K TEL INTERNATIONAL INC
Form 10-Q
November 22, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

Commission File Number: 1-07115

K-TEL INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of incorporation or organization)	**41-0946588** (I.RS. Employer Identification No.)
2491 Xenium Lane North, Plymouth, Minnesota (Address of principal executive offices)	**55441** (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:
None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $0.01
(Title of class)

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

As of November 22, 2006, the registrant had 13,653,738 shares of Common Stock outstanding.

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES
FORM 10-Q

FOR THE THREE MONTH PERIOD
ENDED SEPTEMBER 30, 2006

INDEX

PART I. Financial Information (Unaudited):

Item 1.	Financial Statements
	Condensed Consolidated Balance Sheets as of September 30, 2006 and June 30, 2006
	Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2006 and 2005
	Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2006 and 2005
	Notes to Condensed Consolidated Financial Statements
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations
Item 3.	Quantitative and Qualitative Disclosures About Market Risk
Item 4.	Controls and Procedures

PART II. Other Information:

Item 1.	Legal Proceedings
Item 6.	Exhibits

Signatures

Index to Exhibits

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

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS UNAUDITED
(in thousands except share data)

	September 30, 2006	**June 30, 2006**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,470	$ 1,689
Accounts receivable, net of allowance for doubtful accounts of $2 at September 30 and June 30	632	601
Inventories	452	390
Royalty advances	7	7
Prepaid expenses and other	157	194
Total current assets	2,718	2,881
Property and equipment, net of accumulated depreciation and amortization of $317 at September 30 and $306 at June 30	53	55
Owned catalog masters, net of accumulated amortization of $3,317 at September 30 and $3,277 at June 30	299	336
	$ 3,070	$ 3,272
LIABILITIES AND SHAREHOLDERS DEFICIT		
Current liabilities:		
Notes payable to affiliate and other	$ 12,399	$ 12,098
Accounts payable	967	1,206
Accrued royalties	1,872	1,793
Reserve for returns	109	126
Net liabilities of discontinued operations	31	31
Total current liabilities	15,378	15,254
Shareholders deficit:		
Common stock 50,000,000 shares authorized; par value $.01; 13,653,738 issued and outstanding at September 30 and June 30	136	136
Additional paid-in capital	21,292	21,292
Accumulated deficit	(33,489)	(33,134)
Accumulated other comprehensive loss	(247)	(276)
Total shareholders deficit	(12,308)	(11,982)
	$ 3,070	$ 3,272

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS UNAUDITED
(in thousands - except per share data)

	Three Months Ended September 30,	
	2006	**2005**
Net sales	$ 888	$ 1,196
Costs and expenses:		
Cost of goods sold	287	505
Advertising	63	20
Selling, general and administrative	650	743
Total costs and expenses	1,000	1,268
Operating loss	(112)	(72)
Other expense:		
Interest expense	(239)	(187)
Other	(4)	(2)
Total other expense	(243)	(189)
Loss from continuing operations	(355)	(261)
Loss from discontinued operations		(3)
Net loss	$ (355)	$ (264)
Loss per share - basic and diluted:		
Continuing operations	$ (.03)	$ (.02)
Discontinued operations		
Net loss	$ (.03)	$ (.02)
Shares used in the calculation of loss per share - Basic and Diluted:	13,654	13,654
Comprehensive loss:		
Net loss	$ (355)	$ (264)
Translation adjustment	29	(20)
Comprehensive loss	$ (326)	$ (284)

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS UNAUDITED
(in thousands)

	Three Months Ended September 30,	
	2006	**2005**
Operating activities:		
Net loss	$ (355)	$ (264)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	45	53
Changes in operating assets and liabilities:		
Accounts receivable, net	(12)	495
Inventories	(53)	30
Royalty advances	2	
Prepaid expenses	38	13
Accounts payable	(251)	(718)
Accrued royalties	68	127
Reserve for returns	(17)	3
Cash used in operating activities	(535)	(261)
Investing activities:		
Purchases of property and equipment	(3)	
Cash used in investing activities	(3)	
Financing activities:		
Borrowings on notes payable	915	1,031
Payments on notes payable	(614)	(782)
Cash provided by financing activities	301	249
Effect of exchange rates on cash	18	(1)
Net decrease in cash and cash equivalents	(219)	(13)
Cash and cash equivalents at beginning of period	1,689	1,272
Cash and cash equivalents at end of period	$ 1,470	$ 1,259

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

K-TEL INTERNATIONAL, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BUSINESS AND LIQUIDITY

K-tel International, Inc. (the Company , K-tel or the registrant) was incorporated in 1968 and currently has its corporate offices located in Plymouth, Minnesota. Through its operating subsidiaries, K-tel licenses its music catalog internationally and markets entertainment products mainly derived from its catalog through retail and direct response marketing channels in the United States and Europe. The Company has a focused method of distribution that targets the strengths of selected individual retailers and supplies products suited to each retailer s needs. These products are derived mainly from the Company s master recordings music catalog with the objective of realizing more competitive profit margins. K-tel seeks to license its name and trademarks to other companies. Licenses are granted for a royalty or fee, with no cost to the Company.

Discontinued Operations

The Company s consumer products business, which was concentrated in Europe, consisted primarily of house wares, consumer convenience items and exercise equipment. The Company discontinued its consumer products operations in Germany, the United Kingdom and the United States in June 2000, November 2000 and January 2001, respectively. Accordingly, these activities have been presented in the accompanying financial statements as discontinued operations. The accompanying condensed consolidated financial statements have been prepared to reflect the consumer products division as a discontinued operation. The net liabilities of discontinued operations at September 30, 2006 and June 30, 2006, and results from discontinued operations for the three months ended September 30, 2006 and 2005, relate primarily to legal matters and completion of statutory reporting requirements for the former operations in Germany.

Going Concern

During the three months ended September 30, 2006 and 2005, the Company incurred net losses from continuing operations of $355,000 and $261,000, respectively. Operating activities used $535,000 and $261,000 of cash during the three months ended September 30, 2006 and 2005, respectively. Additionally, the Company had a working capital deficit of $12,660,000 at September 30, 2006.

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

2. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation The accompanying condensed consolidated unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year as a whole. The unaudited condensed consolidated balance sheet for June 30, 2006 has been derived from audited consolidated financial statements as of that date. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended June 30, 2006.

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

Revenue Recognition The Company derives its revenue mainly from two sources: license revenue from the licensing of Company-owned masters and the sale of music compilations (predominately compact discs) produced by the Company. License revenue is recognized when payment is received from customers or when known amounts are receivable, as prior to that date collection is not considered probable. Revenue from music sales is recognized at the time of shipment to the customer. Most music sales are made with a right of return of unsold goods. Estimated reserves for returns are established by management based upon historical experience and product mix and are subject to ongoing review and adjustment by the Company. These reserves are recorded at the time of sale and are reflected as a reduction in revenues. The Company s reserve for returns was $109,000 at September 30, 2006 and $126,000 at June 30, 2006.

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

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

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

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

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

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

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

Long Lived-Assets The Company evaluates its long-lived assets quarterly, or earlier if a triggering event occurs, to determine potential impairment by comparing the carrying value of those assets to the related undiscounted future cash flows of the assets. If an asset is determined to be impaired, it is written down to its estimated fair value.

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

Advertising The Company expenses the costs of advertising when the advertising takes place, except for direct response advertising, which is capitalized and amortized over its expected period of future benefits (usually the period remaining under a related contract, which is generally less than one year). Direct response advertising consists primarily of television advertising whereby customers respond specifically to the advertising and where the Company can identify the advertising that elicited the response. Advertising expenses were $63,000 and $20,000 for the three month periods ended September 30, 2006 and 2005, respectively.

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

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

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

Net Loss Per Share Basic and diluted net loss per share have been computed by dividing net loss by the weighted average number of shares outstanding during the period. For all periods presented, common stock equivalents were excluded from the per share calculation as the net effect would be antidilutive. For the three month periods ended September 30, 2006 and 2005, weighted average options to purchase 2,228,939 shares of common stock, with weighted average exercise price of $.19 were excluded from the computation of common share equivalents for the respective periods as they were antidilutive.

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

3. LOANS PAYABLE TO AFFILIATE

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder and an entity controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of the agreement (the K-5 Facility), K-5 has agreed to make available up to $8,000,000 to K-tel on a revolving basis. The loan bears interest at a variable rate based upon the base rate of a nationally recognized lending institution (8.25% at September 30, 2006), expires July 20, 2008, and is subordinated to the Foothill loan (see below). The K-5 Facility contains the same covenants as the Foothill loan agreement. K-tel has pledged the stock of its foreign subsidiaries as collateral for the loan, and the loan carries a subordinated position to the Foothill loan on all other assets of the Company. K-tel had outstanding balances of $8,399,000 and $8,098,000 as of September 30, 2006 and June 30, 2006, respectively, under the K-5 Facility. At September 30, 2006, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

In addition, K-tel has a second loan agreement with K-5, under which K-5 assumed rights and obligations under a loan from the Company s former banker (Foothill Capital Corporation) pursuant to an Assignment and Acceptance Agreement dated February 27, 2001. This Foothill loan, which has been extended through July 20, 2008, provides for a $10,000,000 credit facility consisting of a $4,000,000 term loan due upon expiration, and a $6,000,000 revolving facility under which borrowings are limited to a percent of eligible receivables. Borrowings under the facility bear interest at a variable rate based on a base rate of a nationally recognized lending institution plus 1% (9.25% at September 30, 2006) and are collateralized by the assets of certain Company subsidiaries in the United States, including accounts receivable, inventories, equipment, music library and general intangibles. The loan agreement contains certain financial and other covenants or restrictions, including the maintenance of a minimum shareholders equity by K-tel, limitations on capital expenditures, restrictions on music library acquisitions, limitations on other indebtedness and restrictions on dividends paid by K-tel. As of September 30, 2006 and June 30, 2006, K-tel had $4,000,000 outstanding under the term loan and there were no borrowings under the revolving facility. At September 30, 2006, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

4. COMMITMENTS AND CONTINGENCIES

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

5. BUSINESS SEGMENT AND GEOGRAPHIC AREA DATA

K-tel s businesses are organized, managed and internally reported as two segments: music licensing and retail music sales. These segments are based on differences in products, customer type and sales and distribution methods.

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

The retail music segment of the Company markets and distributes entertainment products internationally and through its operating subsidiaries. The retail music segment consists primarily of the sales of pre-recorded music from the Company s master music catalog. The Company sells compact discs and DVD s directly to retailers, wholesalers and rack service distributors which stock and manage inventory within music departments for retail stores.

The Company s consumer product and e-commerce operations have been discontinued, are presented in the accompanying financial statements as discontinued operations and are therefore not included in the segment information.

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

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

BUSINESS SEGMENT INFORMATION *(in thousands)*

Three Months Ended September 30,		Licensing	Music	Other	Total Company
Net sales	2006	$ 469	$ 419	$	$ 888
	2005	515	681		1,196
Operating income (loss)	2006	$ 101	$ (213)	$	$ (112)
	2005	164	(236)		(72)
Assets	2006	$ 344	$ 2,701	$ 25	$ 3,070
	2005	482	3,468	131	4,081

GEOGRAPHIC INFORMATION *(in thousands)*

Three Months Ended September 30,		United States	Europe	Total
Net sales	2006	$ 529	$ 359	$ 888
	2005	772	424	1,196
Assets	2006	$ 747	$ 2,323	$ 3,070
	2005	2,051	2,030	4,081

ITEM 2: MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Through its operating subsidiary, Dominion Entertainment, Inc. (Dominion), K-tel licenses its master music catalog internationally and has entered into licensing agreements with several companies that offer electronic downloads via their internet sites of many of Dominion s owned masters. K-tel and Dominion have also entered into agreements with BCI Eclipse Company, LLC (BCI) to market and sell entertainment products derived from Dominion s master music catalog under the K-tel logo in the United States and Canada.

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

A. RESULTS OF OPERATIONS

Net sales for the three months ended September 30, 2006 were $888,000, a decrease of 25.8% from sales of $1,196,000 for the three month period ended September 30, 2005. This sales decrease was primarily attributed to reduced domestic music revenue. The net loss for the three month period ended September 30, 2006 was $355,000, or $.03 per share, compared to a loss of $264,000, or $.02 per share, for the three month period ended September 30, 2005.

General corporate expenses of $98,000 and $105,000 for the three months periods ended September 30, 2006 and 2005, respectively, have been allocated to the segments.

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

BUSINESS SEGMENT RESULTS

Licensing

Licensing revenue was $469,000 for the three month period ended September 30, 2006 compared to $515,000 for the three month period ended September 30, 2005, a decrease of 8.9%. This decrease was due to decreased third party licensing activity in the United Kingdom. The Company continues to concentrate its efforts on expanding the customer base for the Company s master music catalog for electronic downloads and with independent music labels and manufacturers.

Royalty costs within the segment decreased to $87,000 for the three month period ended September 30, 2006 compared to $108,000 for the three month period ended September 30, 2005 due to decreased third party licensing sales in the United Kingdom. Selling, general and administrative expenses for the segment increased $38,000 for the three month period ended September 30, 2006 to $281,000 compared to $243,000 for the three month period ended September 30, 2005. The primary reason for the increase in general and administrative expenses was the additional overhead costs related to the German operation of the Company s subsidiary in the United Kingdom.

There was operating income in the licensing segment of $101,000 for the three month period ended September 30, 2006 compared to operating income of $164,000 for the three month period ended September 30, 2005, a decrease of $63,000.

Music

Sales in the music segment were $419,000 for the three month period ended September 30, 2006 compared to $681,000 for the three month period ended September 30, 2005, a decrease of $262,000, or 38.5%. The decrease was primarily due to decreased domestic music sales related to the Company s transition from primarily a distributions business to a licensing business.

Cost of goods sold in the music segment decreased to 47.7% of sales for the three month period ended September 30, 2006 compared to 58.3% of sales for the three month period ended September 30, 2005 reflecting the decrease in domestic retail music sales that had lower margins. The segment s advertising expenses, which consist primarily of co-operative advertising payments, trade advertising and promotions, increased to $63,000 for the three month period ended September 30, 2006 compared to $20,000 for the three month period ended September 30, 2005. This increase was due to increased advertising expense in the Company s subsidiary in the United Kingdom.

Selling, general and administrative expenses were $369,000, or 88.0% of sales for the three month period ended September 30, 2006 compared to $500,000, or 73.5% of sales for the three month period ended September 30, 2005. The primary reason for the decrease in general and administrative expenses was the reduced overhead costs at the Company s office in the United States relating to retail music sales.

The music segment incurred an operating loss of $213,000 for the three month period ended September 30, 2006 compared to operating loss of $236,000 for the three month period ended September 30, 2005.

B. LIQUIDITY AND CAPITAL RESOURCES

K-tel has a Line of Credit Agreement with K-5 Leisure Products, Inc. (K-5), the Company s largest shareholder and an entity controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. Under the terms of the agreement (the K-5 Facility), K-5 has agreed to make available up to $8,000,000 to K-tel on a revolving basis. The loan bears interest at a variable rate based upon the base rate of a nationally recognized lending institution (8.25% at September 30, 2006), expires July 20, 2008, and is subordinated to the Foothill loan (see below). The K-5 Facility contains the same covenants as the Foothill loan agreement. K-tel has pledged the stock of its foreign subsidiaries as collateral for the loan, and the loan carries a subordinated position to the Foothill loan on all other assets of the Company. K-tel had outstanding balances of $8,399,000 and $8,098,000 as of September 30, 2006 and June 30, 2006, respectively, under the K-5 Facility. At September 30, 2006, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

In addition, K-tel has a second loan agreement with K-5, under which K-5 assumed rights and obligations under a loan from the Company s former banker (Foothill Capital Corporation) pursuant to an Assignment and Acceptance Agreement dated February 27, 2001. This Foothill loan, which has been extended through July 20, 2008, provides for a $10,000,000 credit facility consisting of a $4,000,000 term loan due upon expiration, and a $6,000,000 revolving facility under which borrowings are limited to a percent of eligible receivables. Borrowings under the facility bear interest at a variable rate based on a base rate of a nationally recognized lending institution plus 1% (9.25% at September 30, 2006) and are collateralized by the assets of certain Company subsidiaries in the United States, including accounts receivable, inventories, equipment, music library and general intangibles. The loan agreement contains certain financial and other covenants or restrictions, including the maintenance of a minimum shareholders equity by K-tel, limitations on capital expenditures, restrictions on music library acquisitions, limitations on other indebtedness and restrictions on dividends paid by K-tel. As of September 30, 2006 and June 30, 2006, K-tel had $4,000,000 outstanding under the term loan and there were no borrowings under the revolving facility. At September 30, 2006, K-tel obtained a waiver from K-5 for its non-compliance under the covenants, limitations and restrictions of the credit agreement.

K-tel has primarily funded its recent operations through secured loans from K-5. Assuming K-5 continues to advance funds sufficient to meet the Company s needs, management currently believes that K-tel has sufficient cash and borrowing capacity to ensure the Company will continue operations for the foreseeable future. Although K-5 continues to advance funds sufficient to meet the Company s needs at this time, there can be no assurance that this will be adequate or continue in the future or that K-tel will be able to obtain additional financing upon favorable terms when required.

The Company s ability to continue its present operations is contingent mainly upon its ability to maintain its line of credit arrangements with K-5, increase its revenues and profit margins, and ultimately attain and sustain profitable operations. Without increased revenues and sustained profitability, the Company s current operations will likely not generate cash sufficient to fund operations and service its indebtedness on an ongoing basis. Management is focusing its efforts on music licensing and limited music distribution. However, there can be no assurance that the Company will achieve profitable operations through these efforts. In the event the Company is unable to fund its operations and implement its current business plan properly, it may be unable to continue operations. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material changes in the Company s market risk during the three month period ended September 30, 2006. For additional information, refer to the Company s annual report on Form 10-K for the fiscal year ended June 30, 2006.

ITEM 4. CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act). Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were not effective because of the continued inability of the Company to file its reporting on a timely basis. The untimely filings have resulted in part from the follow up necessary to address the material weaknesses in internal control over financial reporting that had been noted in fiscal year 2004.

The Company did not maintain effective controls over cash disbursements and payroll transactions at its UK subsidiary. In September 2004, the Company discovered that the former Chief Financial Officer of its UK subsidiary misappropriated funds from the subsidiary and one of its customers. Adjustments related to the reversal of overstated expenses and recovery of amounts misappropriated were included in the restatement of the Company s consolidated financial statements for periods prior to June 30, 2004 and for the years ended June 30, 2005 and 2004 and resulted in the Company reporting a material weakness in internal control over financial reporting.

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

In fiscal 2005 and 2004, it was also determined that the segregation of duties in the U.S. office was limited due to the small number of employees. This segregation of duties became further limited by vacancies that occurred in the Company s finance department. In particular, customer orders were recorded by the same person who initiated shipments, checks were deposited by the accounts receivable clerk, and employee payroll and changes were entered by the Operations Manager, who also distributed the payroll checks.

In response to this material weakness in the U.S. office, the former Controller was rehired in the period covered by this report and duties and responsibilities were revised to allow for improved segregation of duties and to increase the level of approvals and reviews. The foregoing remedial steps have allowed the Company to remediate its material weakness and to improve its internal control over financial reporting.

During the fiscal quarter ended September 30, 2006, there was no change in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

During the fiscal quarter ended September 30, 2006, there was no change in the Company s internal control over f

PART II

ITEM 1. LEGAL PROCEEDINGS

Litigation and Disputes

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

ITEM 6. EXHIBITS

See Index to Exhibits.

SIGNATURES

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

K-TEL INTERNATIONAL, INC.
REGISTRANT

Dated: November 22, 2006

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

Dated: November 22, 2006

/s/ KIMMY LOCKWOOD
KIMMY LOCKWOOD
PRINCIPAL FINANCIAL OFFICER

INDEX TO EXHIBITS

Exhibit No.	**Description of Exhibit**
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a).
31.2	Certification by Principal Financial Officer pursuant to Rule 13a-14(a).
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sabanes-Oxley Act of 2002.
32.2	Certification by Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sabanes-Oxley Act of 2002.