestic brokers who facilitate the export) totaled \$31.7 million for the fiscal year ended January 31, 2006 or 2.1% of total revenues. For the most part, our export revenues are denominated in dollars, and the foreign wholesaler is subject to foreign currency risks. We have the availability to control foreign currency risk via increasing or decreasing the local cover price paid in the foreign markets. There is a risk that a substantial increase in local cover price, due to a decline in the local currency relative to the dollar, could decrease demand for these magazines at retail and negatively impact our results of operations.

Domestic distribution (gross) of imported titles totaled approximately \$97.0 million (of a total \$1,413.6 million or 6.9%). Foreign publications are purchased in both dollars and the local currency of the foreign publisher, primarily Euros and pounds sterling. In the instances where we buy in the foreign currency, we generally have the ability to set the domestic cover price, which allows us to minimize if we so choose the foreign currency risk. Foreign titles generally have significantly higher cover prices than comparable domestic titles, are sold only at select retail locations, and sales do not appear to be highly impacted by cover price increases. However, a significant negative change in the relative strength of the dollar to these foreign currencies could result in higher domestic cover prices and result in lower sales of these titles at retail, which would negatively impact our results of operations.

We do not conduct any significant hedging activities related to foreign currency.

**SOURCE INTERLINK COMPANIES, INC.**  
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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors  
Source Interlink Companies, Inc.  
Bonita Springs, Florida

We have audited the accompanying consolidated balance sheets of Source Interlink Companies, Inc. as of January 31, 2006 and 2005 and the related consolidated statements of income, stockholders' equity and cash flows for each of the three years in the period ended January 31, 2006. We have also audited the schedule listed in the accompanying index. These consolidated financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company 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 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 presentation of the consolidated financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Source Interlink Companies, Inc. at January 31, 2006 and 2005 and the results of its operations and its cash flows for each of the three years in the period ended January 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the information in the schedule presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Source Interlink Companies, Inc.'s internal control over financial reporting as of January 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated April 10, 2006 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP  
Chicago, Illinois  
April 10, 2006

**SOURCE INTERLINK COMPANIES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	January 31.	
	2006	2005
<b>ASSETS</b>		
Current Assets		
Cash	\$ 23,239	\$ 1,387
Trade receivables, net	129,782	48,078
Purchased claims receivable	9,922	2,006
Inventories	198,483	16,868
Income tax receivable	2,180	2,275
Deferred tax asset	16,403	2,302
Other	6,058	3,349
	-----	-----
Total current assets	386,067	76,265
	-----	-----
Property, plants and equipment	89,971	36,706
Less accumulated depreciation and amortization	(23,255)	(14,375)
	-----	-----
Net property plants and equipment	66,716	22,331
	-----	-----
Other assets		
Goodwill, net	302,293	71,600
Intangibles	118,988	16,126
Deferred tax asset	--	2,903
Other	10,408	8,528
	-----	-----
Total other assets	431,689	99,157
	-----	-----
Total assets	\$ 884,472	\$ 197,753
	=====	=====

See accompanying notes to Consolidated Financial Statements.

**SOURCE INTERLINK COMPANIES, INC.**  
**CONSOLIDATED BALANCE SHEETS (CONCLUDED)**  
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	January 31,	
	2006	2005
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Checks issued against future advances on revolving credit facility	\$ --	\$ 1,951
Accounts payable and accrued expenses (net of allowance for returns of \$167,423 and \$70,292 at January 31, 2006 and 2005, respectively)	321,074	25,274
Deferred revenue	3,226	2,205
Other	--	19
Current portion of obligations under capital leases	476	--
Current maturities of debt	6,508	5,630
	-----	-----
Total current liabilities	331,284	35,079
Deferred tax liability	4,526	--
Obligations under capital leases	1,118	--
Debt, less current maturities	80,727	34,139
Other	7,224	852
	-----	-----
Total liabilities	424,879	70,070
Commitments and contingencies		
Stockholders' equity		
Contributed capital:		
Preferred stock, \$0.01 par (2,000 shares authorized; none issued)	--	--
Common stock, \$0.01 par (100,000 and 40,000 shares authorized; 51,704 and 23,859 shares issued)	517	238
Additional paid-in-capital	467,543	150,269
	-----	-----
Total contributed capital	468,060	150,507
Accumulated deficit	(10,817)	(23,696)
Accumulated other comprehensive income (loss):		
Foreign currency translation	2,350	1,439
Less: Treasury stock (100 shares at cost)	--	(567)
	-----	-----
Total stockholders' equity	459,593	127,683
	-----	-----
Total liabilities and stockholders' equity	\$ 884,472	\$ 197,753
	=====	=====

See accompanying notes to Consolidated Financial Statements.

**SOURCE INTERLINK COMPANIES, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Year ended January 31.		
	2006	2005	2004
Revenues	\$ 1,527,451	\$ 356,644	\$ 315,791
Cost of revenues (including depreciation of \$1.245, \$1.225 and \$1.258)	1,219,997	258,851	229,748
Gross profit	307,454	97,793	86,043
Selling, general and administrative expense	177,867	51,379	47,712
Fulfillment freight	72,806	21,067	16,381
Depreciation and amortization	18,213	3,751	2,826
Relocation expenses	--	2,450	1,730
Loss on sale of land and building	--	1,122	--
Merger and acquisition charges	3,319	--	--
Operating income	35,249	18,024	17,394
Other income (expense):			
Interest expense (including amortization of deferred financing fees of \$631, \$471, and \$647)	(6,794)	(1,575)	(3,427)
Interest income	220	175	358
Write off of deferred financing costs and original issue discount	--	(1,495)	(865)
Other	203	161	393
Total other expense	(6,371)	(2,734)	(3,541)
Income from continuing operations, before income taxes	28,878	15,290	13,853
Income tax expense	14,553	2,228	3,690
Income from continuing operations	14,325	13,062	10,163
Loss from discontinued operations, net of tax	(1,446)	(980)	(115)
Net income	\$ 12,879	\$ 12,082	\$ 10,048
Earnings (loss) per share - basic			
Continuing operations	\$ 0.29	\$ 0.57	\$ 0.55
Discontinued operation	(0.03)	(0.04)	(0.01)
Total	\$ 0.26	\$ 0.53	\$ 0.54
Earnings (loss) per share - diluted			
Continuing operations	\$ 0.28	\$ 0.53	\$ 0.52
Discontinued operation	(0.03)	(0.04)	(0.01)
Total	\$ 0.25	\$ 0.49	\$ 0.51
Weighted average shares outstanding - basic	49,097	22,963	18,476
Weighted average shares outstanding - diluted	50,894	24,833	19,866

See accompanying notes to Consolidated Financial Statements.

**SOURCE INTERLINK COMPANIES, INC.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
**(IN THOUSANDS)**

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, January 31, 2003	18,363	\$ 184	\$ 97,338	\$ (45,826)	\$ (210)	100	\$ (567)	\$ 50,919
Net income	--	--	--	10,048	--	--	--	10,048
Foreign currency translation	--	--	--	--	1,142	--	--	1,142
Comprehensive income	--	--	--	10,048	1,142	--	--	11,190
Exercise of stock options	624	6	2,820	--	--	--	--	2,826
Tax benefit from stock options exercised	--	--	924	--	--	--	--	924
Original issue discount of note payable from warrants	--	--	936	--	--	--	--	936
Other	4	--	279	--	--	--	--	279
Balance, January 31, 2004	18,991	190	102,297	(35,778)	932	100	(567)	67,074
Net income	--	--	--	12,082	--	--	--	12,082
Foreign currency translation	--	--	--	--	507	--	--	507
Comprehensive income	--	--	--	12,082	507	--	--	12,589
Exercise of stock options	1,058	10	5,915	--	--	--	--	5,925
Tax benefit from stock options exercised	--	--	1,621	--	--	--	--	1,621
Public offer proceeds (net of offering costs of \$3,226)	3,800	38	40,436	--	--	--	--	40,474
Balance, January 31, 2005	23,849	238	150,269	(23,696)	1,439	100	(567)	127,683
Net income	--	--	--	12,879	--	--	--	12,879
Foreign currency translation	--	--	--	--	911	--	--	911
Comprehensive income	--	--	--	12,879	911	--	--	13,790
Exercise of stock options	1,013	11	5,029	--	--	--	--	5,040
Tax benefit from stock options exercised	--	--	1,866	--	--	--	--	1,866
Stock issued in Alliance acquisition	26,942	269	304,445	--	--	--	--	304,714
Exchange of stock options and warrants to acquire Alliance common stock	--	--	6,500	--	--	--	--	6,500
Retirement of treasury stock	(100)	(1)	(566)	--	--	(100)	567	--
Balance, January 31, 2006	51,704	\$ 517	\$ 467,543	\$ (10,817)	\$ 2,350	--	\$ --	\$ 459,593

See accompanying notes to Consolidated Financial Statements.

**SOURCE INTERLINK COMPANIES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(IN THOUSANDS)

	Year ended January 31.		
	2006	2005	2004
<b>OPERATING ACTIVITIES</b>			
Net income	\$ 12,879	\$ 12,082	\$ 10,048
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	20,089	5,447	4,731
Provision for losses on accounts receivable	6,100	3,003	1,819
Deferred income taxes	7,395	(1,382)	(534)
Deferred revenue	997	525	(497)
Loss on sale of land and building	--	1,122	--
Write off of deferred financing costs and original issue discount	--	1,495	865
Excess tax benefit from exercise of stock options	1,866	1,621	924
Other	700	(1,589)	123
Changes in assets and liabilities (excluding business acquisitions):			
(Increase) decrease in accounts receivable	(33,295)	(10,256)	455
(Increase) decrease in inventories	(41,518)	610	(1,329)
Decrease in other current and non-current assets	2,154	706	1,364
Increase (decrease) in accounts payable and other liabilities	81,463	(24,845)	(5,673)
Cash provided by (used in) operating activities	58,830	(11,461)	12,296
<b>INVESTMENT ACTIVITIES</b>			
Capital expenditures	(13,069)	(7,146)	(2,113)
Purchase of claims	(109,095)	(87,230)	(81,341)
Payments received on purchased claims	101,179	91,181	83,144
Collections (advances) under magazine export agreement	--	6,830	(6,830)
Payments under magazine import agreement	--	(1,500)	(1,000)
Payments under magazine export agreement	--	--	(1,400)
Acquisition of Empire State News Corp.	--	(4,212)	--
Acquisition of Worldwide agreements	--	(12,473)	--
Acquisition of Promag Retail Services, LLC	--	(3,352)	--
Net cash from Alliance Entertainment Corp. acquisition	16,882	(2,585)	--
Acquisition of Chas. Levy Circulating Company, LLC, net of cash acquired	(44,991)	--	--
Acquisition of customer list	(2,300)	--	--
Proceeds from the sale of fixed assets	1,548	735	--
Cash used in investing activities	(49,846)	(19,752)	(9,540)
<b>FINANCING ACTIVITIES</b>			
(Decrease) increase in checks issued against revolving credit facilities	(13,529)	(12,178)	7,518
Borrowings (repayments) under credit facilities	25,712	7,554	(27,733)
Payments of notes payable	(23,357)	(23,977)	(5,974)
Borrowings under notes payable	20,605	10,000	20,000
Proceeds from the issuance of common stock	5,040	46,399	2,826
Payments under capital leases	(527)	--	--
Deferred financing cost	(1,076)	(161)	--
Cash provided by (used in) financing activities	12,868	27,637	(3,363)
Increase (decrease) in cash	21,852	(3,576)	(607)
Cash, beginning of period	1,387	4,963	5,570
Cash, end of period	\$ 23,239	\$ 1,387	\$ 4,963

See accompanying notes to Consolidated Financial Statements.

## SOURCE INTERLINK COMPANIES, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### **BUSINESS**

Source Interlink Companies, Inc. (the "Company") and its subsidiaries distribute home entertainment products direct to specialty and mainstream retailers, design, manufacture, install and remove retail fixtures located at the check-out lane, manage retailers' claims for rebates with magazine publishers, provide access to a comprehensive database of point-of-sale data to retailers and product managers, and manufacture and install high-end wood retail display fixtures principally in the United States.

##### **PRINCIPLES OF CONSOLIDATION**

The consolidated financial statements include the accounts of Source Interlink Companies, Inc. and its wholly-owned subsidiaries (collectively, the Company) as of the date they were acquired. All significant intercompany accounts and transactions have been eliminated.

##### **USE OF ESTIMATES**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

##### **REVENUE RECOGNITION**

###### **CD, DVD and Magazine Fulfillment**

Revenues from the sale of CDs, DVDs and magazines the Company distributes are recognized at the time of delivery less allowances for estimated returns. Revenues from the sale of CDs, DVDs and magazines to wholesalers that are not shipped through our distribution centers are recognized at the later of notification from the shipping agent that the product has been delivered or the on-sale date of the CD, DVD or magazine. The Company records a reduction in revenue for estimated CD, DVD and magazine sales returns and a reduction in cost of sales for estimated CD, DVD and magazine purchase returns. Estimated returns are based on historical sell-through rates. A certain number of retailers use scan-based trading terms, in which retailers are not obligated to pay until the item sells at the retail store. In such arrangements, the Company recognizes revenue upon the sale of the merchandise by the retailer.

###### **Fulfillment & Return Processing Services**

Revenues from performing fulfillment and return processing services are recognized at the time the service is performed. The Company is generally compensated on either a per-copy or per-pound basis based on a negotiated price or a cost plus model.

###### **Rebate Claim Filing**

Revenues from the filing of rebate claims with publishers on behalf of retailers are recognized at the time the claim is paid. The revenue recognized is based on the amount paid multiplied by our commission rate. The Company has developed a program (the "advance pay" program) whereby the Company will advance the claimed amount less applicable commissions to the retailers and collect the entire amount claimed from publishers for our own accounts. The Company accounts for the advance as a purchase of a financial asset and records a receivable at the time of purchase.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**Information Products**

Revenues from information product contracts are recognized ratably over the subscription term, generally one year.

**Custom Display Manufacturing**

Revenues from the design and manufacture of custom display fixtures are recognized when the retailer accepts title to the display. Transfer of title usually occurs upon shipment. However, upon request from a customer, the product can be stored for future delivery for the convenience of the customer. If this occurs, we recognize revenue when the manufacturing and earnings processes are complete, the customer accepts title in writing, the product is invoiced with payment due in the normal course of business, the delivery schedule is fixed and the product is segregated from other goods. Services related to the manufacturing of displays such as freight, installation, warehousing and salvage are recognized when the services are performed.

**INVENTORIES**

Inventories are valued at the lower of cost or market. Cost is determined by the first-in, first-out ("FIFO") method.

**PROPERTY, PLANTS & EQUIPMENT**

Property and equipment are stated at cost. Depreciation is computed using the straight-line method for financial reporting over the estimated useful lives as follows:

Asset Class:	Life -----
Buildings	40 years
Machinery and equipment	5-7 years
Vehicles	5-7 years
Furniture and fixtures	5-7 years
Computers	3-5 years

Leasehold improvements are amortized over the shorter of the useful life of the asset or the life of the lease.

**GOODWILL AND OTHER INTANGIBLE ASSETS**

Goodwill represents the excess of cost over the fair value of net assets acquired in connection with business acquisitions. In accordance with SFAS 142, goodwill and other intangible assets are tested for impairment at the reporting unit level, which is defined as an operating segment or a component of an operating segment that constitutes a business for which financial information is available and is regularly reviewed by management. The Company assesses goodwill for impairment at least annually in the absence of an indicator of possible impairment and immediately upon an indicator of possible impairment. The annual impairment review was completed in the first fiscal quarter of 2006, 2005 and 2004 and no impairment charge was necessary. Fair value of the operating unit is determined based on a combination of discounted cash flows and publicly traded company multiples and acquisition multiples of comparable businesses. For goodwill valuation purposes only, the fair value of the operating segment is allocated to the assets and liabilities of the operating segment to arrive at an implied fair value of goodwill, based upon known facts and circumstances as if the acquisition occurred currently. The difference between the carrying value and the estimated fair value of the goodwill would be recognized as an impairment loss.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**INTANGIBLE ASSETS**

The Company currently amortizes intangible assets over the estimated useful life of the asset ranging from 3 to 20 years (See Footnote 6). The weighted average estimated useful life is approximately 18 years for customer lists, 4 years for non-compete agreements, and 7 years for software.

**DEFERRED FINANCING FEES**

Deferred financing fees are capitalized and amortized over the life of the credit facility and are included in other long-term assets.

**IMPAIRMENT OF LONG-LIVED ASSETS**

The Company accounts for long-lived assets in accordance with FAS 144, "Accounting for the Impairment or Disposal of Long Lived Assets." This Statement applies to long-lived assets other than goodwill, and prescribes a probability-weighted cash flow estimation approach to evaluate the recoverability of the carrying amount of long-lived assets such as property, plant and equipment. The Company records impairment losses on long-lived assets used in operations, other than goodwill, when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amount of those items. Our cash flow estimates are based on historical results adjusted to reflect our best estimate of future market and operating conditions. The net carrying value of assets not recoverable is reduced to fair value. Our estimates of fair value represent our best estimate based on industry trends and reference to market rates and transactions.

**CONCENTRATIONS OF CREDIT RISK**

The Company has significant concentrations of credit risk in its CD and DVD Fulfillment, Magazine Fulfillment and In-Store Services segments. If the Company experiences a significant reduction in business from its clients, the Company's results of operations and financial condition may be materially and adversely affected. The Company aggregates customers with a common parent when calculating the applicable percentages. For CD, DVD and magazine distribution the Company calculates contribution to revenue based on the actual distribution and estimated sell-through based on the Company's calculated sales return reserve.

During fiscal 2006, two customers (Barnes and Noble, Inc. and Borders Group, Inc.) accounted for 33.8% (27.5% and 6.3%) of total revenues.

During fiscal 2005, these two customers accounted for 53.2% (28.7% and 24.5%) of total revenues.

During fiscal 2004, these two customers accounted for 53.4% (28.3% and 25.1%) of total revenues.

**ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The Company provides for potential uncollectible accounts receivable at a level management believes is sufficient based on customer specific information and historical collection experience.

**SHIPPING AND HANDLING CHARGES**

Shipping and handling charges related to the distribution of magazines and CDs and DVDs are not included in Cost of Revenues. Shipping and handling costs totaled approximately \$72.8 million, \$21.1 million and \$16.4 million in 2006, 2005 and 2004, respectively.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**RELOCATION EXPENSES**

During fiscal 2005, the Company incurred \$2.5 million of expenses related principally to distribution center relocations. The Company began expansion into the mainstream retail market which resulted in distribution fulfillment centers in Milan, OH, San Diego, CA and Kent, WA being moved to Harrisburg, PA and Carson City, NV.

During fiscal 2004, the Company incurred \$1.7 million of expenses related to relocating its claims submission and fixture billing center, its Corporate Headquarters, and its Magazine Fulfillment administrative offices to its new facility in Bonita Springs, FL.

The Company accounted for the relocations in accordance with FAS 146, "Accounting for Costs Associated with Exit or Disposal Activities". FAS 146 requires recording costs associated with an exit or disposal activity at their fair values when a liability has been incurred.

**INCOME TAXES**

The Company accounts for income taxes under an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements or tax returns. In estimating future tax consequences, the Company generally considers all expected future events other than enactments of changes in the tax laws or rates.

**FOREIGN CURRENCY TRANSLATION AND TRANSACTIONS**

The financial position and results of operations of the Company's foreign subsidiaries are determined using local currency as the functional currency. Assets and liabilities of these subsidiaries are translated at the exchange rate in effect at each year-end. Income statement accounts are translated at the average rate of exchange prevailing during the year. Translation adjustments arising from the use of differing exchange rates from period to period are included in the other comprehensive income account in stockholders' equity. Gains and losses resulting from foreign currency transactions, which are not material, are included in the Consolidated Statements of Income.

**COMPREHENSIVE INCOME**

Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. The Company's comprehensive income item is foreign currency translation adjustments.

**EARNINGS PER SHARE**

In February 1997, the Financial Accounting Standards Board issued FAS No. 128, "Earnings per Share," which requires the presentation of "basic" earnings per share, computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period, and "diluted" earnings per share, which reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**FAIR VALUE OF FINANCIAL INSTRUMENTS**

The carrying amounts of accounts receivable and accounts payable approximates fair value due to their short-term nature. The carrying amount of debt including credit facilities approximates fair value due to their stated interest rate approximating a market rate. The fair value of the Company's fixed-rate debt approximates its carrying amount. These estimated fair value amounts have been determined using available market information or other appropriate valuation methodologies.

**ACCOUNTING FOR STOCK-BASED COMPENSATION**

FAS No. 123, "Accounting for Stock-Based Compensation" defined a fair value method of accounting for stock options and other equity instruments. Under the fair value method, compensation cost is measured at the grant date based on the fair value of the award and is recognized over the service period, which is usually the vesting period. As provided in FAS No. 123, the Company elected to apply Accounting Principles Board ("APB") Opinion No. 25 and related interpretations in accounting for its stock-based compensation plans. No stock based compensation was reflected in the fiscal 2006, 2005 or 2004 net income related to our stock option plans as all options granted in those years had an exercise price equal to or greater than the market value of the underlying stock on the date of grant.

On December 15, 2004, the FASB issued a revision of the standard entitled SFAS No. 123(R), Share Based Payment, which requires all companies to measure compensation cost for all share-based payments, including stock options, at fair value. Publicly traded companies must apply this standard as of the beginning of the first annual period that begins after December 15, 2005. This statement applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date. The Company has not completed its evaluation of the impact of adopting FASB 123R on its consolidated financial statements, but anticipates that more compensation costs will be recorded in the future if the use of options for employees and director compensation continues as in the past. Under the revised standard the Company will be required to recognize compensation expense on any unvested portion of grants not previously accounted for under the fair-value-based method.

The following is a reconciliation of net income per weighted average share had the Company adopted FAS No. 123:

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)	Year ended January 31,		
	2006	2005	2004
Net income (as reported)	\$ 12,879	\$ 12,082	\$ 10,048
Stock compensation costs, net of tax	(1,742)	(423)	(1,330)
Pro-forma net income	\$ 11,137	\$ 11,659	\$ 8,718
Weighted average shares, basic	49,097	22,963	18,476
Weighted average shares, diluted	50,894	24,833	19,866
Basic earnings per share - as reported	\$ 0.26	\$ 0.53	\$ 0.54
Diluted earnings per share - as reported	\$ 0.25	\$ 0.49	\$ 0.51
Basic earnings per share - pro-forma	\$ 0.23	\$ 0.51	\$ 0.47
Diluted earnings per share - pro-forma	\$ 0.22	\$ 0.47	\$ 0.44

The fair value of each option grant is estimated on the grant date using the Black-Scholes option pricing model with the following assumptions:

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

	Year ended January 31,		
	2006	2005	2004
Dividend yield	0%	0%	0%
Expected volatility	0.50	0.50	0.50
Risk-free interest rate	3.65-3.79%	2.18-2.86%	2.16-2.58%
Expected life	3 years	3 years	3 years

**RECLASSIFICATIONS**

Certain prior year amounts have been reclassified in the consolidated financial statements to conform with current year presentation.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In November 2004, the FASB issued FAS 151 - "Inventory Costs" (FAS 151). FAS 151 is effective for the first fiscal year beginning after June 15, 2005. FAS 151 clarifies current guidance regarding the classification of costs associated with inventory, such as idle facility costs, freight, handling, and waste. The Company does not believe that the adoption of FAS 151 will have a material affect on the Company's results of operations or financial position.

In December 2004, the FASB issued FAS 123(R) - "Share-Based Payment" ("FAS 123(R)"). FAS 123(R) is effective for the first fiscal year beginning after June 15, 2005. FAS 123(R) changes the way entities account for the issuance of stock-based compensation. In particular, FAS 123(R) requires that entities begin expensing the fair value of stock options. The Company has not yet completed its evaluation of the impact of adopting FAS 123(R). However, it believes that initial adoption of FAS 123(R) will result in expense being recognized for outstanding and unvested stock options and that additional compensation expense will be recognized in subsequent fiscal years.

In May 2005, the FASB issued FAS 154 - "Accounting Changes and Error Corrections - a replacement of APB Opinion No. 20 and Statement No. 3" ("FAS 154"). FAS 154 is effective for the first fiscal year beginning after December 15, 2005. FAS 154 changes the way entities account for accounting changes for which there is no stated transition method and for the correction of accounting errors. The adoption of FAS 154 will only impact the Company's results of operations and financial position to the extent that it adopts accounting methods for which there is no stated transition method or corrects accounting errors in future periods. Therefore, the Company does not believe that the adoption of FAS 154 will have a material affect on its results of operations or financial position.

In March 2006, the FASB issued FAS 156 - "Accounting for Servicing of Financial Assets - an amendment of FASB Statement No. 140" ("FAS 156"). FAS 156 is effective for the first fiscal year beginning after September 15, 2006. FAS 156 changes the way entities account for servicing assets and obligations associated with financial assets acquired or disposed of. The Company has not yet completed its evaluation of the impact of adopting FAS 156 on its results of operations or financial position, but does not expect that the adoption of FAS 156 will have a material impact.

**2. BUSINESS COMBINATIONS AND ASSET ACQUISITIONS**

**CHAS. LEVY CIRCULATING COMPANY LLC ACQUISITION**

On May 10, 2005, the Company and Chas. Levy Company LLC ("Seller") entered into a Unit Purchase Agreement (the "Purchase Agreement"). Under the terms of the Purchase Agreement, the Company purchased all of the issued

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

and outstanding membership interests in Chas. Levy Circulating Co. LLC ("Levy") from Seller for a purchase price of approximately \$30 million, subject to adjustment based on Levy's net worth as of the closing date of the transaction. Seller was the sole member of Levy. In addition, approximately \$19.3 million was also provided on the date of acquisition to Seller to repay all outstanding intercompany debt of Levy. The purchase price and the intercompany debt repayment were funded from the revolving line of credit.

On May 10, 2005, as contemplated by the terms of the Purchase Agreement, the Company and Levy Home Entertainment LLC ("LHE") entered into a Distribution and Supply Agreement (the "Distribution Agreement"). Under the terms of the Distribution Agreement, LHE appointed the Company as its sole and exclusive subdistributor of book products to all supermarkets (excluding supermarkets combined with general merchandise stores), drug stores, convenience stores, newsstands and terminals within the geographic territory in which the Registrant currently distributes DVDs, CDs and/or magazines. The initial term of the Distribution Agreement begins on May 10, 2005 and expires on June 30, 2015. The parties may renew the agreement thereafter for successive one year periods.

The total cost of the acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values in accordance with FAS 141, Business Combinations. Goodwill and other intangible assets, which is deductible for tax purposes, recorded in connection with the transaction totaled \$61.9 million and \$15.9 million, respectively. These amounts will be tested at least annually for impairment in accordance with FAS No. 142, Goodwill and Other Intangible Assets. Deferred tax amounts associated with the acquisition have not been finalized.

The assets acquired and liabilities assumed in the acquisition were recorded in the quarter ended July 31, 2005. The acquisition was accounted for by the purchase method and, accordingly, the results of Levy's operations have been included in our consolidated statements of income since May 10, 2005.

The assets acquired and liabilities assumed in the acquisition are summarized below:

(IN THOUSANDS)	Amount
Cash	\$ 4,276
Trade receivables, net	6,703
Inventories	37,664
Current deferred tax asset	2,726
Non current-deferred tax asset	1,415
Property and equipment	1,539
Goodwill	61,949
Intangible assets	15,865
Other assets	1,728
Accounts payable and accrued liabilities	(67,928)
Long-term debt	(13,359)
Other long-term liabilities	(3,311)
Total consideration	\$ 49,267

**ALLIANCE ENTERTAINMENT CORP. ACQUISITION**

On February 28, 2005, the Company completed its acquisition with Alliance Entertainment Corp. ("Alliance") pursuant to the terms and conditions of the Agreement and Plan of Merger Agreement dated November 18, 2004 (the "Agreement"). Alliance provides full-service distribution of home entertainment products. They provide product and commerce solutions to "brick-and-mortar" and e-commerce retailers, while maintaining trading relationships with major manufacturers in the home entertainment industry. The Company consummated the acquisition to further its objective of creating the premier provider of information, supply chain management and logistics services to retailers and producers of home entertainment content products.

The purchase price of approximately \$315.5 million consisted of \$304.7 million in the Company's common stock, representing approximately 26.9 million shares, \$6.5 million related to the exchange of approximately 0.9 million

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

options to acquire shares of common stock on exercise of outstanding stock options, warrants and other rights to acquire Alliance common stock and direct transaction costs of approximately \$4.3 million. The value of the common stock was determined based on the average market price of Source Interlink common stock over the 5-day period prior to and after the announcement of the acquisition in November 2004. The value of the stock options was determined using the Black-Scholes option valuation model.

The total cost of the acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values in accordance with FAS 141, Business Combinations. Goodwill and other intangible assets, none of which is deductible for tax purposes, recorded in connection with the transaction totaled \$168.9 million and \$94.2 million, respectively. These amounts will be tested at least annually for impairment in accordance with FAS No. 142, Goodwill and Other Intangible Assets.

The assets acquired and liabilities assumed in the acquisition were recorded in the quarter ended April 30, 2005. The acquisition was accounted for by the purchase method and, accordingly, the results of Alliance's operations have been included in our consolidated statements of income since March 1, 2005.

The assets acquired and liabilities assumed in the acquisition are summarized below:

(IN THOUSANDS)	Amount
Cash	\$ 18,567
Trade receivables, net	47,806
Inventories	102,434
Property and equipment	41,881
Goodwill	168,893
Intangible assets	94,214
Other assets	16,326
Accounts payable and accrued liabilities	(158,264)
Obligations under capital leases	(563)
Long-term debt	(11,811)
Other long-term liabilities	(4,000)
	-----
Total consideration	\$ 315,483
	-----

The acquisition was accounted for by the purchase method and, accordingly, the results of Alliance's operations have been included in our consolidated statements of income since March 1, 2005.

**PRO-FORMA OPERATING RESULTS (Unaudited)**

The following table summarizes pro forma operating results as if the Company had completed the acquisition of Alliance and Levy on February 1, 2003:

(IN THOUSANDS, EXCEPT PER SHARE DATA)	Year ended January 31.		
	2006	2005	2004
Revenues	\$ 1,697,003	\$ 1,674,794	\$ 1,519,982
Net income	\$ 12,604	\$ 19,505	\$ (1,747)
Earnings per share - basic			
Continuing operations	\$ 0.28	\$ 0.40	\$ (0.03)
Discontinued operations	(0.03)	(0.02)	--
	-----	-----	-----
Total	\$ 0.25	\$ 0.38	\$ (0.03)
	-----	-----	-----
Earnings per share - diluted			
Continuing operations	\$ 0.27	\$ 0.39	\$ (0.03)
Discontinued operations	(0.03)	(0.02)	--
	-----	-----	-----
Total	\$ 0.24	\$ 0.37	\$ (0.03)
	-----	-----	-----

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

This information has been prepared for comparative purposes only and does not purport to be indicative of the results of operations which actually would have resulted had the acquisitions occurred on February 1, 2003, nor is it indicative of future results.

Merger charges related to the acquisition of Alliance recorded as expenses by the Company through January 31, 2006 totaled \$3.3 million. These expenses represented severance and personnel-related charges, charges to exit certain merchandiser contracts and a success fee paid to certain Company executives. These expenses were not capitalized as they did not represent costs that provide future economic benefits to the Company.

**MAGAZINE IMPORT AND EXPORT ACQUISITION**

In May, 2002, the Company entered into an agreement giving the Company the right to distribute domestically a group of foreign magazine titles. The agreement called for an initial payment of \$2.0 million, \$1.0 million in fiscal 2004 and additional contingent payments up to \$2.5 million spread over the two years ended May 2005 based on the overall gross profit generated from the sale of these titles.

In March, 2003, the Company entered into an agreement giving the Company the right to distribute internationally a group of domestic magazine titles. The agreement called for an initial payment of \$1.4 million, guaranteed payments totaling \$4.2 million spread over the next four fiscal years, and additional contingent payments up to \$5.6 million based on the overall gross profit generated from the Company's international sales of these titles. Guaranteed payments under both of these agreements were capitalized at inception and were included in intangible assets and were being amortized over fifteen years, the term of the agreements.

In November 2004, these distribution agreements were terminated when the Company acquired all import and export assets, WMS, Inc. naming rights and other intangibles including a non-compete by the seller. The purchase price of the import and export businesses was approximately \$14.1 million (after an allowed reduction of the purchase price for the payments made by the Company under the prior lease agreements). The purchase price was comprised of \$4.2 million paid in cash on the last business day of November 2004 and additional notes payable in the principal amount of \$7.7 million. The first note of \$8.9 million is payable over 13 quarters in equal installments of \$0.7 million. In addition, a second note payable in the amount of \$1.0 million is payable in full on May 1, 2005.

Since the company has historically operated these magazine import and export businesses under leases, included in the magazine fulfillment segment, results of operations for the import and export businesses are included in the statement of operations for the years ended January 31, 2006, 2005 and 2004 respectively. Thus, this acquisition was not material to the Company's operations.

Under the original export lease agreement, the Company agreed to pay the prior owner's outstanding trade payables out of the collections of the prior owner's outstanding receivables. Amounts collected in excess of payments made or payments in excess of collection are to be settled at a future date. The balance was paid in full in November 2004.

In conjunction with this acquisition, the assets liabilities were allocated as follows (in thousands):

Intangible assets:	
Goodwill	8,529
Customer lists and non-compete agreement	3,400
Total assets acquired	11,929
Less: Additional notes payable issued	(7,717)
Total cash paid	\$ 4,212
	=====

**PROMAG RETAIL SERVICES, LLC ACQUISITION**

In August 2004, the Company acquired all customer based intangibles (i.e., all market composition, market share and other value) of the claiming and information services of PROMAG Retail Services, LLC ("Promag") for approximately \$13.2 million. Of the \$13.2 million purchase price, \$10.0 million was funded from a note payable with Wells Fargo Foothill noted in Footnote 7 and \$0.75 million in a promissory note payable over a three year period to Promag in quarterly installments of approximately \$0.05. The results of Promag's operations have been included in our consolidated statements of income since August 1, 2004.

Promag provides claim filing services related to rebates owed retailers from publishers or their designated agent throughout the United States and Canada. Goodwill and other intangible assets recorded in connection with the transaction totaled \$13.2 million. The intangible assets are subject to amortization and consist primarily of customer contracts and non-compete agreements that are amortized on a straight-line basis over a weighted-average useful life of 12.77 years. The fair value assigned to intangible assets and the related weighted-average useful life was based on valuations prepared by an independent third party appraisal firm using estimates and assumptions

provided by management. The goodwill and intangible assets were assigned entirely to our In-Store Services segment. This acquisition was not material to the Company's operations.

In conjunction with this acquisition, the assets liabilities were allocated as follows (in thousands):

Intangible assets:	
Goodwill	8,723
Customer lists and non-compete agreement	4,500
Total assets acquired	13,223
Less: Note payable issued	(750)
	-----
Total cash paid	\$12,473
	=====

### EMPIRE STATE NEWS CORP. ACQUISITION

In September 2004, the Company acquired substantially all of the operating assets and liabilities of Empire State News Corp. ("Empire"), a magazine wholesaler in northwest New York State for approximately \$5.0 million. The purchase price consisted of \$3.4 million of cash paid and \$1.6 million of deferred consideration in the form of two notes payable (see Footnote 7) and deferred consideration, subject to finalization of working capital adjustments in accordance with the purchase agreement. The results of Empire's operations have been included in our consolidated statements of income since September 26, 2004. The total cost of the acquisition was allocated to the assets acquired and liabilities assumed based on their respective fair values in accordance with FAS 141, Business Combinations ("FAS 141"). Goodwill recorded in connection with the transaction totaled \$8.7 million. The fair value assigned to goodwill was based on valuations prepared by an independent third party appraisal firm using estimates and assumptions provided by management. The goodwill was assigned entirely to our Magazine Fulfillment segment. This acquisition was not material to the Company's operations.

In conjunction with this acquisition, the assets liabilities were allocated as follows (in thousands):

Current assets:	485
Fixed assets	1,902
Goodwill	8,612
Total assets acquired	10,999
Less: Current liabilities	(6,080)
Less: Note payable issued	(1,200)
Less: Other long-term liabilities	(367)
	-----
Total cash paid	\$ 3,352
	=====

### 3. TRADE RECEIVABLES

Trade receivables consist of the following:

(IN THOUSANDS)	January 31,	
	2006	2005
Trade receivables	\$ 343,882	\$ 129,031
Less allowances for:		
Sales returns and other	193,418	78,404
Doubtful accounts	20,682	2,549
	-----	-----
Total allowances	214,100	80,953
	-----	-----
Trade receivables, net	\$ 129,782	\$ 48,078
	=====	=====

### 4. INVENTORIES

Inventories consist of the following:

(IN THOUSANDS)	January 31,	
	2006	2005
Raw materials	\$ 2,652	\$ 2,657
Work-in-process	3,458	1,459
Finished goods:		
Pre-recorded music and video	131,601	--
Magazine and book	57,827	1,407
Fixtures	2,945	11,345
	-----	-----
Total inventories	\$ 198,483	\$ 16,868
	=====	=====

In the event of non-sale, pre-recorded music and video, magazine and book inventories are generally returnable to the suppliers thereof for full credit.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**5. PROPERTY, PLANTS AND EQUIPMENT**

Property, plants and equipment consist of the following:

(IN THOUSANDS)	January 31,	
	2006	2005
Land	\$ 8,418	\$ 870
Buildings	17,206	8,809
Leasehold improvements	5,768	2,566
Machinery and equipment	31,649	10,806
Vehicles	494	354
Furniture and fixtures	6,809	3,855
Computers	15,870	9,446
Construction in progress	3,757	--
Total property, plants and equipment	\$ 89,971	\$ 36,706

Depreciation expense from property, plants and equipment was \$8.9 million, \$3.8 million and \$3.3 million for the fiscal years ended January 31, 2006, 2005 and 2004, respectively.

**6. GOODWILL AND INTANGIBLE ASSETS**

A summary of the Company's intangible assets is as follows:

(IN THOUSANDS)	January 31,	
	2006	2005
Amortized intangible assets:		
Customer lists	\$ 111,320	\$ 16,025
Non-compete agreements	2,250	1,000
Software	16,492	--
Total intangibles	130,062	17,025
Accumulated amortization:		
Customer lists	(8,133)	(836)
Non-compete agreements	(556)	(42)
Software	(2,385)	--
Total accumulated amortization	(11,074)	(899)
Intangibles, net	\$ 118,988	\$ 16,126

Amortization expense from intangible assets was \$10.2 million, \$1.2 million and \$0.7 million for the fiscal years ended January 31, 2006, 2005 and 2004, respectively.

Amortization expense for each of the five succeeding years is estimated to be \$11.4 million per year.

Changes in the carrying amount of goodwill for the year ended January 31, 2006 are as follows:

(IN THOUSANDS)	CD and DVD Fulfillment	Magazine Fulfillment	In-Store Services	Consolidated
Balance, January 31, 2005	\$ --	\$ 17,258	\$ 54,342	\$ 71,600
Additions	168,898	61,949		230,847
Foreign currency translation adjustments	--	--	452	452
Working capital adjustments	--	(606)	--	(606)
Balance, January 31, 2006	\$ 168,898	\$ 78,601	\$ 54,794	\$ 302,293

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**7. DEBT AND REVOLVING CREDIT FACILITY**

Debt consists of:

(IN THOUSANDS)	January 31,	
	2006	2005
Revolving credit facility - Wells Fargo Foothill	\$ 45,001	\$ 19,289
Note payable - Wells Fargo Foothill	--	8,766
Note payable - Magazine import and export	6,227	9,879
Note payable - Former owner of Empire	717	1,200
Note payable - Arrangements with suppliers	11,815	--
Mortgage loan - Wachovia Bank	20,000	--
Equipment loans - SunTrust Leasing	3,216	--
Other	259	635
	-----	-----
Total debt	87,235	39,769
Less current maturities	6,508	5,630
	-----	-----
Debt, less current maturities	\$ 80,727	\$ 34,139
	-----	-----

**WELLS FARGO Foothill CREDIT FACILITY**

On February 28, 2005, the Company modified its existing credit facility with Wells Fargo Foothill ("WFF") as a result of its acquisition of Alliance Entertainment Corp. The primary changes from the original line of credit were to (1) increase the maximum allowed advances under the line of credit from \$45.0 million to \$250.0 million and (2) extend the maturity date from October 2009 to October 2010. In addition, in conjunction with the modification of the existing credit facility, the Company repaid the balance of its \$10.0 million WFF term loan. WFF, as arranger and administrative agent for each of the parties that may become a participant in such arrangement and their successors ("Lenders") will make revolving loans to us and our subsidiaries of up to \$250.0 million including the issuance of letters of credit. The terms and conditions of the arrangement are governed primarily by the Amended and Restated Loan Agreement dated February 28, 2005 by and among us, our subsidiaries, and WFF.

Outstanding borrowings bear interest at a variable annual rate equal to the prime rate announced by Wells Fargo Bank, National Association's San Francisco office, plus a margin of between 0.0% and 1.00% (applicable margin was 0.0% at January 31, 2006) based upon a ratio of the Company's EBITDA to interest expense ("Interest Coverage Ratio"). At January 31, 2006 the prime rate was 7.5%. We also have the option of selecting up to five tranches of at least \$1 million each to bear interest at LIBOR plus a margin of between 2.00% and 3.00% based upon our Interest Coverage Ratio. The Company has 3 LIBOR contracts outstanding at January 31, 2006 (expiring through February 2006) and bear interest at a weighted average rate of approximately 6.4%. To secure repayment of the borrowings and other obligations of ours to the Lenders, we and our subsidiaries granted a security interest in all of the personal property assets to WFF, for the benefit of the Lenders. These loans mature on October 31, 2010.

Under the credit agreement, the Company is limited in its ability to declare dividends or other distributions on capital stock or make payments in connection with the purchase, redemption, retirement or acquisition of capital stock. There are also limitations on capital expenditures and the Company is required to maintain certain financial ratios. The Company was in compliance with these ratios at January 31, 2006.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

Availability under the facility is limited by the Company's borrowing base calculation, as defined in the agreement. The calculation resulted in excess availability, after consideration of outstanding letters of credit, of \$195.5 million at January 31, 2006.

WFF and its affiliates together beneficially held 2,631,568 shares, or 5.09%, of the Company's outstanding common stock as of January 31, 2006. The Company did not engage in any material transactions with WFF during the year ended January 31, 2006, other than those listed above.

**EQUIPMENT LOANS**

Through the acquisition of Alliance, the Company entered into a loan agreement with SunTrust Leasing Corporation (the "SunTrust Loan") for the purchase of equipment to be used at various locations. A credit line of \$6.8 million was approved under the SunTrust Loan, with repayment terms for five promissory notes ranging from three to five years. The total principal balance of the SunTrust Loan outstanding as of January 31, 2006 was \$3.2 million.

**SUPPLIER LOANS**

Through the acquisition of Levy, the Company assumed four notes payable with suppliers (the "Supplier Loans") totaling \$14.0 million. The maturity dates of the supplier notes range between March 2007 and August 2014 and bear interest at 5%. Principal repayments range from \$1.0 to \$2.0 million per fiscal year with \$1.6 million and \$1.7 million due to be repaid in fiscal year 2007 and 2008, respectively. The total principal balance of the supplier loans as of January 31, 2006 is \$11.8 million.

**MORTGAGE LOAN**

The Company obtained a 10 year, \$20.0 million conventional mortgage loan through Wachovia Bank (the "Wachovia Mortgage"). The Wachovia Mortgage is collateralized by land and building located in Coral Springs, FL. The Wachovia Mortgage monthly principal payments are approximately \$0.08 million beginning in October 2006 plus interest at a rate of LIBOR plus a margin of 1.60%. At the end of the 10 year term, a balloon payment in the amount of \$11.1 million is due and payable.

**MAGAZINE IMPORT AND EXPORT NOTES**

Concurrent with the magazine import and export acquisition in November 2004, the Company issued an additional \$7.7 million in notes payable. At January 31, 2006, the balance on all magazine import and export notes was \$6.2 million. These notes bear interest at a rate of 2.37% and require quarterly payments through February, 2008.

The aggregate amount of debt maturing in each of the next five fiscal years is as follows:

(IN THOUSANDS)	Amount
-----	-----
Fiscal year:	
2007	\$ 6,508
2008	6,970
2009	4,239
2010	2,509
2011	46,951
Thereafter	20,058
	-----
Total	\$ 87,235
	-----

At January 31, 2006 and 2005, unamortized deferred financing fees were approximately \$2.2 million and \$1.8 million, respectively.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**8. DISCONTINUED OPERATION**

In November 2004, the Company sold and disposed of its secondary wholesale distribution operation for \$1.4 million, in order to focus more fully on its domestic and export distribution. All rights owned under the secondary wholesale distribution contracts were assigned, delivered, conveyed and transferred to the buyer, an unrelated third party. All assets and liabilities of the secondary wholesale distribution operation were not assumed by the buyer. The Company recognized a gain on sale of this business of \$1.4 million (\$0.8 net of tax) in the fourth quarter of fiscal year 2005.

The following amounts related to the Company's discontinued operation have been segregated from continuing operations and reflected as discontinued operations:

(IN THOUSANDS)	Year ended January 31,		
	2006	2005	2004
Revenue	\$ --	\$ 13,380	\$ 17,343
Loss before income taxes	\$ (2,410)	\$ (3,033)	\$ (191)
Income tax benefit	964	1,213	76
Loss from discontinued operation, net of tax	(1,446)	(1,820)	(115)
Pre-tax gain on sale of discontinued business	--	1,400	--
Income tax expense	--	(560)	--
Gain on sale of business, net of tax	--	840	--
Discontinued operations, net of tax	\$ (1,446)	\$ (980)	\$ (115)

**9. EARNINGS PER SHARE**

A reconciliation of the denominators of the basic and diluted earnings per share computation are as follows:

(IN THOUSANDS)	Year ended January 31,		
	2006	2005	2004
Weighted average number of common shares outstanding - basic	49,097	22,963	18,476
Effect of dilutive securities:			
Stock options and warrants	1,797	1,870	1,390
Weighted average number of common shares outstanding - diluted	50,894	24,833	19,866
The following securities were excluded because their effect would be anti-dilutive:			
Stock options and warrants	864	251	843

**10. INCOME TAXES**

Provision (benefit) for federal and state income taxes in the consolidated statements of income for the income from continuing operations before income taxes consists of the following components:

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS)	Year ended January 31.		
	2006	2005	2004
Current			
Federal	\$ 4,701	\$ 2,627	\$ 3,292
State	1,265	539	580
Foreign	1,192	444	482
Total current	7,158	3,610	4,354
Deferred			
Federal	5,916	(1,608)	(694)
State	1,479	466	(9)
Foreign	--	(240)	39
Total deferred	7,395	(1,382)	(664)
Total income tax expense	\$ 14,553	\$ 2,228	\$ 3,690

The following summary reconciles income taxes for continuing operations at the maximum federal statutory rate with the effective rates for 2006, 2005 and 2004:

(IN THOUSANDS)	Year ended January 31.		
	2006	2005	2004
Income tax expense at statutory rate	\$ 10,107	\$ 5,351	\$ 4,848
Permanent difference relating to non-deductible amortization of intangibles	2,263	--	--
Change in valuation allowance	--	(4,104)	(3,208)
State income tax expense, net of federal income tax benefit	1,894	653	371
Difference in foreign tax rates	13	(61)	(104)
Other, net	276	389	1,783
Income tax expense	\$ 14,553	\$ 2,228	\$ 3,690

Components of income from continuing operations before income taxes are as follows:

(IN THOUSANDS)	Year ended January 31.		
	2006	2005	2004
United States	\$ 26,832	\$ 14,259	\$ 12,065
Foreign	2,046	1,031	1,788
Total income from continuing operations	\$ 28,878	\$ 15,290	\$ 13,853

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amount of the assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The sources of the temporary differences and their effect on deferred taxes are as follows:

(IN THOUSANDS)	January 31.	
	2006	2005
Deferred tax assets		
Net operating loss carryforwards	\$ 4,122	\$ 4,576
Allowance for doubtful accounts	8,056	1,025
Goodwill	--	456
Payroll related items	2,222	312

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

Deferred revenue	1,246	882
Inventory reserve	2,456	--
Other	3,144	606
	-----	-----
Total deferred tax asset	21,246	7,857
	-----	-----
Deferred tax liabilities		
Book/tax difference in capital assets	7,448	1,791
Goodwill	1,149	--
Prepaid expenses	772	861
	-----	-----
Total deferred tax liabilities	9,369	2,652
	-----	-----
Net deferred tax asset	\$ 11,877	\$ 5,205
	=====	=====
Classified as:		
Current asset	\$ 16,403	\$ 2,302
Long-term (liability) asset	(4,526)	2,903
	-----	-----
Net deferred tax asset	\$ 11,877	\$ 5,205
	=====	=====

At January 31, 2006, the Company had net operating loss ("NOL") carryforwards of approximately \$11.8 million expiring in 2019.

Internal Revenue Service regulations limit the utilization of these operating losses to approximately \$1.2 million per year. At January 31, 2006, the Company assessed the future utilization of its deferred tax assets, including NOL carryforwards and determined that it is more likely than not that the benefit of such deferred tax assets will be realized and a valuation allowance is not necessary.

#### 11. RELATED PARTY TRANSACTIONS

The Company purchased legal services from Armstrong Teasdale LLP totaling approximately less than \$0.1, \$0.3 and \$0.7 million for the years ended January 31, 2006, 2005 and 2004, respectively.

Pursuant to an agreement through August 2007, the Company conducts significant business with one customer distributing magazines, music and DVDs. The Chairman and major stockholder of this customer is a passive minority investor of AEC Associates, the Company's largest shareholder. During the fiscal year ended January 31, 2006, the Company had revenues of \$421.0 million related to this customer and this customer's subsidiaries.

AEC Associates is the majority stockholder of Digital On-Demand, Inc. In connection with the spin-off of certain assets by Alliance to Digital On-Demand, Inc. which occurred prior to the merger, Alliance and Digital On-Demand, Inc. entered into a number of agreements including a distribution and separation agreement, licensing and co-marketing agreement, transition/shared services agreement and tax-sharing and indemnification agreement. We assumed the rights and obligations of Alliance under these agreements upon consummation of our merger with Alliance.

Carol Kloster, one of our executive officers, is a Director of Chas. Levy Company, LLC, formerly the sole member of Chas. Levy Circulating Co. LLC. Concurrent with our acquisition of Chas. Levy Circulating Co. LLC, we entered into an agreement with Levy Home Entertainment, LLC, a wholly owned subsidiary of Chas. Levy Company, LLC to purchase book product for distribution to our customers. During the period beginning in May 2005 and ending January 31, 2006, we purchased \$23.1 million in book product from Levy Home Entertainment, net of returns.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**12. COMMITMENTS AND CONTINGENCIES**

**LEASES**

The Company leases office and manufacturing space, computer equipment and vehicles under leases that expire over the next 15 years. Management expects that in the normal course of business, leases will be renewed or replaced with other leases.

Rent expense was approximately \$9.2 million, \$5.5 million and \$5.9 million for the years ended January 31, 2006, 2005 and 2004, respectively.

Future minimum payments, by year and in the aggregate, under non-cancelable operating leases with initial or remaining terms of year or more consisted of the following at January 31, 2006:

(IN THOUSANDS)	Amount
Fiscal year:	
2007	\$ 11,367
2008	9,561
2009	8,609
2010	7,499
2011	4,970
Thereafter	16,245
 Total	 \$ 58,251

**CHALLENGE GRANT PROGRAM**

On March 1, 2005 the Company adopted the Challenge Grant Program (the "Program") to incentivize key executive personnel to maximize shareholder value resulting from the Alliance Entertainment Corp. acquisition. The effective date of the Program is March 1, 2005 and is in effect for the three year period commencing February 1, 2005 and ending January 31, 2008.

The Aggregate Payout under the Program shall be equal to that amount set forth in the following table opposite the applicable range which encompasses the cumulative operating income, as defined, over the three year period:

Greater Than	Less Than or Equal to	Aggregate Payout
\$0	\$195.2 million	\$0
\$195.2 million	\$202.8 million	\$2.50 million
\$202.8 million	\$210.4 million	\$5.00 million
\$210.4 million	\$218.0 million	\$7.50 million
\$218.0 million	\$227.2 million	\$10.00 million
\$227.2 million	\$236.4 million	\$11.00 million
\$236.4 million	\$245.6 million	\$12.00 million
\$245.6 million	\$254.8 million	\$13.00 million
\$254.8 million	\$264.0 million	\$14.00 million
\$264.0 million	Unlimited	\$15.00 million

The Aggregate Payout, if any, shall be allocated among the Executives in such amounts and proportions as may be determined by the Chief Executive Officer with, in the case of Executives that are also officers of the Corporation subject to the reporting requirements of Section 16 promulgated under the Securities Exchange Act of 1934, as amended, the approval of the Compensation Committee of the Board of Directors; provided however that 35% of the Aggregate Payout shall be allocated to S. Leslie Flegel. Based on current performance and projected performance levels, the Company has not accrued any aggregate payout related to the Program at January 31, 2006.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

If a Change of Control, as defined, shall occur during the Challenge Period, the Aggregate Payout under the Program shall be equal to that amount set forth in the following table opposite the applicable period in which the Change of Control occurs.

Twelve Month Period Ending	Aggregate Payout
January 31, 2006	\$10.0 million
January 31, 2007	\$12.5 million
January 31, 2008	\$15.0 million

**LITIGATION**

The Company has pending certain legal actions and claims, which were incurred in the normal course of business, and is actively pursuing the defense thereof. In the opinion of management, these actions and claims are either without merit or are covered by insurance and will not have a material adverse effect on the Company's financial condition, results of operations or liquidity.

**13. EMPLOYEE BENEFIT PLANS**

Under the Company's stock option plans, options to acquire shares of Common Stock have been made available for grant to certain employees and non-employee Directors. Each option granted has an exercise price of not less than 100% of the market value of the Common Stock on the date of grant. The contractual life of each option is generally 10 years. The vesting of the grants varies according to the individual options granted.

	Number of Options	Range of Exercise Prices		Weighted
		Low	High	Average Exercise Price
Options outstanding at January 31, 2003	4,840,917	\$ 2.42	\$ 21.60	\$ 7.09
Options granted	826,750	4.56	9.66	5.09
Options forfeited or expired	(141,972)	4.21	16.63	7.29
Options exercised	(623,661)	2.42	5.94	4.52
Options outstanding at January 31, 2004	4,901,034	2.42	21.60	7.07
Options granted	223,500	8.58	12.55	9.40
Options forfeited or expired	(586,089)	4.56	21.60	12.37
Options exercised	(982,446)	2.42	8.04	5.53
Options outstanding at January 31, 2005	3,555,999	2.42	21.60	6.48
Options granted	587,500	9.79	11.00	10.95
Options acquired	807,107	1.77	9.21	7.07
Options forfeited or expired	(28,923)	1.77	16.63	7.14
Options exercised	(994,493)	1.77	9.75	4.85
Options outstanding at January 31, 2006	3,927,190	\$ 2.30	\$ 18.31	\$ 7.64

The following table summarizes information about the stock options outstanding at January 31, 2006:

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Exercise Price	Remaining Contractual Life (Months)	Number Exercisable	Weighted Average Exercise Price
Range of exercise prices:					
\$2.30 - \$5.00	1,168,708	\$ 4.52	17 - 84	1,168,708	\$ 4.52
\$5.01 - \$7.50	693,550	5.31	24 - 82	693,550	5.31
\$7.51 - \$10.00	1,044,032	8.55	2 - 112	998,365	8.55
\$10.01 - \$15.00	913,000	11.29	37 - 112	835,667	11.32
\$15.01 - \$18.31	107,900	16.61	46 - 50	107,900	16.61
Total	3,927,190	\$ 7.64	2 - 112	3,804,190	\$ 7.56

Options exercisable at January 31, 2005 and 2004 totaled 2,894,983 and 4,281,918, respectively and had weighted average exercise prices of \$6.65 and \$7.35, respectively.

The weighted average fair value of each option granted during the year was \$4.08, \$3.40 and \$1.82 (at grant date) in 2006, 2005 and 2004, respectively. The options were issued at exercise prices which were equal to or exceeded the quoted market price of the Company's Common Stock on the date of grant. At January 31, 2006, there were 290,522 options remaining, under the Company stock option plans.

**PROFIT SHARING AND 401(k) PLAN**

The Company has a combined profit sharing and 401(k) Plan. Annual contributions to the profit sharing portion of the Plan are determined by the Board of Directors and may not exceed the amount that may be deducted for federal income tax purposes. There were no profit sharing contributions charged against operations for the years ended January 31, 2006, 2005 and 2004.

Under the 401(k) portion of the Plan, all eligible employees may elect to contribute 2% to 20% of their compensation up to the maximum allowed under the Internal Revenue Code. The Company matches one half of an employee's contribution, not to exceed 5% of the employee's salary. The amounts matched by the Company during the years ended January 31, 2006, 2005 and 2004 pursuant to this Plan were approximately \$1.4 million, \$0.3 million and \$0.4 million, respectively.

**UNION PLAN**

At January 31, 2006, 385 of the Company's 6,206 employees were members of a collective bargaining unit. The Company is party to three collective bargaining agreements, which expire at various times through October 31, 2008. Contributions to the union funds were approximately \$0.7 million, \$0.3 million and \$0.4 million for the years ended January 31, 2006, 2005, and 2004, respectively.

**SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN**

The Company also provides an Supplemental Executive Retirement Plan ("SERP") that is designed to supplement the retirement benefits available through the Company's other savings plans to certain of the Company's executive officers. The minimum SERP liability is measured at year-end.

The accumulated year-end SERP benefit obligation, based on a discount rate of 7.00%, was \$0.7 million at January 31, 2006 and is reflected in the Consolidated Balance Sheets as a liability. Benefits are funded by the Company through a Rabbi Trust. The year-end balance included in Other Assets was \$1.1 million at January 31, 2006.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**14. WARRANTS**

The following table summarizes information about the warrants for common stock outstanding at January 31, 2006:

	Number Outstanding	Number Exercisable	Grant Date	Expiration Date
Exercise price:				
\$ 6.82	150,000	150,000	10/23/2003	10/23/2013
\$ 8.04	338,667	338,667	10/30/2003	10/3/2008
\$ 8.58	35,000	11,667	8/30/2004	8/30/2014
\$ 11.62	10,000	10,000	4/4/2005	4/4/2015

**15. SUPPLEMENTAL CASH FLOW INFORMATION**

Supplemental information on the approximate amount of interest and income taxes paid (refunded) is as follows:

(IN THOUSANDS)	Year ended January 31.		
	2006	2005	2004
Interest	\$ 6,303	\$ 2,168	\$ 3,945
Income taxes	\$ 6,606	\$ 359	\$ (2,962)

Significant non-cash activities were as follows:

**YEAR ENDED JANUARY 31, 2006**

On February 28, 2005, as discussed in Note 2, the Company acquired Alliance Entertainment Corp. for the total consideration of \$315.5 million as follows:

(IN THOUSANDS)	Amount
Fair value of common stock issued to Alliance shareholders	\$ 304,714
Fair value of options to purchase common stock issued to Alliance shareholders	6,500
Cash paid for direct acquisition costs (of which, \$1.7 million were paid during the year ended January 31, 2005)	4,269
Total purchase price for acquisition of Alliance	\$ 315,483

The total purchase price was allocated to the assets and liabilities of Alliance Entertainment Corp. as disclosed in Note 2.

**YEAR ENDED JANUARY 31, 2005**

In conjunction with the acquisition of Empire State News Corp., the Company incurred \$1.6 million of deferred consideration in the form of two notes payable totaling \$1.2 million (see Note 7) and deferred compensation of \$0.4 million, subject to finalization of working capital adjustments in accordance with the purchase agreement.

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

In conjunction with the acquisition of WMS, Inc., the Company issued an addition \$7.7 million in notes payable to acquire all import and export assets, naming rights and other intangibles, including a non-compete by the seller (see Note 7).

The Company paid in full a note payable it had with Hilco Capital and wrote off the original issue discount of \$0.9 million and the unamortized deferred financing fees of \$0.64 million.

**YEAR ENDED JANUARY 31, 2004**

In connection with a magazine export agreement entered into with WMS, Inc., a liability of \$4.2 million was recognized for the guaranteed payments owed under the agreement.

In connection with the with establishment of the Wells Fargo Foothill credit facility, the outstanding balances (including any accrued but unpaid interest and fees) with Bank of America and Congress Financial were paid in full. Termination of our existing facilities resulted in a write-off of the related unamortized deferred financing fees of \$0.9 million.

**16. SHAREHOLDERS' EQUITY**

In February 2005, the Company issued 26.9 million shares of common stock to the former shareholders of Alliance Entertainment Corp. as partial consideration for the Company's acquisition of Alliance at a value of approximately \$304.7 million, valued at the average market price over the 5 day period preceding and following the announcement of the acquisition. The Company also exchanged 0.9 million Alliance stock options, which were valued using the Black-Scholes option pricing model and assumptions substantially the same as those presented in Note 1.

Also in February 2005, the Company reincorporated from Missouri into Delaware, and retired 100,000 shares of stock it held in treasury.

In March 2004, the Company completed the sale of 3.8 million shares of common stock at \$11.50 per share, excluding underwriting discounts and expenses. Net proceeds to the Company of approximately \$40.5 million, after costs of issuance of \$3.2 million, were utilized to repay the Wells Fargo Foothill note payable and revolving credit facility and all but a nominal amount on the Hilco Capital note payable in March 2004.

In October 2003, the Company issued 400,000 warrants to purchase shares of the Company's common stock at \$8.04 per share. The warrants were valued at \$0.9 million using the Black-Scholes option pricing model.

**17. SEGMENT FINANCIAL REPORTING**

The Company's segment reporting is based on the reporting of senior management to the Chief Executive Officer. This reporting combines the Company's business units in a logical way that identifies business concentrations and synergies.

The reportable segments of the Company are CD and DVD Fulfillment, Magazine Fulfillment, In-Store Services, and Shared Services. The accounting policies of the segments are materially the same as those described in the Summary of Accounting Policies.

Based on the comparability of the operations, Levy's results are included in the Magazine Fulfillment group. As a result of the acquisition of Alliance on February 28, 2005, the Company created a CD and DVD Fulfillment reporting segment. Based on the reporting of the senior management, the previous Wood Manufacturing group's results are included in the In-Store Services group. The results for the years ended January 31, 2005 and 2004 have been restated to conform to this presentation.

The CD and DVD Fulfillment segment derives revenues from (1) selling and distributing pre-recorded music, videos, video games and related products to retailers, (2) providing product and commerce solutions to "brick-and-mortar" and e-commerce retailers, and (3) providing consumer-direct fulfillment and vendor managed inventory services to its customers.

The Magazine Fulfillment segment derives revenues from (1) selling and distributing magazines, including domestic and foreign titles, to major specialty and mainstream retailers and wholesalers throughout the United States and Canada,

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(2) exporting domestic titles internationally to foreign wholesalers or through domestic brokers, (3) providing return processing services for major specialty retail book chains and (4) serving as an outsourced fulfillment agent.

The In-Store Services segment derives revenues from (1) designing, manufacturing, and invoicing participants in front-end fixture programs, (2) providing claim filing services related to rebates owed retailers from publishers or their designated agent, (3) designing, manufacturing, shipping, installation and removal of front-end fixtures, including high end wood and wire and (4) providing information and management services relating to retail magazine sales to U.S. and Canadian retailers and magazine publishers.

Shared Services consists of overhead functions not allocated to individual operating segments.

The segment results are as follows:

(IN THOUSANDS)	CD and DVD Fulfillment	Magazine Fulfillment	In-Store Services	Shared Services	Consolidated
<b>YEAR ENDED JANUARY 31, 2006</b>					
Revenues	\$ 889,380	\$ 566,438	\$ 71,633	\$ --	\$ 1,527,451
Cost of revenues	733,173	437,869	48,955	--	1,219,997
Gross profit	156,207	128,569	22,678	--	307,454
Selling, general and administrative expense	79,564	68,488	8,515	21,300	177,867
Fulfillment freight	30,993	41,813	--	--	72,806
Depreciation and amortization	11,147	4,446	601	2,019	18,213
Relocation expense	--	--	--	--	--
Merger and acquisition costs	--	--	344	2,975	3,319
Operating income (loss)	<u>\$ 34,503</u>	<u>\$ 13,822</u>	<u>\$ 13,218</u>	<u>\$ (26,294)</u>	<u>\$ 35,249</u>
Capital Expenditures	\$ 8,469	\$ 1,576	\$ 623	\$ 2,401	\$ 13,069
<b>AS OF JANUARY 31, 2006</b>					
Total assets	\$ 507,546	\$ 205,782	\$ 109,762	\$ 57,525	\$ 884,472
Goodwill, net	\$ 168,898	\$ 78,601	\$ 54,794	\$ --	\$ 302,293
Intangibles, net	\$ 87,742	\$ 27,374	\$ 3,872	\$ --	\$ 118,988
<b>(IN THOUSANDS)</b>					
<b>YEAR ENDED JANUARY 31, 2005</b>					
Revenues	\$ --	\$ 280,171	\$ 76,473	\$ --	\$ 356,644
Cost of revenues	--	210,639	48,212	--	258,851
Gross profit	--	69,532	28,261	--	97,793
Selling, general and administrative expense	--	28,481	9,154	13,744	51,379
Fulfillment freight	--	21,067	--	--	21,067
Depreciation and amortization	--	1,392	504	1,855	3,751
Relocation expense	--	2,090	360	--	2,450
Loss on sale of land and building	--	--	--	1,122	1,122
Operating income (loss)	<u>\$ --</u>	<u>\$ 16,502</u>	<u>\$ 18,243</u>	<u>\$ (16,721)</u>	<u>\$ 18,024</u>
Capital Expenditures	\$ --	\$ 2,379	\$ 279	\$ 4,488	\$ 7,146
<b>AS OF JANUARY 31, 2005</b>					
Total assets	\$ --	\$ 69,116	\$ 109,172	\$ 19,465	\$ 197,753
Goodwill, net	\$ --	\$ 17,258	\$ 54,342	\$ --	\$ 71,600
Intangibles, net	\$ --	\$ 11,800	\$ 4,326	\$ --	\$ 16,126

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS)	CD and DVD Fulfillment	Magazine Fulfillment	In-Store Services	Shared Services	Consolidated
YEAR ENDED JANUARY 31, 2004					
Revenues	\$ --	\$ 238,471	\$ 77,320	\$ --	\$ 315,791
Cost of revenues	--	179,460	50,288	--	229,748
Gross profit	--	59,011	27,032	--	86,043
Selling, general and administrative expense	--	25,474	9,357	12,881	47,712
Fulfillment freight	--	16,381	--	--	16,381
Depreciation and amortization	--	1,076	261	1,489	2,826
Relocation expense	--	1,654	--	76	1,730
Operating income (loss)	\$ --	\$ 14,426	\$ 17,414	\$ (14,446)	\$ 17,394
Capital Expenditures	\$ --	\$ 312	\$ 407	\$ 1,394	\$ 2,113
AS OF JANUARY 31, 2004					
Total assets	\$ --	\$ 47,718	\$ 98,207	\$ 18,176	\$ 164,101
Goodwill, net	\$ --	\$ --	\$ 45,307	\$ --	\$ 45,307
Intangibles, net	\$ --	\$ 7,824	\$ 107	\$ --	\$ 7,931

Approximately \$31.7 million, \$38.5 million, and \$32.0 million of our total revenues in the Magazine Fulfillment segment for the years ended January 31, 2006, 2005 and 2004, respectively, were derived from the export of U.S. publications to overseas markets. For the years ended January 31, 2006, 2005 and 2004, identifiable assets attributable to the export of U.S. publications were \$14.3 million, \$18.0 million and \$16.4 million, respectively.

**18. SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

Quarterly financial data for 2005 has been restated due to the discontinued operation as discussed in Note 8 and is as follows:

(IN THOUSANDS)	Three months ended			
	April 30	July 31	October 31	January 31
2006				
Revenues	\$ 234,421	\$ 393,790	\$ 425,859	\$ 473,381
Gross profit	\$ 50,545	\$ 78,989	\$ 86,084	\$ 91,826
Income from continuing operations	\$ 1,671	\$ 4,076	\$ 6,083	\$ 2,495
Income (loss) from discontinued operation	\$ --	\$ (1,446)	\$ --	\$ --
Net income	\$ 1,671	\$ 2,630	\$ 6,083	\$ 2,495
Earnings (loss) per share - Basic				
Continuing operations	\$ 0.04	\$ 0.08	\$ 0.12	\$ 0.05
Discontinued operation	--	(0.03)	--	--
Total	\$ 0.04	\$ 0.05	\$ 0.12	\$ 0.05
Earnings (loss) per share - Diluted				
Continuing operations	\$ 0.04	\$ 0.08	\$ 0.11	\$ 0.05
Discontinued operation	--	(0.03)	--	--
Total	\$ 0.04	\$ 0.05	\$ 0.11	\$ 0.05

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

2005					
Revenues	\$ 82,181	\$ 86,858	\$ 90,756	\$ 96,849	
Gross profit	\$ 22,079	\$ 23,676	\$ 25,710	\$ 26,328	
Income from continuing operations	\$ 633	\$ 4,063	\$ 4,029	\$ 4,337	
Income (loss) from discontinued operation	\$ (135)	\$ 74	\$ 349	\$ (1,268)	
Net income	\$ 497	\$ 4,138	\$ 4,378	\$ 3,069	
Earnings (loss) per share - Basic					
Continuing operations	\$ 0.03	\$ 0.17	\$ 0.17	\$ 0.18	
Discontinued operation	(0.01)	0.01	0.02	(0.05)	
Total	\$ 0.02	\$ 0.18	\$ 0.19	\$ 0.13	
Earnings (loss) per share - Diluted					
Continuing operations	\$ 0.03	\$ 0.17	\$ 0.16	\$ 0.17	
Discontinued operation	(0.01)	0.00	0.01	(0.05)	
Total	\$ 0.02	\$ 0.17	\$ 0.17	\$ 0.12	

During the year ended January 31, 2006, the Company filed Consolidated Financial Statements on Forms 10-Q, which reflected \$119 million in goodwill resulting from the acquisition of Alliance and \$7.1 million in goodwill resulting from the acquisition of Levy as vendor lists classified as indefinite lived intangible assets. In these Consolidated Financial Statements included herein these amounts are now properly reflected as goodwill. If the previously filed Forms 10-Q had been filed with the same classification as shown herein, then goodwill and intangible assets at April 30, 2005, July 31, 2005, and October 31, 2005, by segment would have been as follows:

(IN THOUSANDS)	CD and DVD Fulfillment	Magazine Fulfillment	In-Store Services	Shared Services	Consolidated
	-----	-----	-----	-----	-----
APRIL 30, 2005					
Goodwill, net	\$ 169,520	\$ 16,652	\$ 50,139	\$ 4,139	\$ 240,450
Intangibles, net	\$ 91,268	\$ 13,891	\$ 4,210	\$ --	\$ 109,369
JULY 31, 2005					
Goodwill, net	\$ 169,925	\$ 107,872	\$ 50,322	\$ 4,139	\$ 332,258
Intangibles, net	\$ 89,867	\$ 6,829	\$ 4,097	\$ --	\$ 100,793
OCTOBER 31, 2005					
Goodwill, net	\$ 170,144	\$ 88,751	\$ 50,502	\$ 4,139	\$ 313,536
Intangibles, net	\$ 87,984	\$ 26,052	\$ 3,985	\$ --	\$ 118,021

**SOURCE INTERLINK COMPANIES, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONCLUDED)**

**19. SUBSEQUENT EVENTS**

On March 2, 2006, the Company engaged an affiliate of The Yucaipa Companies, LLC as a consultant in connection with the process of pursuing strategic alternatives pursuant to a Consulting Agreement entered into between the Company and Yucaipa in February 2006. Yucaipa is an affiliate of AEC Associates, LLC, the largest single stockholder of the Company. In addition, the Company's Board of Directors, in consultation with The Yucaipa Companies, LLC, hired Deutsche Bank Securities Inc. to act as its exclusive financial advisor in the process of evaluating strategic alternatives. In connection with this evaluation process, Deutsche Bank Securities, Inc. will work with the affiliate of The Yucaipa Companies, LLC.

On March 30, 2006, the Company and Anderson News, LLC entered into a Unit Purchase Agreement pursuant to which the Company purchased all of the issued and outstanding membership interests of Anderson Mid-Atlantic News, LLC ("Mid-Atlantic") from Anderson News, LLC for a purchase price of approximately \$4.0 million, subject to adjustment based on the negative net worth as of the closing date of the transaction. In addition, approximately \$9.6 million was also provided on the date of acquisition to Mid-Atlantic to repay a portion of its outstanding intercompany debt. The remaining outstanding intercompany debt of Mid-Atlantic was satisfied by issuance of a promissory note totaling \$4.1 million. The promissory note will be repaid by the Company over a six month period beginning April 2006 and bears interest at LIBOR minus one (3.83% at March 30, 2006). The purchase price and the intercompany debt repayment were funded from the revolving line of credit.

On March 30, 2006, the Company and Anderson News, LLC entered into a Unit Purchase Agreements pursuant to which the Company purchased all of the issued and outstanding membership interests of Anderson-SCN Services, LLC ("SCN") from Anderson News, LLC for a purchase price of approximately \$9.0 million, subject to adjustment based on the negative net worth as of the closing date of the transaction. In addition, approximately \$17.0 million was also provided on the date of acquisition to SCN to repay a portion of its outstanding intercompany debt. The remaining outstanding intercompany debt of SCN was satisfied by issuance of a promissory note totaling \$10.2 million. The promissory note will be repaid by the Company over a six month period beginning April 2006 and bears interest at LIBOR minus one (3.83% at March 30, 2006). The purchase price and the intercompany debt repayment were funded from the revolving line of credit.

**SOURCE INTERLINK COMPANIES**  
**SCHEDULE II**  
**VALUATION AND QUALIFYING ACCOUNTS SCHEDULE**  
**(IN THOUSANDS)**

Column A ----- Description -----	Column B ----- Balance at beginning of period -----	Column C ----- Charged to expense -----	Column C ----- Charge to other accounts -----	Column D ----- Deductions -----	Column E ----- Balance at end of period -----
Year ended January 31, 2006:					
Allowance for doubtful accounts	\$ 2,126	\$ 6,100	\$ 18,833	\$ 6,377	\$ 20,682
Sales return reserves	\$ 78,404	\$ 1,178,681	\$ 109,663	\$ 1,173,330	\$ 193,418
Year ended January 31, 2005:					
Allowance for doubtful accounts	\$ 4,568	\$ 3,003	\$ 200	\$ 5,645	\$ 2,126
Sales return reserves	\$ 64,566	\$ 356,691	\$ 3,147	\$ 346,000	\$ 78,404
Year ended January 31, 2004:					
Allowance for doubtful accounts	\$ 5,925	\$ 1,819	\$ --	\$ 3,176	\$ 4,568
Sales return reserves	\$ 36,994	\$ 317,303	\$ --	\$ 289,731	\$ 64,566

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## Corporate Information

**Source Interlink Companies, Inc**  
World Headquarters  
27500 Riverview Center Boulevard  
Bonita Springs, Florida 34134

**Stock Listing**  
NASDAQ National Market: **SORC**

### Website

[www.sourceinterlink.com](http://www.sourceinterlink.com)

Our website contains electronic copies of our corporate governance documents, news releases, U.S. Securities and Exchange Commission filings, descriptions of our products and services, and other information about our Company.

### Our Annual Report on Form 10-K

A printed copy of our annual report on Form 10-K may be obtained without charge on our website, [www.sourceinterlink.com](http://www.sourceinterlink.com), or on the website of the U.S. Securities and Exchange Commission, [www.sec.gov](http://www.sec.gov). It is also available without charge by calling or writing to our Investor Relations Department:  
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### Transfer Agent and Registrar

Account information and transactions are managed by Mellon Investor Services, LLC. Please direct notices of address changes or questions regarding account status, stock transfers, or lost certificates to:

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**SOURCE  
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*END*