TWEETER HOME ENTERTAINMENT GROUP INC
Form 10-K
December 17, 2002

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended September 30, 2002

or

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

Commission file number: 0-24091

Tweeter Home Entertainment Group, Inc.

(Exact name of Registrant as specified in its charter)

Delaware	**04-3417513**
(State or other jurisdiction of incorporation)	*(I.R.S. Employer Identification No.)*

40 Pequot Way

Canton, MA 02021
(Address of principal executive offices)

(781) 830-3000

(Registrant s telephone number including area code)

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

Common Stock, $.01 par value

(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 þ No o

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

Indicate by check mark whether the registrant is an accelerated filer as defined in Exchange Act Rule 12b-2). Yes o No þ

As of December 11, 2002 there were outstanding 23,574,803 shares of Common Stock, $.01 par value per share. The aggregate market value of shares of Common Stock held by non-affiliates of the Registrant, based upon the last sales price for such stock on that date as reported by The Nasdaq Stock Market, was approximately $238,354,242.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the 2003 Annual Meeting of Stockholders to be held on January 21, 2003 are incorporated by reference into Part III.

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PART I

In this Annual Report on Form 10-K, the Company, Tweeter, we, us, and our mean Tweeter Home Entertainment Group, Inc. and its subsidiaries.

This Annual Report on Form 10-K contains forward-looking statements regarding Tweeter s performance, strategy, plans, objectives, expectations, beliefs and intentions. The actual outcome of the events described in these forward-looking statements could differ materially. This report, and especially the sections entitled Risk Factors and Management Discussion and Analysis of Financial Condition and Results of Operations, contains a discussion of some of the factors and risks that could contribute to those differences.

Item 1. *Business*

General

Tweeter is a specialty retailer of mid- to high-end audio and video consumer electronics products. We operate 173 stores under the Tweeter, HiFi Buys, Sound Advice, Bang & Olufsen, Electronic Interiors, Showcase Home Entertainment and Hillcrest names in New England, the Mid-Atlantic, the Southeast, Texas, California, greater Chicago, Florida and Arizona. We operate in a single business segment of retailing audio and video consumer electronics products. Our stores feature an extensive selection of home and car audio systems and components, portable audio equipment, and home video products including flat panel Plasma and LCD TV s, big screen televisions, DVD players, digital satellite systems, camcorders and video recording devices. We differentiate ourselves by focusing on consumers who seek audio and video products with advanced features, functionality and performance. We do not offer consumer electronics products such as personal computers or home office equipment. Our stores display products in an inviting retail environment averaging 10,000 square feet and are staffed with attentive, knowledgeable sales personnel. We seek to build name recognition and customer loyalty by combining a high level of service with competitive prices backed by our patented Automatic Price Protection program.

We opened our first store in 1972 in Boston under the Tweeter name and over the next two decades grew exclusively through new store openings in New England, expanding to 18 stores by 1995. In 1995, we adopted an aggressive growth strategy to (i) open new stores in current regional markets and relocate certain stores to more favorable sites and (ii) to selectively pursue acquisitions in new regional markets and achieve operating improvements by converting the acquired company to our core operating model and leveraging distribution, marketing and corporate infrastructure. We completed the acquisition of Bryn Mawr Radio and Television, Inc. (Bryn Mawr) in May 1996, HiFi Buys Incorporated (HiFi Buys) in June 1997, Home Entertainment of Texas, Inc. (Home Entertainment) in February 1999, DOW Stereo/ Video, Inc. (Dow Stereo/ Video) in July 1999, United Audio Centers, Inc. (United Audio Centers) in April 2000, Douglas T.V. & Appliance, Inc. and Douglas Audio Video Centers, Inc. (collectively, Douglas) in October 2000, The Video Scene, Inc. (Big Screen City) in May 2001, SMK Marketing, Inc. (Audio Video Systems) in June 2001, Sound Advice, Inc. (Sound Advice) in August 2001 and Hillcrest High Fidelity, Inc. (Hillcrest) in March 2002. In addition, in September 2002, we launched the Tweeter Internet site to market and sell consumer electronics over the Internet.

Our business is subject to seasonal variations. Historically, we have realized a significant portion of our total revenue and more than half of our net income for the year during the first fiscal quarter. Due to the importance of the holiday shopping season, any factors negatively impacting the holiday selling season could have a material adverse effect on our financial condition and results of operations. Our quarterly results of operations may also fluctuate significantly due to a number of factors, including the timing of new store openings and acquisitions and unexpected changes in volume-related rebates from manufacturers. In addition, operating results may be negatively affected by increases in merchandise costs, price changes in response to competitive factors and unfavorable local, regional or national economic developments that result in reduced consumer spending.

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Business Strategy

Our goal is to become the leading national specialty retailer of high-quality audio and video products. The key elements of our business strategy are as follows:

Extensive Selection of Mid- to High-End Audio and Video Products. We concentrate on mid- to high-end audio and video consumer electronics products. This focus differentiates us from larger format superstores and mass merchandisers, which offer a broad array of consumer electronics and non-electronics products with a higher emphasis on products priced at introductory price levels. Our emphasis on higher-end products positions us attractively to manufacturers seeking to sell more advanced or limited distribution products as part of their distribution strategy. As a result of our higher-end product focus, a historical early adopter customer base and our extensively trained sales force, we are often among the earliest retailers to offer new product innovations on behalf of manufacturers. In addition, we believe that our focused product offering allows for higher gross margin opportunities, appeals to a more service-conscious consumer and results in enhanced brand awareness of our regional names to our targeted customer group.

Exceptional Customer Service. We believe that the quality and knowledge of our sales associates is critical to our success and represents a significant competitive advantage. Our relationship-selling model encourages sales associates to promote a comfortable, trusting, low-pressure environment. We provide new sales associates with five weeks of intensive classroom training, and all sales associates receive five to fifteen days of ongoing training per year, both at the store and at Tweeter s regional training centers. Our sales force receives technical product and sales training prior to our introduction of significant new products. We believe that the success of our operating model has enabled us to engender long-term customer loyalty.

Dynamic, Inviting Stores. Our stores display products in a dynamic and inviting setting intended to encourage the customer to view and hear products in sound rooms architecturally and acoustically designed to simulate the customer s home or car environment. The store prototype is brightly painted, with many in pastel colors, with some stores exhibiting hand-painted murals and other decorative artwork. Innovative and interactive product displays enable customers to audition and compare a sample of products. Each store contains a television wall displaying an extensive selection of televisions and related products, and many stores contain a movie theater room, complete with theater-style seats, which showcases our home theater products.

Everyday Competitive Pricing. Except in the Florida and Arizona markets and in our Hillcrest stores, we utilize an everyday competitive pricing strategy with fixed prices clearly marked on our products. Store managers regularly visit local competitors to ensure that our pricing remains competitive within the store s local market. In addition, our patented Automatic Price Protection program backs all product sales. Under this program, if a customer purchases a consumer electronics product from one of our stores and a competitor within 25 miles of the store advertises a lower price within 30 days, we *automatically* send a check to the customer for the difference without requiring the customer to request payment. The Automatic Price Protection program is designed to remove pricing concerns from the purchase decision and, as a result, allows customers and the sales staff to focus on product functionality, performance and quality. The Company is currently evaluating the adoption of Automatic Price Protection in Florida and Arizona and in our Hillcrest stores.

Growth Strategy

Our current growth strategy is to:

- capitalize on new technologies to drive comparable store sales;
- open new stores in current regional markets and relocate certain stores to more favorable sites; and
- develop our in-house home installation business.

New Stores. We intend to open new stores and relocate a limited number of stores within existing markets in order to increase penetration and leverage regional advertising, distribution, and operating

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efficiencies. During fiscal 2002, we opened twenty-two stores and relocated eight stores in the following regions:

Region	New Stores Opened	Relocated/Remodeled Stores
New England		1
Mid Atlantic	4	
Southeast	3	1
Texas	4	2
California	2	3
Chicago	4	1
Florida	3	
Arizona	2	
Total	22	8

For fiscal year 2003, we intend to open sixteen stores and to relocate two stores. We believe that ten acquisitions made since May 1996 have provided us with the platforms from which to open new stores within and around their markets.

Recent Acquisitions

Acquisition of Big Screen City. In May 2001, we completed the acquisition of Big Screen City, a four-store chain located in the San Diego, California and Temecula, California areas. Big Screen City, a specialty consumer electronics retailer with annual sales approaching $16 million, had been in business in the San Diego market for 20 years. We consolidated the operations of Big Screen City with the Tweeter operations and implemented key aspects of our business strategy, including changing the brand name to Tweeter and our Automatic Price Protection program.

Acquisition of Audio Video Systems. In June 2001, we completed the acquisition of Audio Video Systems, a three-store chain located in the greater Charlotte, North Carolina area. Audio Video Systems, a specialty consumer electronics retailer with annual sales of approximately $15 million, had been in business in the Charlotte market for 13 years. We implemented the aspects of our business strategy, including changing the brand name to Tweeter and our Automatic Price Protection program.

Acquisition of Sound Advice. In August 2001, we completed the acquisition of Sound Advice, a 32-store chain with locations in Florida and in the Phoenix, Arizona market. Sound Advice had annual sales of approximately $200 million and had operated in the Florida markets for 27 years. Since its acquisition, Sound Advice has operated as our wholly-owned subsidiary with its finance and MIS operations being performed out of our corporate office in Canton, Massachusetts. To better leverage our corporate infrastructure, we plan to transfer the remaining administrative operations of Sound Advice to our corporate office during fiscal 2003.

Acquisition of Hillcrest. In March 2002, we completed the acquisition of Hillcrest, a two-store chain located in the greater Dallas, Texas area. Hillcrest, a specialty retailer with a significant focus on custom installation, had annual sales of approximately $14 million and had operated in the Dallas market for 53 years. We implemented some key aspects of our business strategy and integrated their operations with our existing Dallas operations.

Other Business Developments

Termination of Joint Venture. On November 9, 2001, Cyberian Outpost.com was sold to FCOP Acquisition, Inc., a wholly-owned subsidiary of Fry s Electronics, a private company operating in the state of California, for $.25 per share. Tweeter owned 285,423 shares of Cyberian Outpost.com prior to this sale. Our joint venture with Cyberian Outpost.com, Tweeter.Outpost.com, LLC ceased operations on December 31, 2001. On February 9, 2002, the joint venture and all related agreements with Cyberian Outpost.com were terminated.

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Store Format and Operations

As of September 30, 2002, we operated 167 stores, consisting of 114 Tweeter stores in New England, the Mid-Atlantic, the Southeast, Texas, San Diego, California and in the greater Chicago area; 14 HiFi Buys stores in the Southeast; 25 Sound Advice stores in Florida; 5 Bang & Olufsen stores in Florida; 2 Electronic Interiors stores in Florida; 4 Showcase Home Entertainment stores in the Phoenix, Arizona market; 1 Bang & Olufsen store in Phoenix, Arizona and 2 Hillcrest stores in Dallas, Texas. While our stores vary in size, the current prototype is 10,000 square feet, with approximately 70% of our square footage devoted to selling space.

Our store concept combines the comfort of the home environment with practical displays enabling consumers to sample and compare the features and functions of products in various combinations. The store prototype is brightly painted, often in pastel colors, with many stores exhibiting hand painted murals and other decorative artwork. Unlike many of our competitors stores, which contain large, open spaces in which many different audio and video products are tested and sampled, our stores feature individual sound rooms. The sound rooms architecturally and acoustically resemble a home environment to enable the customer to see and hear how products will perform at home. These sound rooms allow the customer to listen to and compare various combinations of receivers, CD and DVD players and speakers. In addition, each store contains a traditional television wall displaying an extensive selection of flat panel televisions, tube and projection televisions and related video products, and many stores contain a movie theater room, complete with theater-style seats, which showcases our home theater products. Other displays, such as the big red button, allow the customer to change, by pushing a button, mono television sound into a five speaker or surround sound experience. Each store also features a camcorder gallery that allows customers to sample different camcorders, and to shoot videos of their children within the adjacent children s play area. Some stores display a car on the selling floor that features a state-of-the-art car stereo system and serves to exhibit our car installation capabilities. Most stores provide car stereo installation through on-premises installation bays.

Stores are typically staffed with a store manager, an assistant manager, twelve sales associates and two mobile electronics installers. We provide new sales associates with five weeks of intensive classroom training, and all sales associates receive five to fifteen days of ongoing training per year, both at the store and at the regional training centers. The sales force receives technical product and sales training prior to the introduction of significant new products. All stores are open seven days a week.

Most of our store managers are compensated through base pay and monthly bonuses based on store operating income. Store managers can earn a substantial portion of their annual compensation through such bonuses. Sales associates are compensated through a commission program that is based on the retail prices and gross margin of products sold.

Merchandise

Our stores feature home and car audio systems and components, video products such as large screen televisions, including flat panel Plasma, LCD, digital projection and digital tube televisions, digital satellite systems, digital video recorders, camcorders, DVD players and other consumer electronics products such as wireless phones and portable audio equipment. We offer home and car stereo installation services and provide warranty and non-warranty repair services through all of our stores. We also offer insurance replacement services to insurance companies, providing replacement products to the policyholders of those insurance companies. Additionally, we have a corporate sales division, which markets and sells to businesses, institutions and other organizations. Our emphasis on mid- to high-end products enables us to offer limited distribution products and to be among the earliest retailers to offer new product innovations on behalf of manufacturers.

We stock products from many vendors, including, Alpine, Bose, Boston Acoustics, Denon, Kenwood, Klipsch, Mirage, Mitsubishi, Monster Cable, Panasonic, Philips, Pioneer, Samsung, Sharp, Sony, Toshiba and Yamaha. We seek to manage our product mix to maximize gross margin performance. Historically, video products have yielded lower gross margin than audio products. Total sales of video products have increased at rates faster than the increases in audio product sales during the last several years as a result of the increased customer interest in large format televisions. Accordingly, we have enhanced our in-home installation business

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and adopted a Sell Audio with Video strategy in order to enhance our overall gross margin through increased sales of higher margin audio products and in-home services.

The table below sets forth the approximate percentages of revenues for each of our primary product categories for our fiscal years ended September 30, 2000, September 30, 2001 and September 30, 2002, respectively. The percentage of revenues represented by each product category may be affected by, among other factors, competition, economic conditions, consumer trends, the introduction into the market of new products, changes in our product mix, and the timing of marketing events. The percentages are also affected by our acquisitions of stores offering different mixes of products. The historical percentages set forth below may not be indicative of revenue percentages for future periods:

Percentage of Retail Revenues

	Fiscal Years Ended September 30,		
Product Category	**2000**	**2001**	**2002**
Audio Equipment(1)	31%	28%	25%
Video Equipment(2)	45%	50%	51%
Mobile Equipment and Other(3)	24%	22%	24%

(1) Includes speakers, cassette decks, receivers, turntables, compact disc players, mini-disc players, amplifiers, preamplifiers, home theater in a box, and portable audio equipment.

(2) Includes televisions, projection televisions, video recording devices, camcorders, DVD players, satellite dishes and video accessories.

(3) Includes car decks, amplifiers and speakers, car security products, navigation equipment, wireless phones, audio and car accessories, installation and service labor, and extended performance guaranties.

Purchasing and Inventory

Our purchasing and inventory control functions are primarily based at our executive offices in Canton, Massachusetts with some buyers located in our Florida office. The purchasing decisions are made by our buying team, which has primary responsibility for product selection, stocking levels and pricing. Purchasing decisions are facilitated by our information systems, which analyze stocking levels and product sell-through. The purchasing group continuously reviews new and existing products with a view towards maintaining a wide range of high quality, brand-name consumer electronics products within the product mix. In order to remain current with new and developing products, we regularly host presentations by our major suppliers.

In addition to making direct purchases, we are a member of the Progressive Retailers Organization (the PRO), a volume-buying group of 15 specialty electronics retailers across the country. This affiliation often provides us with the opportunities to obtain additional vendor rebates, product discounts and promotional products. We are not obligated to make purchases through the PRO. Our President and Chief Executive Officer serves on the Board of Directors of the PRO.

We source products from many vendors, the largest of whom, Sony, accounted for 22% of fiscal 2002 purchases. We do not maintain long-term commitments or exclusive contracts with any particular vendor, but instead consider numerous factors, including price, credit terms, distribution, quality and compatibility within existing product mix in making our purchasing decisions. We utilize an automatic replenishment system for store inventory, maintaining stock levels and minimizing total dollars invested in inventory. We believe that our relationship with our large vendors is excellent and that our focused merchandising and high degree of customer service makes us an important distribution channel, particularly for the introduction of new products.

We distribute products to stores through our regional distribution centers. The Canton, Massachusetts distribution center is 80,000 square feet and services the New England stores. The King of Prussia, Pennsylvania distribution center is 50,000 square feet and services the Mid-Atlantic stores. The Atlanta, Georgia facility is 80,000 square feet and the Charlotte, North Carolina distribution center is 15,000 square feet both servicing the Southeast stores. The Houston distribution center is 32,000 square feet and services the Houston area stores. The Dallas distribution centers total 25,600 square feet and service the Dallas area stores.

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The San Diego facility is 57,200 square feet and services the Southern California stores. The Chicago facility is 122,000 square feet and services the Illinois stores. The Florida distribution facilities total approximately 234,000 square feet and service all the Florida stores. The Arizona distribution facility is 14,300 square feet and services the Arizona stores. We believe that these facilities are sufficient to handle our planned expansion in these markets through at least the year 2003.

Advertising and Marketing

Tweeter targets consumers seeking informed advice concerning product selection and system integration of audio and video consumer electronics products. Our marketing strategy differs from our primary competitors in that we rely substantially on electronic media, radio and an extensive direct marketing effort. Our radio advertising campaigns seek to generate name recognition and to reinforce brand identification of Tweeter as a source of high quality products at competitive prices, staffed with a knowledgeable, attentive sales force. Branding Tweeter as the leader in high quality electronics in general, rather than focusing on individual price and item advertising, allows us to keep our margins relatively high. We complement our radio strategy with print advertisements throughout the year. The specific allocation of advertising dollars among the various types of advertising media is reviewed from time to time by management and, if necessary, adjusted to reflect our assessment of advertising results and market conditions. During the last quarter of fiscal 2002, we tested a more aggressive print strategy, which we will be executing through the first half of fiscal 2003.

We also rely on a sophisticated direct marketing campaign to our customers. We have developed a comprehensive database-marketing program to match past customer purchasing history to the next logical purchase option for that customer. For example, we have distributed direct mail regarding surround sound and DVD products to customers who recently purchased large screen televisions. We also distribute a 32-50 page catalog two to four times per year and other smaller, product-specific catalogs periodically throughout the year. Management believes that our relatively inexpensive direct mail activities leverage and complement our general media advertising campaigns.

We believe that our commitment to providing competitive pricing on our products is a critical component of our marketing and advertising strategy. In 1993, we abandoned our promotional, up-and-down sale strategy and adopted an everyday competitive pricing strategy, with fixed prices clearly marked on our products. Store managers regularly visit the local competition to ensure the store s pricing remains competitive. At the same time, our competitive prices are backed by our Automatic Price Protection program. Under the Automatic Price Protection program, if a customer purchases a consumer electronics product from one of our stores and a competitor within 25 miles of that store advertises a lower price within 30 days of the customer s purchase, we automatically send a check to the customer for the difference. Unlike other price guarantee programs in place within the industry, the refund process does not require the customer to call or return to the store of purchase and request a price match refund. The Automatic Price Protection program is intended to be hassle-free, customer friendly and viewed as a reflection of our commitment to customer service. In fiscal 1997, we implemented a Wise-Buys program. Under this program, Tweeter s merchandise buyers identify special, reduced-priced items, often closeouts or last year s top-of-the-line models, which are purchased from the manufacturer and offered to the consumer at a substantial discount from the original retail price. We believe that the pricing of the Wise-Buys items represents substantial value to the consumer with little or no negative impact to gross margin. Our advertisements frequently describe or refer to the Automatic Price Protection and Wise-Buys programs.

Everyday competitive pricing and Automatic Price Protection are not implemented at the Sound Advice stores in Florida, the Showcase Home Entertainment stores in Arizona or the Hillcrest stores in Dallas, Texas. The Sound Advice, Showcase Home Entertainment and Hillcrest stores follow a more traditional, promotional sale strategy in their general marketing effort. We are currently evaluating the implementation of Automatic Price Protection in these markets.

Site Selection

Our stores average approximately 10,000 square feet and are typically located in freestanding buildings or strip shopping centers within high traffic shopping areas. New store sites are selected on the basis of several

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factors, including physical location, demographic characteristics of the local market, proximity to superstore competitors, access to highways or other major roadways and available lease terms. We look for co-tenants that are likely to draw customers whom we would otherwise target within the site s relevant market and believe that the proximity of superstore competitors is, on balance, a positive factor due to increased customer traffic. We lease substantially all of our stores.

The following table presents the number and locations of stores we operated at the end of each of the last three fiscal years:

State	September 30, 2000	2001	2002
Alabama	2	2	3
Arizona		4	5
California	9	14	15
Connecticut	7	7	7
Delaware	2	2	2
Florida		29	32
Georgia	14	15	14
Illinois	7	12	16
Maine	1	1	1
Maryland	4	7	6
Massachusetts	14	16	16
New Hampshire	4	4	4
New Jersey	3	3	4
New York		1	1
North Carolina		3	4
Pennsylvania	14	14	14
Rhode Island	1	1	1
South Carolina		1	1
Tennessee			1
Texas	8	11	17
Virginia			3
Total	90	147	167

Information Systems

We utilize a sophisticated, fully integrated mainframe based management information system which updates after every transaction, and which is accessible on a real time basis to management, sales associates and product buyers. Extensive sales reporting and sales tracking are provided real time on screen to store managers and individual sales associates. The screen tracks category sales and benchmarks key sales data. This system enables management and store managers to review sales volume, gross margin and product mix on a per store or per sales associate basis, allows for the viewing of open orders, inventory value and mix, and tracks sales by product category, by sales associate, and by store. We provide ongoing training and support in the use of this system and compensate and benchmark the store managers based upon this information.

Employees

As of September 30, 2002, we had 3,771 employees, consisting of 3,643 full-time and 128 part-time employees. None of our employees are covered by collective bargaining agreements, and we believe our relations with our employees are good.

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RISK FACTORS

The value of an investment in Tweeter will be subject to the significant risks inherent in its business. Investors should consider carefully the risks and uncertainties described below. If any of the events described below actually occur, our business, financial condition or operating results could be adversely affected in a material way. This could cause the trading price of our common stock to decline, perhaps significantly.

This annual report contains forward-looking statements regarding Tweeter s performance, strategy, plans, objectives, expectations, beliefs and intentions. The actual outcome of the events described in these forward-looking statements could differ materially. The following is a discussion of some of the factors and risks that could contribute to those differences.

Risks Associated with Growth

Tweeter s success depends in large part on its ability to open, or acquire through strategic acquisitions, new stores in both existing and new geographic markets and to operate those stores profitably. We may not be able to achieve our planned expansion or to effectively integrate any new stores into our existing operations. The opening of additional stores in new geographic markets could present competitive and merchandising challenges different from those we currently or previously faced within our existing geographic markets. In addition, we may incur higher costs related to advertising, administration and distribution as we enter new markets.

There are a number of factors that could affect our ability to open or acquire new stores consistent with our business plan. These factors also affect the ability of any newly opened or acquired stores to achieve sales and profitability levels comparable with our existing stores, or to become profitable at all. These factors include:

- The identification and acquisition of suitable sites and the negotiation of acceptable leases for such sites;
- The identification of existing audio and video consumer electronics retailers appropriate for strategic acquisition;
- The successful consummation of such acquisitions;
- The obtaining of governmental and other third-party consents, permits and licenses needed to operate such additional sites;
- The hiring, training and retention of skilled personnel;
- The availability of adequate management and financial resources;
- The adaptation of our distribution and other operational and management systems to an expanded network of stores;
- The ability and willingness of vendors to supply on a timely basis at competitive prices; and
- Continued consumer demand for our products at levels that can support acceptable profit margins.

In addition, our expansion through the opening or acquisition of new stores will place significant demands on our management, resources, operations and information systems. Such expansion requires us to expend significant effort and additional resources to ensure the continuing adequacy of our financial controls, operating procedures, information systems, product purchasing and distribution systems and employee training programs. We also need to attract and retain additional qualified personnel, including new store managers, for such new stores.

Our continued growth also depends on our ability to increase sales in our existing stores. The opening of additional stores in an existing market could result in lower net sales at our existing stores in that market.

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Risks Associated with Acquisitions

Integration of newly acquired stores may involve significant delay or expense. Additional suitable acquisition candidates may not be identified. Further, we may not consummate acquisitions of any identified candidates and new stores acquired through such acquisitions may not operate profitably or integrate successfully into our operations. Previously acquired stores have had, and newly acquired stores may have, different merchandising, advertising, store format and operating approaches from ours, and our success in integrating such stores will depend on our ability to affect significant changes in the operations of such stores to conform to our approach in these areas. We may not be successful in affecting such changes without an adverse effect on the revenues or profitability of such stores. In addition, future acquisitions could involve the issuance of equity securities which could dilute the holdings of existing stockholders. Future acquisitions could also involve the incurrence of additional debt and contingent liabilities, and amortization expenses related to intangible assets, any of which could have a material adverse effect on our results of operations or financial condition.

Dependence on Key Personnel

Our success depends upon the active involvement of senior management personnel, particularly Samuel J. Bloomberg, Tweeter s Chairman of the Board, Jeffrey Stone, Tweeter s President and Chief Executive Officer and Joseph McGuire, Tweeter s Senior Vice President and Chief Financial Officer. The loss of the full-time services of Messrs. Stone, Bloomberg, or McGuire, or other members of senior management, could have a material adverse effect on Tweeter s results of operations and financial condition. Tweeter has employment contracts with Messrs. Stone, Bloomberg, McGuire, Peter Beshouri, Senior Vice President and Michael Blumberg, Senior Vice President. Tweeter has no other employment agreements with any members of its senior management team. Tweeter currently maintains key-man life insurance on the lives of Messrs. Stone and Bloomberg in the amounts of $5,000,000 and $1,000,000, respectively.

Risks Associated with Competition

The retail consumer electronics industry is highly competitive. Tweeter competes against a diverse group of retailers, including several national and regional large format merchandisers and superstores, such as Circuit City and Best Buy, which sell, among other products, audio and video consumer electronics products similar and often identical to those Tweeter sells. Tweeter also competes in particular markets with a substantial number of retailers that specialize in one or more types of consumer electronics products that Tweeter sells. Certain of these competitors have substantially greater financial resources than Tweeter that may increase their ability to purchase inventory at lower costs or to initiate and sustain predatory price competition. In addition, the large format stores are continuing to expand their geographic markets, and such expansion may increase price competition within those markets. A number of different competitive factors could have a material adverse effect on Tweeter s results of operations and financial condition, including:

Increased operational efficiencies of competitors;

Competitive pricing strategies;

Expansion by existing competitors;

Entry by new competitors into markets in which Tweeter is currently operating; or

Adoption by existing competitors of innovative store formats or retail sales methods.

Seasonal and Quarterly Fluctuations in Sales

Seasonal shopping patterns affect our business, like that of many retailers. The fourth calendar quarter, which is Tweeter s first fiscal quarter and which includes the December holiday shopping period, has historically contributed, and is expected to continue to contribute, more than half of Tweeter s operating income for its entire fiscal year. As a result, any factors negatively affecting Tweeter during such calendar quarter of any year, including adverse weather or unfavorable economic conditions, would have a material adverse effect on Tweeter s results of operations for the entire year. More generally, Tweeter s quarterly results of operations may fluctuate based upon such factors as:

The timing of new store openings and new store acquisitions;

The amount of store pre-opening expenses;

The amount of net sales contributed by new and existing stores;

The mix of consumer electronics products sold in its stores;

Profitability of sales of particular products; and

Other competitive factors.

Fluctuations in Comparable Store Sales

A number of factors have historically affected, and will continue to affect, Tweeter s comparable store sales results, including, among other factors:

Competition;

General regional and national economic conditions;

Consumer trends;

Changes in Tweeter s product mix;

Timing of promotional events;

New product introductions; and

Tweeter s ability to execute its business strategy effectively.

Tweeter does not expect comparable store sales to increase at historical rates, and comparable store sales, as they did in fiscal 2002, may decrease in the future. Changes in Tweeter s comparable store sales results could cause the price of the common stock to fluctuate substantially.

Potential Need for Additional Financing

Financing for the opening and acquisition of new stores may be in the form of debt or equity or both and may not be available on terms acceptable to Tweeter, if at all. We estimate that the average cash investment, including pre-opening expenses for tenant fit-out and inventory (net of payables), required to open a store to be approximately $1.1 million. The actual cost of opening a store may be significantly greater than such estimates, however, and we may need to seek additional debt and/or equity financing in order to fund our continued expansion through 2003 and beyond. In addition, our ability to incur additional indebtedness or issue equity or debt securities could be limited by covenants in present and future loan agreements and debt instruments. Additional issuances of equity by Tweeter may result in dilution of existing stockholders ownership interest.

Changes in Consumer Demand and Preferences

Tweeter s success depends on its ability to anticipate and respond in a timely manner to consumer demand and preferences regarding audio and video consumer electronics products and changes in such demand and preferences. Consumer spending patterns, particularly discretionary spending for products such as those Tweeter markets, are affected by, among other things, prevailing economic conditions. In addition, the periodic introduction and availability of new products and technologies at price levels that generate wide consumer interest stimulate the demand for audio and video consumer electronics products. Also, many products that incorporate the newest technologies, such as high-definition television, are subject to significant technological and pricing limitations and to the actions and cooperation of third parties such as television broadcasters. It is possible that these products or other new products will never achieve widespread consumer acceptance. Furthermore, the introduction or expected introduction of new products or technologies may depress sales of existing products and technologies. Significant deviations from the projected demand for products Tweeter sells would have a materially adverse effect on its results of operations and financial condition, either from lost sales or lower margins due to the need to mark down excess inventory. Any sustained failure by Tweeter to identify and respond to changes in consumer demand and preferences would have a material adverse effect on Tweeter s results of operations and financial condition.

Dependence on Suppliers

The success of Tweeter s business and growth strategy depends to a significant degree upon its suppliers, particularly its brand-name suppliers of stereo and video equipment such as Sony, Mitsubishi, Panasonic, Pioneer, Monster Cable, Boston Acoustics and Yamaha. Tweeter does not have any supply agreements or exclusive arrangements with any suppliers. Tweeter typically orders its inventory through the issuance of individual purchase orders to suppliers. In addition, Tweeter relies heavily on a relatively small number of suppliers. Tweeter s two largest suppliers accounted for approximately 35% of its sales during fiscal 2002. The loss of any of these key suppliers or the failure by Tweeter to establish and maintain relationships with these or other suppliers could have a material adverse effect on Tweeter s results of operations and financial condition and its expansion. It is possible, especially given Tweeter s growth strategy, that Tweeter will be unable to acquire sufficient quantities or an appropriate mix of consumer electronics products at acceptable prices, if at all. Specifically, Tweeter s ability to establish additional stores in existing markets and to penetrate new markets depends to a significant extent on the willingness and ability of suppliers to supply those additional stores, and suppliers may not be willing or able to do so. As we continue to open or acquire new stores, the inability or unwillingness of suppliers to supply some or all of their products to us at acceptable prices in one or more markets could have a material adverse effect on our results of operations and financial condition.

Uncertainty of Intellectual Property Rights

Our Tweeter, etc., Audio, Video and a Boatload of Know How, and Slamfest service marks have been registered with the United States Patent and Trademark Office. Tweeter has not registered the HiFi Buys, Sound Advice and some of its other service marks. We are aware that other consumer electronics retailers use the name HiFi Buys and Sound Advice. Tweeter has submitted applications for registration of some of its other service marks, which applications are currently pending. Tweeter may be unable to successfully register such service marks. In addition, Tweeter s service marks, whether registered or unregistered, and patents may not be effective to protect its intellectual property rights, and infringement or invalidity claims may be asserted by third parties in the future. Any such assertions, if proven to be true, could have a material adverse effect on Tweeter s results of operations and financial condition.

Effect of Certain Charter and By-law Provisions; Anti-Takeover Provisions

Tweeter s corporate charter and by-laws, as well as certain provisions of the Delaware General Corporation Law, contain provisions which may deter, discourage or make more difficult a change in control of Tweeter, even if such a change in control would be in the interest of a significant number of Tweeter s stockholders or if such change in control would provide such stockholders with a substantial premium for their shares over then current market prices. For example, the charter authorizes Tweeter s Board of Directors to issue one or more classes of preferred stock, having such designations, rights and preferences as they determine, and such issuances may, among other things, have an adverse effect on the rights of holders of common stock.

Tweeter s stockholders have no right to take action by written consent and may not call special meetings of stockholders. Any amendment of the by-laws by the stockholders or certain provisions of the charter requires the affirmative vote of at least 75% of the shares of voting stock then outstanding. The charter also provides for the staggered election of directors to serve for one, two and three-year terms, and for successive three-year terms thereafter, subject to removal only for cause upon the vote of not less than 75% of the shares of common stock represented at a stockholders meeting.

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In addition, under the terms of Tweeter s Stockholder Rights Plan, in general, if a person or group acquires more than 15% of the outstanding shares of common stock (an Acquiring Person), all other stockholders of Tweeter would have the right to purchase securities from Tweeter at a discount to such securities fair market value, thus causing substantial dilution to the holdings of the Acquiring Person. The Stockholder Rights Plan may inhibit a change in control and, therefore, could adversely affect the stockholders ability to realize a premium over the then prevailing market price for the common stock in connection with such a transaction.

Volatility of Stock Price

The trading price of our common stock has been and is likely to continue to be highly volatile and could be subject to wide fluctuations in response to a variety of internal and external factors. The stock market in general, and the Nasdaq National Market in particular, have experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of particular companies. These broad market factors may have a material adverse effect on the market price of our common stock, regardless of our actual operating performance. In the past, following periods of volatility in the market price of a company s securities, securities class-action litigation has often been instituted against such companies. Such litigation, if instituted, could result in substantial costs and a diversion of management s attention and resources, which would materially adversely affect Tweeter s results of operations and financial condition.

Item 2. ***Properties***

Our corporate offices and the New England distribution and service centers are located in two owned facilities totaling 140,000 square feet in Canton, Massachusetts. In addition, we lease over 630,000 square feet of regional operating facilities including distribution and service centers in King of Prussia, Pennsylvania, Atlanta, Georgia, Charlotte, NC, Houston, Texas, Dallas, Texas, San Diego, California, Chicago, Illinois, Deerfield Beach, Florida and Phoenix, Arizona.

Our stores, substantially all of which are leased, include sales space, inventory storage, management offices and employee areas. The majority of the leases provide for a fixed minimum rent with scheduled escalation dates and amounts. Leases for thirty-five of the stores have a percentage rent provision ranging from 1.5% to 5% of gross sales at each location in excess of certain specified sales amounts. The initial terms of the leases range from 5 to 20 years and generally allow us to renew for up to three additional five-year terms. The terms of a majority of the leases, including renewal options, extend beyond the year 2023.

Item 3. ***Legal Proceedings***

From time to time, we are involved in litigation in the ordinary course of our business. In the opinion of management, no such litigation is likely to have a material adverse effect on our results of operations, cash flows or financial condition.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None

PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Our common stock is traded on the Nasdaq National Market, under the symbol TWTR. Public trading in our common stock commenced on July 16, 1998. Prior to that date, there was no public market for our common stock. The following table sets forth the high, low and last sale prices for the common stock for the

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last eight quarters in which the Common Stock was publicly traded.

Quarter Ended	High	Low	Last
December 31, 2000	$36.250	$ 9.938	$12.188
March 31, 2001	$22.250	$10.469	$19.438
June 30, 2001	$37.680	$17.250	$35.300
September 30, 2001	$36.100	$12.870	$13.640
December 31, 2001	$30.000	$12.020	$29.000
March 31, 2002	$30.990	$14.210	$19.550
June 30, 2002	$22.600	$13.740	$16.340
September 30, 2002	$15.980	$ 5.260	$ 6.900

The last sale price of the common stock on December 11, 2002, as reported by Nasdaq, was $10.88 per share. As of December 11, 2002, there were approximately 5,500 holders of record of our common stock.

We do not anticipate paying any cash dividends for the foreseeable future. In addition, current lending arrangements prohibit the payment of cash dividends or will limit our ability to declare or pay such dividends.

Recent Sales of Unregistered Securities

None

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Item 6. ***Selected Financial Data (amounts in thousands, except per share and number of stores data)***

Set forth below is selected financial and operating data for each of the five years ended September 30, 2002. The selected statement of operations and balance sheet data for each of the five years ended September 30, 2002 have been derived from our financial statements, which have been audited by our independent auditors. The information set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the notes thereto included elsewhere in this Report.

	1998	1999(3)	2000(4)	2001(5)	2002(6)
Statement of Operations:					
Total revenue	$228,946	$279,562	$399,926	$540,123	$ 796,072
Cost of sales	147,938	179,227	253,672	347,942	509,258
Gross profit	81,008	100,335	146,254	192,181	286,814
Selling expenses	56,907	69,225	99,645	135,766	213,663
Corporate, general and administrative expenses	11,128	14,822	19,342	26,250	41,437
Amortization of intangibles	917	1,056	1,522	2,380	1,573
Impairment charge					194,902
Income (loss) from operations	12,056	15,232	25,745	27,785	(164,761)
Income (loss) from joint venture			518	843	(26)
Loss on investment				1,162	
Interest income (expense), net	(2,737)	(106)	1,147	692	(2,255)
Income (loss) before income taxes	9,319	15,126	27,410	28,158	(167,042)
Income tax expense (benefit)	3,724	6,050	10,964	11,263	(1,913)
Income (loss) before extraordinary item	5,595	9,076	16,446	16,895	(165,129)
Extraordinary item (less applicable income taxes)	(340)				
Net income (loss)	5,255	9,076	16,446	16,895	(165,129)
Accretion of preferred stock	2,514				
Income (loss) available to common stockholders	$ 2,741	$ 9,076	$ 16,446	$ 16,895	$(165,129)
Basic earnings (loss) per share:					
Income (loss) available to common stockholders before extraordinary item	$ 0.62	$ 0.63	$ 0.97	$ 0.87	$ (7.07)
Extraordinary item	(0.07)				
Net income (loss)	$ 0.55	$ 0.63	$ 0.97	$ 0.87	$ (7.07)
Diluted earnings (loss) per share:					
Income (loss) available to common stockholders before extraordinary item	$ 0.55	$ 0.57	$ 0.89	$ 0.84	$ (7.07)
Extraordinary item	(0.03)				
Net income (loss)	$ 0.52	$ 0.57	$ 0.89	$ 0.84	$ (7.07)
Weighted-average shares outstanding:					

Basic	4,973	14,385	17,006	19,333	23,342
Diluted(1)	10,068	15,972	18,551	20,119	23,342
Operating Data:					
Stores open at beginning of period	47	52	73	90	147
New stores	5	5	10	14	22
Closed stores	0	0	0	0	4
Stores acquired	0	16	7	43	2
Stores open at end of period	52	73	90	147	167
Remodeled/relocated stores	2	3	1	1	8
Comparable Store Sales Growth:(2)	12.5%	5.0%	13.5%	0.6%	(3.3)%
Balance Sheet Data:					
Working capital	$ 18,263	$ 31,524	$ 83,540	$ 70,478	$ 89,291
Total assets	91,643	141,619	235,038	487,669	335,878
Long-term debt, excluding current portion	5,250	5,717	14	35,936	50,074
Stockholder s equity	51,610	87,245	174,951	332,392	174,611

(footnotes on following page)

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(1) Shares outstanding include 5,095, 1,587, 1,545, 786 and 0 shares issuable upon exercise of stock options and warrants outstanding as of September 30, 1998, 1999, 2000, 2001 and 2002, respectively, after applying the treasury stock method.

(2) Stores are included in the comparable store base after they are in operation for 12 full months. Acquired stores are included after 12 months from acquisition if the store was open for 12 full months as of the date of acquisition. Remodeled or relocated stores are excluded from the comparable store base until they have completed 12 full months of operation from the date the remodeling was completed or the store re-opened after relocation.

(3) The fiscal year 1999 data includes the results of the Home Entertainment acquisition from February 1, 1999, which was accounted for using the purchase method; and the DOW Stereo/ Video acquisition from July 1, 1999, which was accounted for using the purchase method.

(4) The fiscal year 2000 data includes the results of the United Audio Centers acquisition from April 1, 2000, which was accounted for using the purchase method.

(5) The fiscal year 2001 data includes the results of the Douglas acquisition from October 2, 2000, the Big Screen City acquisition from May 1, 2001, the Audio Video Systems acquisition from June 1, 2001 and the Sound Advice acquisition from August 1, 2001. Each acquisition was accounted for using the purchase method.

(6) The fiscal year 2002 data includes the results of the Hillcrest acquisition from March 1, 2002, which was accounted for using the purchase method.

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operation***

This annual report contains forward-looking statements regarding Tweeter s performance, strategy, plans, objectives, expectations, beliefs and intentions. The actual outcome of the events described in these forward-looking statements could differ materially. Therefore, this report, and especially this section and the section entitled Risk Factors contains a discussion of some of the factors and risks that could contribute to those differences.

Our business has been particularly challenging for the past year, and the current business and consumer-spending climate is difficult to decipher. Given the erratic nature of our sales over recent periods, we feel there is a higher than usual degree of risk relative to our revenue and operating performance for the upcoming 2002 Holiday season.

General

Tweeter is a leading specialty retailer of mid- to high-end audio and video consumer electronics products operating under the Tweeter, HiFi Buys, Sound Advice, Bang & Olufsen, Electronic Interiors, Showcase Home Entertainment and Hillcrest names. We opened our first Tweeter store in New England in 1972. Over 30 years, we have refined our retail concept to meet the needs of consumers seeking brand name products with advanced features, functionality and performance which we sell through our highly trained, relationship-driven sales force. We believe that our effective merchandising and superior customer service has enabled us to generate substantial customer loyalty.

In 1995, we adopted an aggressive growth strategy to:

- open new stores in current regional markets and relocate certain stores to more favorable sites; and
- selectively pursue acquisitions in new regional markets and achieve operating improvements by converting the acquired companies to our core operating model and leveraging distribution, marketing and corporate infrastructure.

To support this growth strategy, we obtained equity investments in fiscal 1996 of approximately $10.6 million, net of issuance costs, from a group of investors led by Weston Presidio and Advent International. In May 1996, we completed the acquisition of Bryn Mawr. In May 1997, we raised an additional $22 million, comprised of $6.8 million of equity and $14.7 million of subordinated debt from these investors and a new group of investors. We used the proceeds primarily to finance the HiFi Buys acquisition.

In February 1999, we completed a follow-on public offering, raising approximately $24.3 million, which we used to pay off debt and fund the acquisitions of Home Entertainment and DOW Stereo/ Video. In February 1999, we acquired the retail operations of Home Entertainment. In July 1999, we completed the acquisition of DOW Stereo/ Video.

In February 2000, we completed an additional follow-on public offering, raising approximately $60 million, which we used to pay off debt and fund working capital requirements. In April 2000, we acquired United Audio Centers.

In October 2000, May 2001, June 2001, and August 2001 we completed the acquisitions of Douglas, Big Screen City, Audio Video Systems and Sound Advice, respectively.

In March 2002, we completed the acquisition of Hillcrest.

We seek to increase sales, profitability and asset productivity at acquired companies by converting them to our standard operating model with enhanced training for sales personnel, superior customer service, improved merchandising focused on higher-end audio and video equipment and more stringent operating controls. We also have aggressively expanded our corporate infrastructure over the past four years to support our growth, including expanding our management team with the addition of senior financial, information systems, merchandising and real estate personnel. We have made enhancements to our management information systems with the addition of a new mainframe and operating platform, and to our distribution and administrative infrastructure to enable us to support all eight regions on an integrated basis.

Our current growth strategy is to:

capitalize on new technologies to drive comparable store sales;

open new stores in current regional markets and relocate certain stores to more favorable sites; and

develop our in-house home installation business.

Results of Operations

The following table is derived from the consolidated statements of income and sets forth, for the periods indicated, the actual amounts, in thousands, of certain income and expense items and their percentages, relative to total revenue:

	Fiscal Years Ended September 30,					
	2000		2001		2002	
Statement of Operations:						
Total revenue	$399,926	100.0%	$540,123	100.0%	$ 796,072	100.0%
Gross profit	$146,254	36.6%	$192,181	35.6%	$ 286,814	36.0%
Selling expenses	99,645	25.0%	135,766	25.1%	213,663	26.8%
Store Contribution	46,609	11.6%	56,415	10.5%	73,151	9.2%
Corporate, general and administrative expenses	19,342	4.8%	26,250	4.9%	41,437	5.2%
Amortization of intangibles	1,522	0.4%	2,380	0.4%	1,573	0.2%
Impairment charge					194,902	24.5%
Income (loss) from operations	25,745	6.4%	27,785	5.1%	(164,761)	-20.7%
Income (loss) from joint venture	518	0.1%	843	0.2%	(26)	0.0%
Loss on investment		0.0%	1,162	0.2%		0.0%
Interest income (expense), net	1,147	0.3%	692	0.1%	(2,255)	-0.3%
Income (loss) before income taxes	27,410	6.8%	28,158	5.2%	(167,042)	-21.0%
Income tax expense (benefit)	10,964	2.7%	11,263	2.1%	(1,913)	-0.2%
Net income (loss) available to common stockholders	$ 16,446	4.1%	$ 16,895	3.1%	$(165,129)	-20.8%

Fiscal 2002 as Compared to Fiscal 2001

Total Revenue. Total revenue includes delivered merchandise, labor, net commissions on service contracts sold, completed service center work orders, insurance replacement and corporate sales. Total revenue increased $255.9 million, or 47.4%, to $796.1 million in the year ended September 30, 2002 from $540.1 million for the year ended September 30, 2001. The increase was primarily comprised of revenues of $195.9 million derived from acquired stores from the date of acquisition and $69.2 million from new stores. This was offset by a comparable store sales decrease of $15.3 million or 3.3%. Home installation labor revenue as a percentage of revenue doubled during the year ended September 30, 2002 from 1.1% to 2.2%.

Cost of Sales and Gross Profit. Cost of sales includes merchandise costs, net delivery costs, distribution costs, home installation labor costs, purchase discounts, and vendor volume rebates. Cost of sales increased $161.3 million, or 46.4%, to $509.3 million in the year ended September 30, 2002 from $347.9 million in the year ended September 30, 2001. Gross profit increased $94.6 million, or 49.2%, to

$286.8 million in the year ended September 30, 2002 from $192.2 million for the year ended September 30, 2001. The gross margin for the years ended September 30, 2002 and 2001 was 36.0% and 35.6%, respectively. The increase in gross margin is due primarily to higher product margins, as a result of a change in mix, and the reduction of inventory shrink.

Selling Expenses. Selling expenses include the compensation of store personnel and store specific support functions, occupancy costs, store level depreciation, advertising, pre-opening expenses and bank fees and excludes corporate, general and administrative expenses. Selling expenses increased $77.9 million, or 57.4%, to $213.7 million for the year ended September 30, 2002 from $135.8 million for the year ended September 30, 2001. As a percentage of total revenue, selling expenses increased to 26.8% for the year ended September 30, 2002 from 25.1% in the prior year period. The percentage increase was attributable to more fees associated with extended credit card financing, increased occupancy costs, additional depreciation from the new and acquired stores and higher insurance costs.

Corporate, General and Administrative Expenses. Corporate, general and administrative expenses include the costs of the finance, information systems, merchandising, marketing, human resources, training departments, related support functions and executive officers. Corporate, general and administrative expenses for the year ended September 30, 2002 increased 57.9% to $41.4 million from $26.2 million for the year ended September 30, 2001. As a percentage of total revenue, corporate, general and administrative expenses increased to 5.2% for the year ended September 30, 2002 from 4.9% for the prior year period. The increase was due to higher occupancy costs relative to the acquired companies, payroll and depreciation.

Amortization of Intangibles. Amortization of intangibles decreased to $1.6 million for the year ended September 30, 2002 from $2.4 million for the year ended September 30, 2001. The decrease was due to the adoption of Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets. This statement requires that amortization be recorded only on intangible assets with definitive lives and not on goodwill or intangible assets with indefinite useful lives.

Net Interest Income (Expense). Net interest expense was $2.3 million for the year ended September 30, 2002 compared to net interest income of $692,000 for the year ended September 30, 2001. This fluctuation is due primarily to the borrowings on our revolving credit agreement during the year ended September 30, 2002 compared to cash investment income realized on our outstanding cash balances during the first ten months of the year ended September 30, 2001. The increase in borrowings was due to the debt acquired in the Sound Advice acquisition and the opening of new stores.

Income Tax Expense (Benefit). The effective tax rate for the years ended September 30, 2002 and 2001 was 1.1% and 40.0%, respectively. Excluding the impairment charge of $194.9 million and the related tax benefit of $13.1 million, the effective tax rate for the year ended September 30, 2002 would have been 40.0%. The tax benefit is attributable to the portion of goodwill impaired which was deductible for income tax purposes. Management expects that the effective tax rate will be 40.0% in fiscal 2003.

Fiscal 2001 as Compared to Fiscal 2000

Total Revenue. Total revenue increased $140.2 million, or 35.1%, to $540.1 million in the year ended September 30, 2001 from $399.9 million for the year ended September 30, 2000. The increase was primarily comprised of revenues of $63.4 million derived from acquired stores from the date of acquisition, $38.5 million from new stores, $14.9 million from relocated/remodeled stores and $2.3 million from comparable store sales growth. Comparable store sales increased by .6%. This excludes an 11.4% decrease in comparable store sales at United Audio Centers from October 1, 2000 through March 31, 2001, an 11.0% decrease in comparable store sales at Douglas from October 2, 2000 through September 30, 2001, a 7.0% increase in comparable store sales at Big Screen City from May 1, 2001 through September 30, 2001, a 15.2% decrease in comparable store sales at Audio Video Systems from June 1, 2001 through September 30, 2001, and an 8.5% decrease in comparable store sales at Sound Advice from August 1, 2001 through September 30, 2001.

Cost of Sales and Gross Profit. Cost of sales increased $94.3 million, or 37.2%, to $347.9 million in the year ended September 30, 2001 from $253.7 million in the year ended September 30, 2000. Gross profit increased $45.9 million, or 31.4%, to $192.2 million in the year ended September 30, 2001 from $146.3 million for the year ended September 30, 2000. The gross margin for the years ended September 30, 2001 and 2000 was 35.6% and 36.6%, respectively. The decrease in gross margin was due to the mix change from audio to video, which has lower margins than audio. Additionally, the costs of running our distribution centers

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increased in dollars and as a percent of sales. This was a result of consolidating and relocating some of our distribution centers during the early part of the year.

Selling Expenses. Selling expenses increased $36.1 million, or 36.2%, to $135.8 million for the year ended September 30, 2001 from $99.6 million for the year ended September 30, 2000. As a percentage of total revenue, selling expenses increased to 25.1% for the year ended September 30, 2001 from 25.0% in the prior year period. The percentage increase was attributable to higher occupancy costs and deprecation associated with new store openings. The net advertising expense as a percent of sales was lower to offset these increases.

Corporate, General and Administrative Expenses. Corporate, general and administrative expenses for the year ended September 30, 2001 increased 35.7% to $26.2 million from $19.3 million for the year ended September 30, 2000. As a percentage of total revenue, corporate, general and administrative expenses increased to 4.9% for the year ended September 30, 2001 from 4.8% for the prior year period. The increase was due to higher occupancy costs and depreciation relative to the acquired companies, which was offset by a decrease in payroll as a percent of sales.

Amortization of Intangibles. Amortization of intangibles increased to $2.4 million for the year ended September 30, 2001 from $1.5 million for the year ended September 30, 2000. This increase is attributable to goodwill recorded for a full year in connection with the United Audio Centers acquisition as well as goodwill recorded for the acquisitions of Douglas, Big Screen City and Audio Video Systems.

Loss on Investment. Loss on investment was due to the write down of the investment in Cyberian Outpost, which was sold to FCOP Acquisition, Inc., a wholly-owned subsidiary of Fry s Electronics, a private company, on November 9, 2001 for $.25 per share.

Net Interest Income (Expense). Net interest income decreased to $692,000 for the year ended September 30, 2001 from $1.1 million for the year ended September 30, 2000. This decrease was due primarily to the borrowings on our revolving credit agreement made in the last fiscal quarter of 2001.

Income Tax Expense (Benefit). The effective tax rate for the years ended September 30, 2001 and 2000 was 40.0%.

Liquidity and Capital Resources

Our cash needs are primarily for working capital to support our inventory requirements and capital expenditures, pre-opening expenses and beginning inventory for new stores and for remodeling or relocating older stores. Additionally, capital needs are created as acquisition opportunities are pursued.

Our primary sources of financing have been net cash from operations, borrowings under our credit facility, and proceeds from the sale of equity or subordinated notes. At September 30, 2002 and 2001, our working capital was $89.3 million and $70.5 million, respectively. Cash provided by operations was $27.7 million for the year ended September 30, 2002. This was a result of $16.7 million in income before the non-cash impairment charge, depreciation and amortization of $18.1 million, a decrease of $5.9 million in accounts receivable and a tax benefit of options exercised of 3.0 million. This was offset by an increase in inventory of $12.1 million, a deferred income tax benefit of 7.4 million, an increase of $6.0 million in prepaid and other current assets and a decrease of $5.9 million in accounts payable and accrued expenses as well as minor changes in other operating accounts.

Net cash used in investing activities during fiscal 2002 was approximately $42.2 million. Purchase of property and equipment of $54.6 million was the primary use of cash in investing activities. Approximately $32.2 million was used to open twenty-two new stores and relocate/remodel eight stores and the balance of $16.3 million was used for other miscellaneous capital expenditures for equipment, fixtures and leasehold improvements. In addition, $6.1 million was used for new stores to be opened or relocated after fiscal 2002. Cash paid for acquisitions and related expenses were $4.8 million. In fiscal 2002, net proceeds of $13.8 million were received from the sale of five of the Company s owned properties which the Company leases from the buyer. The termination of the joint venture investment with Cyberian Outpost.com provided $3.2 million in cash, which represented our share of the distribution upon the cessation of the joint venture. During fiscal 2001, net cash used in investing activities was approximately $74.6 million and was used to fund acquisitions, open new stores, relocate/remodel stores and other capital expenditures for equipment, fixtures and leasehold improvements. There are no other material commitments for capital expenditures other than new store openings and remodeling or relocating existing stores, which is estimated to be $19 million in the next 12 months.

On June 29, 2001, the Company signed a three-year senior credit facility which provided the Company the ability to borrow up to $75 million. On May 31, 2002 the credit facility was amended to increase the availability to $100 million. The credit facility was amended on September 27, 2002 to allow the restrictive covenants to be calculated without the impact of an impairment charge to intangible assets. Borrowings under the credit facility are collateralized by the Company s inventory and certain other assets and bear interest at the lender s base rate (4.75% at September 30, 2002), or Eurodollar pricing plus 1.5% if the Company commits to borrow amounts for a period of at least 30 days. The Company s weighted-average interest rate on outstanding borrowings during 2002 was approximately 3.1%. The credit facility contains restrictive covenants and conditions, including requirements to maintain certain minimum financial ratios and a designated net worth level as well as limits on capital expenditures. The Company was in compliance with all restrictive covenants at September 30, 2002. The credit facility also restricts the Company from paying cash dividends. There was $49,900,000 outstanding under the credit facility as of September 30, 2002. The credit facility has a maturity date of July 31, 2004.

We believe that cash expected to be generated from operations, and available borrowings under our credit facility, will be sufficient to finance our working capital and capital expenditure requirements, exclusive of acquisitions, for the next 12 months. We may need to seek additional debt and/or equity financing in order to fund any future acquisitions.

Impact of Inflation

Management does not believe that inflation has had a material adverse effect on our results of operations. However, we cannot predict accurately the effect of inflation on future operating results.

Seasonality

Our business is subject to seasonal variations. Historically, we have realized a significant portion of our total revenue and net income for the year during the first and fourth fiscal quarters, with a majority of net income for such quarters realized in the first fiscal quarter. Due to the importance of the holiday shopping season, any factors negatively impacting the holiday selling season could have a material adverse effect on financial condition and results of operations. Our quarterly results of operations may also fluctuate significantly due to a number of factors, including the timing of new store openings and acquisitions and unexpected changes in volume-related rebates or changes in cooperative advertising policies from manufacturers. In addition, operating results may be negatively affected by increases in merchandise costs, price changes in response to competitive factors and unfavorable local, regional or national economic developments that result in reduced consumer spending.

Critical Accounting Policies

Presented below is a discussion about our application of critical accounting policies that require us to make assumptions about matters that are uncertain at the time the accounting estimate is made, and where different estimates that we reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of our financial condition, changes in financial condition or results of operations. Management has identified the following accounting estimates as critical for the Company, and will discuss them separately below: allowance for bad and doubtful accounts; inventory obsolescence provision; income tax accruals; self-insurance reserves; goodwill and other intangible assets valuation and deferred cash discounts, volume rebates and coop advertising.

Management has discussed the development and selection of these critical accounting estimates with the audit committee of our Board of Directors and the audit committee has reviewed our disclosure relating to them in this MD&A.

Allowance for Bad and Doubtful Accounts

Most of our accounts receivable are due from our vendors and less than 10% are due from customers. Our net accounts receivable balance at September 30, 2002 of $23,116,000 constitutes 6.9% of our total assets, and the reserve of $1,075,000 is 4.4% of gross accounts receivable.

We categorize our accounts receivable by business type and estimate our bad debt reserve using four aging classifications: current, 31 to 60 days, 61 to 90 days and over 90 days. For each business type, based on the amounts in each aging category, we apply a percentage to determine the amount of the reserve to be applied to each category. If a further review of a business type shows that this methodology needs to be adjusted, the percentage of reserve is adjusted accordingly.

In recent years, as a result of a combination of the factors described above, we have increased our bad debt reserve to reflect our estimated valuation of gross receivables. It is also possible that bad debt write-off could increase significantly in the future. We have historically estimated our bad and doubtful debt allowance as a percentage of the aging categories, which could differ materially if the historical trend changed. Estimating an allowance for doubtful accounts requires significant management judgment. In addition, different reserve estimates that we reasonably could have used would have had a material impact on our reported accounts receivable balance and thus would have had a material impact on the presentation of the results of operations. For those reasons, and in view of the fact that our accounts receivable balance is 6.9% of our total assets at September 30, 2002, we believe that the accounting estimate related to bad and doubtful accounts is a critical accounting estimate.

If we were to assume that our estimate of bad debts was changed to the lower end or upper end of the range we developed in the course of formulating our estimate, the estimate for bad debt as of September 30, 2002 would range from $210,000 to $2,097,000. Accordingly, the amounts we would record for net receivables would range from $23,981,000 to $22,094,000 as compared to the recorded amount of $23,116,000.

Inventory Obsolescence

Inventory represents a significant portion of our assets (42.6%). Our profitability and viability is highly dependent on the demand for our products. An imbalance between purchasing levels and sales could cause rapid and material obsolescence, and loss of competitive price advantage and market share. We believe that our product mix has provided sufficient diversification to mitigate this risk. At the end of each reporting period, we reduce the value by our estimate of what we believe to be obsolete, and we recognize an expense of the same amount, which is included in cost of sales in our consolidated statement of income.

In our industry merchandise models change periodically. When they do, we reclassify the old model into a discontinued category. We also reclassify merchandise into the discontinued category when we decide we no longer want to sell the item. Generally, we will sell these discontinued models for normal retail. In estimating our reserve, we analyze the sales of discontinued merchandise by department and determine what profit or loss was made in the quarter. If product of the discontinued department sold for below cost during the quarter, then we apply that negative percentage to the value of the inventory on hand as of the balance sheet date. In addition to this reserve we also identify the selling costs to be incurred in the sale of such discontinued inventory and add that to this obsolescence reserve. We also evaluate the obsolescence of our service parts inventory based on the aging of this inventory. We apply a percentage to each aging category in order to determine the reserve amount.

As a result of a combination of the factors described above, we have reduced our net inventory value to reflect our estimated amount of inventory obsolescence. It is also possible that obsolescence could rapidly become a significant issue in the future. In addition, different reserve estimates that we reasonably could have used would have had a material impact on our reported net inventory and cost of sales, and thus would have had a material impact on the presentation of our results of operations. For those reasons, we believe that the accounting estimate related to inventory obsolescence is a critical accounting estimate.

If we were to assume that our estimate of future inventory obsolescence for all of our merchandise and parts was changed to the lower end or upper end of the range we developed in the course of formulating our estimate, the estimate as of September 30, 2002 would range from $1,282,000 to $3,315,000, as compared to the actual recorded amount of $2,298,000. Accordingly, the amounts by which we would record net inventory would range from $144,250,000 to $142,217,000 as compared to the actual recorded amount of $143,234,000.

Income taxes

Our estimate of the expense or benefit and the sufficiency of the income tax accrual is somewhat dependent on our assessment of certain tax filing exposures. We provide for potential tax exposures arising from routine audits by taxing agencies. It is reasonably possible to assume that actual amounts payable as a result of such audits could be materially different from amounts accrued in the consolidated balance sheet.

Our estimate of deferred tax assets is impacted by our assessment of our ability to generate sufficient taxable income to be able to realize the deferred tax asset. Based on management s assessment of our historical performance and the current economic conditions, we have determined that no valuation allowance against our deferred tax asset is required as of September 30, 2002 as we believe that we will be sufficiently profitable as to realize all recognized deferred tax assets. Should we not generate the expected levels of taxable income, a valuation allowance could be required.

Self-Insurance Reserves

We are self-insured for workers compensation, general liability insurance and medical/dental benefits and evaluate our liability estimate on a quarterly basis based on actuarial information and past experience. Historical claims are reviewed as to when they are incurred versus when they are actually paid and an average claims lag is determined. Once the average historical lag is determined, it is applied to the current level of claims being processed. Management believes, and past experience has confirmed, the underwriting cost reductions outweigh the financial risk incurred by self-insurance of workers compensation, general liability and medical/dental benefits. Accounting standards require that a related loss contingency be recognized in our consolidated balance sheet.

We determined that the total future liability related to claims that have already incurred but not billed is $2,950,000.

We believe that the accounting estimate related to assessment of future liability for current insurance claims is a critical accounting estimate because it is highly susceptible to change from period to period due to the requirement that our management make assumptions about future costs of claims based on historical costs.

Goodwill and Other Intangible Assets Valuation

We amortize intangible assets with definite useful lives on a straight-line basis over the period of their useful lives. We review goodwill and other intangible assets with indefinite useful lives for impairment on an annual basis, or more frequently if impairment indicators arise. We performed our annual test for impairment in September 2002. We performed a valuation analysis of the Company with the assistance of a third party valuation specialist. As a result of this review, it was determined that 100% of our goodwill ($191,477,000) and a portion of our intangibles ($3,425,000) were impaired. As of September 30, 2002, no goodwill balance remains on the consolidated balance sheet and the net book value of other intangible assets is $2,607,000.

We believe that the accounting estimate related to goodwill and other intangible assets is a critical accounting estimate because it is highly susceptible to change from period to period due to the requirement that several assumptions are inherent within the discounted cash flow analysis, such as anticipated revenue and expense growth rates discount rates, among others.

Deferred Cash Discounts, Volume Rebates and Coop Advertising

We receive cash discounts for timely payment of merchandise invoices and recognize these amounts based on the sale of the inventory. The amount of the deferral for discounts received but not yet recognized is $4,553,000 as of September 30, 2002 and is classified as a reduction in gross inventory in the consolidated balance sheet.

We also receive substantial funds from our vendors for volume rebates and coop advertising. These funds can be earned in two ways; the first is based on levels of inventory purchases and the second is based on performance of specific advertising activities. Amounts earned based on levels of inventory purchases are recognized in the income statement based on when the inventory from each vendor is sold. Amounts earned based on performance of specific advertising activities are recognized in the income statement as these activities are performed. The amount of the deferral for amounts received related to levels of inventory purchases is $4,032,000 as of September 30, 2002. No amounts were deferred as of September 30, 2002 for specific advertising activities as we did not have any unfulfilled obligations in relation to cash received prior to the year-end.

We believe that the accounting estimate related to deferred cash discounts, volume rebates and coop advertising is a critical accounting estimate because it is highly susceptible to change from period to period due to changes in inventory levels, the vendor mix of the inventory on hand, and the timing of performance of specific advertising activities in relation to when the cash for these activities is received.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 143, Accounting for Asset Retirement Obligations, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS No. 143 is effective for the fiscal year ending September 30, 2003 and we do not believe that the impact of the adoption of SFAS No. 143 will be significant.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets . SFAS No. 144 supercedes SFAS No. 121, Accounting for the Impairment of Long-Lived Assets to be Disposed Of and the accounting and reporting provisions of Accounting Principles Board (APB) Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, The statement creates one accounting model, based on the framework established in SFAS No. 121, to be applied to all long-lived assets including discontinued operations. The provisions of SFAS No. 144 are effective for t